CONDUCT OF MONETARY POLICY
(Pursuant to the Full Employment and Balanced Growth Act of 1978, P.L. 95–523)

HEARING

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

SECOND SESSION

JULY 29, 1986

Serial No. 99-88

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

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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CONDUCT OF MONETARY POLICY

TUESDAY, JULY 29, 1986

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

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

Present: Chairman St Germain; Representatives Gonzalez, Fauntroy, Neal, Hubbard, LaFalce, Vento, Schumer, Frank, Roemer, Lehman, Cooper, Erdreich, Levin, Carper, Kanjorski, Gordon, McKinney, Leach, Shumway, Wortley, Roukema, Bereuter, Hiler, McCandless, Kolbe, and McMillan.

The CHAIRMAN. The committee will come to order.

These semi-annual reports on monetary policy reflect the great uncertainty as well as the unpredictability of the U.S. economy. Six months ago, we reviewed monetary policy against a backdrop of the administration's projections that suggested a robust economy with the GNP growing at 4 percent or more.

Now, reality has overtaken the Reagan administration's projections and the Nation is mired in a sluggish economy. Some sectors and some regions are more than sluggish—disastrous comes closer to describing the situation.

Unless there is an economic miracle in the last two quarters, the prediction of a 4 percent GNP rate will go into the growing trash heap of Reagan administration off-target economic projections.

To its credit, the Federal Reserve was much more cautious in its predictions when it presented its monetary report to this committee last February. However, even the Federal Reserve's projection of a GNP growth of 3 to 3½ percent appears very optimistic at this point in time.

The difficulty of establishing precise projections about the performance of the United States or other economies of the world are the very reason we need flexibility in both monetary and fiscal policy.

For years, the so-called monetarists insisted that a rigid, tight-fisted control of monetary aggregates was all that was needed at the Federal Reserve. Wiser heads contended accurately that the U.S. economy was too complex, too uncertain to be placed on a monetary automatic pilot. While the Federal Reserve prevailed against these rigid notions of monetary policy, many of these same forces have moved their simplistic theories to the fiscal arena.

Gramm-Rudman-Hollings—combined with an administration that lacks either the common sense or the courage to even consider

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revenue needs—places the Nation in an economic straitjacket. Foolhardy in the best of times, dangerous when economic conditions might require a quick change of course.

Chairman Volcker, I realize you will be presenting us with still more projections, deeper views into the economic crystal ball today. Before we lapse into this never-never land, I would like to have a specific rundown of just what the Federal Reserve would plan to do if the economy continues in its present sluggish course, if the second-quarter growth, or nongrowth, extends into the third and fourth quarters. What happens to monetary policy and interest rates in that event?

Of course, I am really convinced you will answer that last question.

Anyone else have opening comments? If not, Chairman Volcker, we will put your entire statement into the record.

Maybe you would like to tell us about interest rates initially?

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

Mr. VOLCKER. I will not forecast interest rates with any precision.

The CHAIRMAN. We always live in hope. The press sits there with bated breath, hoping for some little clue, some indicia. You are very good at never giving them any.

Mr. VOLCKER. They might misinterpret that. We live in a world of some uncertainty, as you suggested, Mr. Chairman.

I will not repeat my whole statement. Perhaps I will take a few minutes to summarize some of the points.

You already pointed out that there has been a marked contrast between various sectors of the economy this year, specifically consumption and housing. It moved ahead strongly while the investment side of the economy, more broadly, the manufacturing side, has been sluggish.

Some areas like agriculture and energy are under great pressure. There are recession-like conditions in the energy and agricultural belt of the country. Over all, the growth has been quite moderate for the last year or more, around 3 percent. The second quarter, as you know, the preliminary estimates show a drop to a 1-point, 1-percent rate of growth. Some of the problems that have led to this mixed and overall sluggish picture, I think we could say are homegrown.

I think the tax reform effort, whatever its long-term merits, have led to some hesitation in investment ordering and investment activity.

Certainly, in the area of commercial building, we have a lot of office building vacancies. That area has been declining and, as I noted, while it is not quite a purely domestic consideration, agriculture and energy are under very great strain.

But the burden of my prepared testimony is that many of our problems and potentials need to be assessed in a worldwide context and that the solutions are going to require complementary approaches both here and abroad. That is very obvious, it seems to me, Mr. Chairman, in the very large imbalance we have in our

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trade picture. It is that rising deficit in our trade and current account that accounts for the sluggishness of manufacturing activity and to a considerable extent the growing sluggishness in investment during the early part of this year. It has been a very strong drag in activity.

Of course, that is a situation that is addressed in part through the exchange rate changes that have been taking place, and I think that some of those exchange rate changes are an essential part of an approach toward the problem by making our industry essentially more competitive in world markets.

But I also think we can't rely upon exchange rate changes alone to redress the imbalance. Indeed, taken alone, exchange rate changes have a down side as well as an up side. They are potentially inflationary and without any other changes, they run the risk of slowing economic activity abroad as their industry becomes less competitive relative to ours.

I think we have to look beyond the exchange rate changes and look at the growth patterns here and abroad. We generally have had well-maintained domestic growth, growth arising from domestic factors alone as particularly evident in the consumption picture, whereas much of the rest of the world, at least until recently, the opposite has taken place. They have been dependent upon external growth, growth in their export markets, particularly to the United States.

Obviously that cannot persist if we are going to correct those trade imbalances and have a more buoyant picture in manufacturing and investment in the United States. That points to the relevance of an importance of faster growth abroad internally generated.

At the same time, I emphasized in my statement, we have become very heavily dependent upon flows of capital from abroad. They go hand in hand with the trade deficit. The current account deficit—and if we are going to get ourselves in a position to reduce those trade deficits, we have to also get along without those large inflows of foreign capital.

I think the implication of that is quite clear, that as we move to improve the trade deficit, we also better move to reduce that internal budget deficit that adds so much to demands on our capital markets.

I also review in my statement the debt situation with respect to the developing countries, particularly in Latin America. I note there has been a good deal of progress in that area over the past 3 or 4 years; but the sharp decline in oil prices has brought very great new strains on Mexico as the most important country involved, but also Ecuador, Venezuela, and Nigeria and in Africa, and it has posed very severe adjustment problems upon those countries; and those pressures focus very heavily on Mexico.

Mexico last week announced a new program of both adjustment and structural change to help deal with those problems; but it is inevitable they will require a large amount of external financing. Some of that can be available in the IMF, the World Bank is stepping up its lending in connection particularly with structural change in Mexico; but there is also a sizable amount of lending that is going to have to be done by commercial banks if this situa-

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tion is going to be handled in an orderly way, a way consistent with international financial stability.

We have a very great test there of our ability to continue to manage the international debt situation in a way that is consistent with economic progress and also consistent with political and social objectives that are so heavily bound in with developments in Mexico and elsewhere.

None of these problems are going to be solved by monetary policy alone. As you suggested, Mr. Chairman—I don't think monetary policy in this situation can be guided by any simplistic single target for its operations. Monetary policy, I think, can be characterized as having been broadly accommodative during this period in terms of both Reserve position and in terms of declines in the discount rate.

The discount rate has been reduced three times so far this year. Interest rates are down in both the short-term area and longer term area. In fact, they have gone down somewhat more in the longer term area than the short-term area, continuing a pattern that developed late last year.

All of that has helped reduce the cost of capital. It has been accompanied by much higher stock prices. The exchange rate depreciation and the higher real incomes for consumers that grow out of the oil situation do provide continuing support for economic activity.

The members of the Open Market Committee, the Reserve bank presidents have now estimated growth this year in the area of 2½ to 3 percent. That implies just a small increase in the rate of growth over the first half average and then 3 to 3½ percent next year.

Meanwhile, M1, looking at that one indicator of policy and financial conditions, has increased quite rapidly, continuing a pattern that developed last year, increased by about 13 percent in the first half of the year, which was well above our target of 3 to 8 percent.

It raises some questions about behavior of that aggregate and what lies behind it. I think without question during this period with interest rates declining and with the institutional structure that now exists, including the payment of interest on NOW accounts, individuals and businesses have been inclined to hold more of their funds in the most liquid form including demand deposits in NOW accounts. That has been reflected in this exceptional growth in M1.

We did not judge it appropriate, given the surrounding circumstances, to restrain provision of reserves and increase pressures on reserve positions in order to keep M1 within our target ranges. It presumably would have taken a significant tightening in that respect.

We did not do that because of, first of all, the other monetary targets, M2 and M3 were behaving quite in accordance with our target. They ended up the first half of the year at just about the midpoint of their 6 to 9 target ranges.

More broadly, the economy was growing only moderately, as you indicated with many cross-currents. The inflation rate was down very appreciably, reflecting in part the decline in oil prices but also the rather stable behavior of goods' prices generally for some time.

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Commodity prices, more broadly than in oil, have generally been declining, were declining during most of the first half of the year. Those were not circumstances in which a tightening of policy seemed appropriate to bringing M1 back on target.

The committee decided, looking ahead, that it would find it acceptable if M1 came out for the year above its target, certainly in that kind of economic environment and with M2 and M3 broadly on target. The committee decided to retain the target ranges that had been established at the beginning of the year for M2 and M3.

It also decided to reduce those targets by a small amount next year to 5½ to 8½ percent on a tentative basis on the idea that that is in line with the general effort over a long period of time to reduce growth in money and credit to amounts consistent with price stability.

We believe that those target ranges are consistent with an increase in growth next year, assuming that inflation does not accelerate at a troublesome rate during the year ahead. In a very tentative way the committee suggested a range of 3 to 8 percent for M1 might be appropriate if velocity returns to more normal and predictable amounts but it suspends judgment really on that question.

It may be some years before we know how velocity for M1 will develop and whether it will be consistent in the changed institutional environment in which we now live in the banking world. Any judgment about M1 for next year will certainly be reviewed afresh at the beginning of 1987.

I mentioned I think our targets for next year are consistent with a greater rate of economic growth provided that the inflationary picture does not accelerate markedly.

We do expect an increase in inflation next year for a couple of obvious reasons. The oil prices are not going to go down forever. We were not going to have that downward drag on the price indices into 1987. We also face the certainty that the depreciation of the dollar has, in effect, on prices of imported goods, and to some extent that will affect domestic price levels as well.

So the committee has assumed that some rather modest increase in inflationary trend may develop next year, although not in the amount that I believe is inconsistent with the general progress toward stability that has been achieved over a longer period of time.

I noted that the economic situation here and abroad involves conditions that are not susceptible to cure by monetary policy alone. I touched upon the budget situation in the United States. I think it is also important that we see more rapid internally generated growth abroad if we really are going to be successful in dealing with our trade imbalance and dealing with that trade imbalance seems to me a key to the business outlook more generally and a key toward stability over a period of time in the future.

I should say I do not see any answer to that question in simply retreating into protectionism but rather in positive measures that are appropriate in their own right: More rapid growth abroad, dealing with our budget deficit here, continuing vigilance in monetary policy. None of those things are very easy but I do think they are necessary to provide a solid base for expansion and stability, not

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just in our economy but in the world economy in the year ahead and in the years ahead.

That generally summarizes what I tried to say at somewhat greater length in my prepared statement, Mr. Chairman.

[The prepared statement of Mr. Volcker can be found in the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman.

The chairman of the Subcommittee on Domestic Monetary Policy has asked unanimous consent to deliver an opening statement which would appear prior to the statement of Chairman Volcker. He would like to do that in living color, I understand.

Is there objection? The Chair hears none. The chairman is recognized for his opening statement.

Mr. FAUNTROY. Thank you, Mr. Chairman.

Welcome, Mr. Volcker.

Over the past several years, we have experienced a substantial increase in the amount of domestic and international debt owed others by the United States. Last year we became a net debtor Nation, and within several years we will have accumulated more debt than any other country in the world. While we continue to enjoy the fruits of strong economic growth since World War II, for the first time in American history we may well be facing a secular decline in the standard of living.

The tax cuts and other fiscal decisions of the Reagan administration have finally begun to hit home. The New York Times quoted one professor as stating that he wondered whether Reagan will be viewed as a President who "stored up problems for the future." This "mortgage on the future," namely the sizable deficit spending of the Reagan administration, largely responsible for spurring economic growth in 1983–84, has now begun to exact its price.

Other related problems in the economy include: The record size of the trade deficit and its implications on manufacturing and agriculture; the 7-percent unemployment which has lingered with us over the past 2 years with particularly adverse and increasingly negative effects on minorities; the international glut and subsequent deflation in commodity prices; a lack of business investment in the United States and the shifting of production overseas.

In light of these problems, one can become skeptical in addressing whether continued economic growth is possible in the short run. If we are facing a slowdown in the rate of economic growth, what will the implications be for minorities, for trade-sensitive industries, for Third World countries, and for future economic growth? Can economic slowdown be forestalled through measures other than those increasing the debt position of the United States?

In a New York Times article dated July 27, 1986, Robert D. Hershey stated the problem well. He writes:

> The United States is importing far more goods than it sends abroad, and the industrial countries from whom it buys are piling up huge surpluses of cash that for lack of investment opportunities at home is sent back here to support an artificially high American standard of living. At the same time, the Third World cannot sell enough of its raw commodities in sluggish world markets to service its huge debts.

In essence, we are living on both "borrowed time and borrowed money." The manner in which we as a people address this issue

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will likely determine both short- and longrun prospects for the citizens of the United States.

While I join my colleagues in welcoming Chairman Volcker, I do so in the hopes of receiving direct answers to how we might better address these problems.

The CHAIRMAN. Chairman Volcker, recently the stock market, the dollar, the bond market have all experienced significant declines. As a matter of fact, I hope it has nothing to do with your appearance here this morning. You saw what happened yesterday, the seventh largest drop, 36.14 in the stock market.

With the weaker economic outlook, we can understand why the stock market and the dollar have been falling. But it is less clear as to what the reasons are for the bond market falling.

Usually a weaker economy sends the bond market up and interest rates down. Now, despite Federal discount rate cuts and a weaker economy, the bond market is falling and long-term rates are rising. Of course, this could send mortgage rates up again, thereby aggravating the already precarious situation that the thrift industry finds itself in.

Could you give us some analysis as to why long-term interest rates are rising at this point in time?

Mr. VOLCKER. I can't give you an adequate analysis of one day's market performance—yesterday—where everything was falling.

You are quite right. In a longer perspective, the bond market has not been falling; it has gone up in the past year a great deal. I suppose long-term interest rates are 4 percent or less or more below where they were a year ago. I think that follows in general your precept that a more sluggish economy is usually accompanied by falling long-term interest rates and rising bond prices. I think very broadly we have seen that.

You have some ups and downs within that general pattern. We certainly had a down recently, but it was not very many days ago that the bond market was rising.

I don't think that that one-day or several-day decline in bond prices, particularly in the face of a very large straight refinancing operation that is coming up in a few days, is necessarily of great significance.

The CHAIRMAN. Mr. Chairman, haven't interest rates, in fact, since they reached their low in May, begun to rise again?

Mr. VOLCKER. They reached a low point sometime in April or May. I don't know as I would say they have begun to rise. They retreated from that low point in May and declined again during much of June or July. They were back about where they were at the low point. Now they have gone up again a little bit.

The CHAIRMAN. Instead of saying—there was a rise, you say the decline retreated?

Mr. VOLCKER. The decline retreated. That is right.

The CHAIRMAN. That is wonderful.

Now we have been on a period of economic expansion for about 44 months. The post-war average was 33 months.

There are those who feel that there are strong signs and strong signals that the economy is slowing down. Do you feel that this is accurate? And do you agree with those harbingers or prophets who

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recently in the financial press have been quoted as predicting that we are on the way to a recession in the not-too-distant future?

Mr. VOLCKER. The economy has certainly slowed from the rate of speed it had in the first couple of years of recovery. It was on, according to the latest revisions of the GNP figures, a 3-percent path until this past quarter when it fell because of two factors in particular, a decline in the rate of inventory accumulation and a further decline into greater deficit of the trade balance.

I think the signals, the harbingers one normally associates with a near-term recession are generally absent, but we live in a much more complex world, I think, than even a few years ago. Certainly in the sense that our fortune is much more closely tied with the external sector of the economy now than I think it ever has been before.

The trade balance, the decline in the trade balance, the large deficit in the trade balance, the growing deficit in the trade balance has been the most fundamental factor accounting for the relative sluggishness of the economy as a whole, and particularly the sluggishness of manufacturing activity for a couple of years.

The longer that persists, I think, the more difficult and dangerous a situation we are in, because we become more and more dependent upon borrowing from abroad. That is one factor.

Our financial markets are, in a sense, more and more hostage to the continuing flow of capital from abroad which is not absolutely assured so long as the deficits remain so great because those deficits in themselves can undermine the basic confidence that is necessary to attract capital from abroad.

So that is clearly a very vulnerable point in the economy. I believe the outlook is better in view of the pronounced changes that have taken place in the exchange rate.

But what we are finding out and what we should have known all along is that it takes more than large changes in exchange rates to produce early and pronounced changes in the trade balance. That is a way of pointing out that our economic fortunes are to a considerable extent dependent upon the strength of markets abroad, the strength of markets for our own products, but as Mr. Fauntroy pointed out, the strength of markets for products of developing countries and others, as well.

We cannot expect that situation to resolve itself without a healthy world economic circumstance. So, our vulnerability lies in part and in a significant part on what is going on with the economic activity abroad.

The CHAIRMAN. Getting back to my question, you have given us a good dissertation on the interdependence, but I refer to the question which was that there are those who feel that there are signs that we may be heading for a recession in the not-to-distant-future.

I asked you what your thoughts were.

Mr. VOLCKER. I am not, and we are not as a group, anticipating that.

The CHAIRMAN. To flip over to a different matter entirely for a very brief question, I believe the Fed agreed with the committee's actions on money laundering not too long ago. Did you agree that financial institutions should not be used for the purpose of laundering money, particularly for drug traffickers?

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You do agree with that, don't you?

Mr. VOLCKER. I think that is a reasonable general principle.

The CHAIRMAN. It seemed to me that was my recollection of the position of the Fed. Has this subject been discussed at the Basle committee?

Mr. VOLCKER. Not to my knowledge, no.

The CHAIRMAN. Has the Fed discussed this problem with any of the other central banks?

Mr. VOLCKER. Not to my knowledge.

The CHAIRMAN. You know, Mr. Chairman, the testimony received, the description of what is happening as far as money laundering is concerned, made it very clear to us that some central banks are being utilized and others may not only be being utilized but rather may be in complicity with money launderers, drug traffickers.

For that reason, I am wondering why this subject has not arisen between the Fed and other central banks. I don't think we should be like ostriches with our heads in the sand. It is a significant problem.

The central banks are involved, and I am, frankly, disappointed to hear you say there hasn't been discussions.

Do you feel it inappropriate to bring this matter up at the Basle committee meetings?

Mr. VOLCKER. I have been given a note the concern was raised at one of the committee meetings. I just have no knowledge as to what happened during that discussion, but I can certainly review the matter.

I don't have any knowledge that central banks are involved in this.

The CHAIRMAN. Those wonderful monastics at the Fed, I am sure, without much trouble, we will present them the testimony that was garnered in our hearings. I am sure they will be able to point out the significant portions.

I would hope that the Fed would look at this problem and consider discussions with the other central banks as well as discussion at the Basle committee, and keep this committee informed. It is a matter of concern not only to us but, you know, I think after the deficit, the next matter of most concern to the American people.

Mr. VOLCKER. I would be glad to review the matter, Mr. Chairman. I don't know what central banks you are referring to in particular. I would note at the central banks meeting at Basle, essentially the Group of 10 central banks, it does not involve central banks in many of the countries where the drug traffic may originate.

The CHAIRMAN. That is why I asked that there be discussions as well with those central banks who may not be members of the Basle committee.

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Upon checking further, Chairman Volcker subsequently submitted the following for inclusion in the record:

The problem of money laundering was raised with members of the Basle Supervisors Committee when that committee met in Washington in June. The discussion that took place revealed a good deal of sympathetic awareness about a problem that infects most of the societies represented on the committee. The problem was characterized as going beyond organized crime and the drug business to encompass all types of illegal activities that can benefit from the use of international banking transactions.

On the other hand, doubts were expressed about the ability of supervisors, collectively or bilaterally, to deal effectively with the problem. In a number of countries, the supervisors posses limited powers vis-a-vis the affairs of bank customers. In general, supervisors do have responsibilities to inform their law enforcement agencies when they encounter transactions of uncertain legitimacy. Many are bound by secrecy laws from transmitting any such information to any other authorities. For this reason, these supervisors believe that international cooperation must take place largely between national law enforcement authorities. Any contribution by bank supervisors was thought likely to be marginal at best.

At the end of the discussion, there was a consensus that because of the community of interest involved, more thought

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should be given to the role that bank supervisors might usefully play to supplement the efforts of law enforcement authorities. To this end, we intend to send to each member of the Basle Supervisors Committee a copy of your Committee's report on the Comprehensive Money Laundering Prevention Act. In addition, the Federal Reserve intends to continue to explore this important topic with other central banks and bank supervisors, both within and outside the Basle Supervisors Committee.

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The CHAIRMAN. Mr. Fauntroy.

Mr. FAUNTROY. Thank you.

Mr. Chairman, upon receipt of the May 20, 1986 directive from the Federal Open Market Committee—that was issued following the most recent reduction in the discount rate—I noted for the first time in at least a year that the FOMC discussed at some length your concerns with inflation in "light of the expectations of increased economic growth." Since that time, the release of industrial production and the employment statistics at the end of June has clouded the economic picture. In fact, the shift in thinking implied by the decision to cut the discount rate appears to indicate a rather dramatic turnaround from the type of thinking that was affected in the release of the May 1986 directive. Given the continuation of 7 percent unemployment, the substantial domestic and foreign debt incurred by the United States and the unevenness of the economic growth in the country, do you anticipate that the Federal Open Market Committee can do anything other than ease monetary policy? What other options are currently available to the central bank? Do you anticipate any further cuts in the discount rate?

Mr. VOLCKER. I think those options depend upon the economic situation as it unfolds, the monetary situation, developments abroad, all the rest, developments in the exchange markets.

You can obviously assume a set of conditions in which anything but further easing would be inappropriate, but we will wait and see whether those conditions, in fact, develop in that way. We, to date, as you now, have been supplying reserves rather freely and recently reduced the discount rate as you just pointed out once again.

That has been the judgment so far.

Mr. FAUNTROY. Several economists have compared the recent monetary policies of the Federal Reserve with the concept of "pushing on a string," particularly in light of the extensive commodity deflation apparent in the economy. Do you agree with that analysis?

Mr. VOLCKER. Not actually, no. But I agree in the sense that I do not think this is the economic situation.

This is the whole emphasis of my testimony. Where there is a straightforward, simple answer to even the rate of growth in the economy through easier monetary policy. That does not say that monetary policy does not have a role to play, but to the extent that our fortunes are dependent upon what happens abroad, our monetary policy has limited, if any, impact on that directly.

To the extent we were concerned about an increase in debt that you emphasized in your opening statement, easier monetary policy presumably does not go in the direction of dealing with that particular problem

There is the question of the exchange rate itself and drawing a distinction between a healthy and needed change in exchange rates and a more precipitous self-reinforcing decline in exchange rates that might not be constructive. So I don't think there is any single button you can push in monetary policy or any other single policy that deals with the situation.

What we need is a combination of policies.

Mr. FAUNTROY. Again, if that analogy is true, namely, that neither an easing of monetary policy nor future cuts in the discount

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rate will result in an improvement in economic growth, then what options are we left with?

Mr. VOLCKER. I don't rule those out. They may have a role to play, too, depending upon surrounding circumstances. I simply say I do not think it is the only answer.

Mr. FAUNTROY. Mr. Chairman, if deflation is as serious a problem as some people seem to think, what options does the Federal Reserve have in attempting to stimulate economic growth? Will you consider targeting cuts in the discount rate toward depressed industries or areas?

Mr. VOLCKER. I don't really think that is feasible. Monetary policy is a very broad brush tool. It affects all: Upon the lame and the healthy alike. There is not much we can really do to change that.

You change the total environment in the financial markets, but it is not directed toward one particular sector or another.

Mr. FAUNTROY. My time has expired.

The CHAIRMAN. Mr. McKinney.

Mr. MCKINNEY. Mr. Chairman, as usual, welcome again. I have a couple of questions for you. You said something I have always said, and that is that we have to look overseas for more markets, both Third World and our allies.

I would like your estimation of what percentage we have in the domestic market of the world, of what we have in the Eastern World. I have a pretty high figure from sometime ago but I think it has gone down since then.

What do you see as our role when, and I say this bluntly and with all apologies for those who are here most of our foreign trading partners cheat right, left, and center on every regulation God ever made.

They cheat with their tax systems, their power subsidies, their water subsidies, their export licenses, their quotas, and everything else, and we are in the unenviable position, it seems to me, of being Uncle Sap and we will never get a bigger percentage of the world market until we get tough with these people.

It isn't a problem just of the Reagan administration. It was a problem of the Carter administration and others, but we have got a textile bill override coming up on August 6. We have a trade bill in front of the Congress. Congress is frustrated at how we are going to deal with it. When I was in business, the customer was always right, even though it sometimes cost me money.

Mr. VOLCKER. We certainly have a long list of complaints. I think a great many of those complaints are legitimate and affect our trade. They have a certain amount of complaints about us, too.

I think we should note we are not entirely blameless in some of these respects. It seems to me the only constructive way to approach these at this point is through international trade negotiations.

I think the prospect of dealing with these in a significant way through unilateral action is very limited. As you well know, that invites recrimination and escalation of what we do, and you get a kind of retaliation that in the end hurts trade and hasn't done much on balance to deal with those complaints except in a contractionary way.

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I think it is also fair to say that while many of those complaints are very legitimate, when you look at a trade deficit of the size of ours—and in the area of $150 billion or so—only a fraction, a relatively small fraction of that trade deficit can probably be traced to those kinds of concerns. That is pretty fundamental.

There is something else the matter as well in terms of misalignment of economic policies on an international scale, and to really deal with that trade deficit in a fundamental way, we are going to have to deal with those other policies.

I would urge that you give the multilateral trade negotiations which are planned shortly one more try at these problems of unfair trade restrictions that you emphasize, and quite properly emphasize.

Don't get them out of perspective as the source of all our trade problems.

Mr. McKinney. I must say I am a little disappointed with the prospects of trade policies. I agree with both you and Mr. Baker on the reaction that our foreign partners have had as far as their discount rates and spurring their economies on are concerned.

Let me ask another question. We are in what is known around this town as a philosophical thicket about what to do about the Federal regulators. We will throw FSLIC, the Comptroller of the Currency, a few others, into that pot, probably you at the Fed as well. What do you see as the temporary future of the regulators? More regulations? Less regulations? About the same?

Mr. Volcker. Well, I would have to subdivide that, I think. In the area of safety and soundness, where we clearly have some problems in the banking system and even more problems in the savings and loan system, it seems to me there is a clear need for effective supervision and regulation.

Maybe that means more in some respects. Certainly in the savings and loan area, there have been some new regulations that I think are generally in a constructive vein aiming toward the safety and soundness problem.

That does not seem to me inconsistent with more openness and less regulation in other areas that this committee and others have been struggling with in terms of what banks can do, what powers they have. What savings and loans can do or—the problem is quite different there where they have much more liberal powers in the past and some have gotten them in trouble.

I think you can go in this case in two directions at the same time depending upon which area you are looking at.

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

Thank you, Mr. Chairman, for the time.

The Chairman. Mr. Cooper.

Mr. Cooper. Thank you, Mr. Chairman.

Chairman Volcker, as you are probably aware there is considerable talk and pressure in Congress for us to abandon the Gramm-Rudman deficit targets. You have been a great leader on this.

Do you think it would be appropriate for us at this time to give up those targets considering the weakness in today's economy.

Mr. Volcker. I wouldn't give up those targets because of a short-term concern about the economy. I think there is a question with the deficit significantly larger this year than was anticipated at the

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time those targets were set whether it is really practical or feasible at this stage to make much bigger cuts than we anticipated at the time in order to reach the specific figure set out in the congressional legislation.

From my point of view, looking at it economically, what is called for is substantial and significant progress in that direction; whether you meet a particular number or not is not economically significant.

You have to grapple with the problem of whether that political target, if I may put it that way, is so significant it must be kept as a kind of goal to achieve the substantial progress I continue to feel is necessary.

Mr. COOPER. From an economic standpoint, a number in the ballpark of $144 billion for next year would be an appropriate one?

Mr. VOLCKER. I have a certain skepticism, frankly, that that can be reached, I must confess. I would be satisfied with progress short of that. Whether you get the progress short of that without keeping that out there as a target is a nice question.

Mr. COOPER. On the point of our dependency on foreign capital, what would be some of the specific early-warning signs if there were to be a withdrawal of foreign capital from this country, say in the coming months or years, if the foreign economies did do better, then there were more investment opportunities in those countries?

Mr. VOLCKER. I think the major points you would see involve on the exchange rates and interest rates—that is the price that must be paid to attract foreign capital.

We are going to have to attract foreign capital. There is absolutely no doubt about that. We have to finance the current account deficit. That will not disappear in a hurry.

What is at issue is the price we have to pay for that foreign capital. Naturally, we would like to get it as cheap as possible.

Mr. COOPER. By the time interest rates fall or exchange rates go up, it is too late. What are the early-warning signals we should be looking for?

Mr. VOLCKER. I think the exchange rate may be a pretty early warning signal. You are also right that once it has a pretty pronounced effect, it is already too late. You can sometimes see evidence of flows in the market itself but I tell you from experience, those are hard to interpret and often pretty erratic.

The market speculates from time to time how much are the Japanese buying now, are they going to buy less of this refunding or more of that refunding, whatever. Those signals are pretty hard to interpret.

I think the problem we have is precisely the one that you point out. By the time you see the strong signals, it is too late. The answer to that is to do what is necessary before those strong signals arise.

Mr. COOPER. On another matter, regarding tax reform, it seems to me the nondeductibility of consumer interest could well be the most powerful and unpopular element of the bill. Hopefully it would increase net savings as apparently the IRA accounts have failed to do.

Are you hopeful refusing deductibility for consumer interest would have a strong impact on improving net savings?

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Mr. VOLCKER. I am inclined to think that is a step in the right direction. A strong impact on savings, I am a little skeptical about. I think those savings habits are deeply ingrained and we have done quite a few things to try to affect it without much evidence in the overall savings rate that it has had a real impact.

I think you are dealing here with one of the more difficult economic phenomena or habits to change. I wouldn't get too hopeful that it will make any dramatic change.

I note just in passing that what the nondeductibility of interest means depends a lot upon how one defines mortgage borrowing. The market can obviously find ways of getting around in large part the nondeductibility of interest on consumer loans by converting them into some kind of second mortgage on a house and the same economic process goes forward.

Mr. COOPER. Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. Mr. Erdreich.

Mr. ERDREICH. Thank you, Mr. Chairman.

Mr. Volcker, thank you for being here again.

I was reading your testimony and your comment which I guess is, obviously, that the momentum of our economy, on page 6, you are saying has been sustained almost entirely by consumer spending and housing construction. Where do you foresee the continued momentum of this economy coming from with the industrial production aspect being—even declining in the last 3, 4, and 5 months? Where is the continued momentum going to come from?

It seems those two elements, consumer spending and housing, have done almost their full share. Can they do more?

Mr. VOLCKER. They certainly have done their full share. I don't know they can do more, but I don't know they have to stop either in the short run.

Looking ahead, I certainly think a key to the economic outlook and a factor that must underlie any economic forecast extending over a year or more is going to be what happens to the trade balance. That is where a central continuing source of weakness has been. And I think that is where we have to look for a reversal.

If we don't see a reversal in that sector over let's say the next year, many more questions would arise about the performance of the economy, because I don't think you can carry it on consumer spending and housing indefinitely.

Mr. ERDREICH. You also then would again urge, as your comments and testimony do, that the other nations' economies must expand, Japan, West Germany, whatever?

Mr. VOLCKER. Expand from internal factors, and I think the evidence of that remains somewhat mixed. In some of those countries, such as Germany, there may be some developing evidence of that stronger growth. I don't see that so clearly elsewhere. Of course, there is some question even in Germany.

Yes, that is a central theme of my testimony, the importance of the trade outlook to our own industrial production, to our own economy, and the extent to which that rests upon economic performance abroad.

Mr. ERDREICH. Do you have any reason, any knowledge, or information to indicate that those countries are embarked on any expansion efforts internally?

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Mr. VOLCKER. Well, most of them have had some easing of monetary policy in the past 6 months or longer. Most of them have become equally reluctant to do anything on the fiscal side. Some of them argue that there is enough "baked in the cake," so to speak, to produce that kind of stronger internally generated economic expansion. So there are obviously differences of opinion on this score.

A lot rides upon whether, in fact, that judgment on their part is correct, that there is a certain amount of momentum building in their internal economies. You don't see it uniformly.

Mr. ERDREICH. Is it then fair to say that your view is the next 6 or 12 months of continued growth for the U.S. economy will be substantially dependent upon what these other countries around the world do?

Mr. VOLCKER. Certainly when you extend that out a year or so, yes.

Mr. ERDREICH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

In politics, we have ideas that become in vogue now and again. In economics, we appear to have statistics that come into vogue.

The new statistic this year that is being emphasized the most, particularly in recent months, is this new one about debt to GNP. As I understand it, over most of the 1960's and 1970's, we had a debt of about 160 percent of GNP. And in the last 4 years it has leaped to a little over 200 percent of GNP.

Economists tell us the way debt is paid back is through greater earnings or through an inflated dollar. If your predictions on economic growth hold true, it doesn't appear there is a lot of hope in greater earnings in the next year or two.

Would you care to estimate then for the committee whether you think in the latter part of the 1980's we may see a great inflation to bring us back to a lower debt to GNP, or do you think we will see a continued trend towards greater debt and a more difficult capacity to pay it back?

Mr. VOLCKER. Certainly to the extent we can influence the process, we do not want to see the gains inflated away. That would bring more problems in my judgment in its wake. You have to grow up to it in real terms and hopefully introduce policies that don't contribute to such a rapid expansion in debt.

One element of that is directly under the control of the Government itself and the Congress. That is the Federal portion of the debt. But it is also true that the non-Federal debt relative to the GNP has been rising very rapidly. Part of it, I suppose, supports that growth in consumer spending that we just discussed and raises some question about how long that can be sustained when it is so heavily dependent upon debt creation.

In the business area, we have seen a great deal of increased leveraging of businesses through various techniques that you are familiar with, mergers, leveraged buy-outs, and so forth. Some of that is aided and abetted in a more general sense by the tax system. We touched upon that earlier: Dealing with the deductibility of consumer credit is one small aspect of that. Generally the tax system has been biased in favor of debt. For some reason that has

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become more important in recent years, although it is a long-term phenomena.

The tax reform legislation may go some direction in dealing with that simply by the lowering of marginal rates but that is the only way it deals with it in any significant way.

I think we should be looking at all our policies in terms of whether or not it artificially encourages this rise in debt which has very troublesome aspects, as you suggest.

Mr. LEACH. Let's just switch gears briefly. In your written statement, you made a very profound anti-protectionist plea. In the next week or so, Congress is going to be looking at the prospect of veto override on the textile bill.

Would you care to comment on that particular issue in relationship to the protectionism principle in general?

Mr. VOLCKER. It is certainly an indication of the political pressures that exist toward protectionism. I think to pass that bill over veto would be a very large step backward and a large step in the direction of encouraging a kind of mutual raising of protectionist barriers around the world that would be decidedly counterproductive in terms of working out our problem in a constructive way.

Mr. LEACH. Finally, let me ask a question that is regional. As you have noted, growth is somewhat anemic in the country, but it is real. Regionally, in some parts of the country, it is negative. My State of Iowa, for instance, in the last quarter or so had a negative 1.9 percent real income growth.

Do you have anything to predict that might suggest in the great farm States that have lost half their asset values if not more in the last 5 or 6 years this could have leveled out and we may see a bottoming out of these trends?

Mr. VOLCKER. I think we do see some indications that with land prices so much reduced, they have returned at least close to levels that—where new entry into the business would make farming profitable again and that, of course, would be the fundamental economic force that would bring some level in recovery over time. This is true in the midst of, I suppose, and can only be characterized as a worldwide surplus or worldwide balance between production capabilities and demand.

That is a basic problem which I think lies behind these very severe adjustments in Iowa and elsewhere. I don't think that is going to disappear very quickly without some meteorological events around the world. So this adjustment has been very severe and reduces the chances of a sudden recovery.

I think there are signs that a better equilibrium is returning and that values in that area of the world are leveling off at much lower levels.

Mr. LEACH. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Roemer.

Mr. ROEMER. Thank you, Mr. Chairman.

Mr. GONZALEZ. Will the gentleman yield for a unanimous consent request?

Mr. Chairman, I ask unanimous consent the record show I am present and that a Democratic Caucus is now considering a matter having some relevancy to my district, and I must leave at this point.

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Mr. ROEMER. Thank you.

The CHAIRMAN. Without objection.

Mr. ROEMER. Mr. Volcker, I am pleased and know the folks in my district will be pleased with your prediction that, and I quote, "oil prices won't go down forever." There is some doubt in my district.

Mr. VOLCKER. Small comfort.

Mr. ROEMER. There are a million families without work in Texas, Oklahoma, and Louisiana in large part because of the depression in the oil industry.

I notice at the top of page 8, you characterize it as recession-like conditions. That has not met with the facts in many parts of my district and others. Unemployment is 30 percent and rising.

Two things bother me. One is tax reform, and I would like to get your direct impressions in looking across American as to what you think it might do in your vision of the upcoming future. Is it a benefit? What ways might it be strengthened to improve the beneficial chances? What is your opinion of tax reform as it stands now?

Mr. VOLCKER. I can only give you a most general impression. I have no expertise on the details of that very complex subject. I don't know how helpful I can be.

My feeling is that, very broadly, the combination of a much broader base and dealing with many of the special provisions in the Tax Code and limiting them offset by a reduction in rates is a healthy and appropriate direction in which to go.

At the same time, I do think during a transitional period of some length, it tends to raise new uncertainties and additional problems in the investment sector; and——

Mr. ROEMER. You are talking of the uncertainty?

Mr. VOLCKER. I think it is a problem of the uncertainty. We will find that out when the bill is finally enacted.

I think a good many companies are hesitant about making or carrying through firm investment plans and placing the orders from the sheer uncertainty of how it will be treated in any bill that emerges. Some of that will go forward—once almost any reasonable bill is enacted. But, as you know, some investment incentives are clearly reduced in both the versions of the reform legislation that is before the conference committee.

For some interim period, at least, that may mean less investment in some sectors of the economy than you otherwise would have. One very clear area seems to me is in the area of commercial construction, which is suffering most basically from overbuilding in the office area in many areas of the country; but a lot of that activity—and I am sure some of the overbuilding has resulted from the strength of the tax incentives.

If those tax incentives are withdrawn, you get an aggravated effect on the industry, not only from the basic economic fact that there is a great surplus of office space in many areas, but now the somewhat artificial life support system is being withdrawn at the same time. In the long run, I don't think those incentives were particularly desirable, but you have a timing problem here.

Mr. ROEMER. You know, the suspicion grows, to my mind, and you might not agree or want to comment on it, we would have been better off 1½ years ago to put on some sort of fair minimum tax

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across the board on wealthy individuals and corporations, put that against the deficit, and do away with tax reform. We might have been more healthy today.

In regard to interest rates, I know you are pleased with the fact rates are down. But are they? Since you have had your responsibility and I mine, the real interest rates have stayed about the same according to my figures. If you take the inflation rate, subtract that from the denominal interest rate, real interest rates are about as high as they have been. Am I correct?

Mr. VOLCKER. It is awfully hard to measure real interest rates. I don't have a chart in front of me. I don't know exactly what period you were using.

In assessing rates today in the short-term area, I would point out we are getting the effects of the decline in oil price that is hurting your State and other States, which has an exaggerated rate but temporary influence on the price indices. I don't think you can reasonably take a snapshot of last month's consumer price index or the last 3 months' or the last 6 months' consumer price index, and put that against nominal interest rates and say that is a fair measure of real rates. You get out in the longer term area, you are dealing with expectations.

My sense is that in the past year or so, real interest rates have declined in a meaningful sense. That nonimal interest rates have declined more than expectations of inflation, though I think expectations of inflation have declined during this period.

Mr. ROEMER. My time is about up.

I think I have heard you say in private and public conversation that the real interest rate is somewhere around 6 percent, maybe even higher. Let's say if the prime was at 9, inflation at 2, that is 7 or some variation of that. Isn't that abnormally high?

Mr. VOLCKER. I think real interest rates given my expectations of inflation are historically high, yes, in the long-term area. It does depend upon one's expectations of what the inflation rate is.

Mr. ROEMER. It can't help the economy, so I don't think we can brag about interest rates. I think they are abnormally and historically high. That is not your fault.

Mr. VOLCKER. I would agree real interest rates are higher than they have been historically in this country.

The CHAIRMAN. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

Mr. Chairman, the balance of trade is something that concerns me, because I think it tends to be the root of a lot of our current problems. There appears to be a feeling on the part of economists, and I believe you may have listed yourself in this category, that our balance of trade is improving, but there is a time needed before certain things that have taken place are actually cranked into the system and show that improvement.

My question would be, would a further decline of the dollar speed that process, and if so, would there be a tradeoff there that we might want to look at?

Mr. VOLCKER. Well, there are certainly tradeoffs. It is very much a two-edged sword.

You say the trade balance is improving. It is a little hard to detect. It is probably getting worse at a slower rate of speed.

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Mr. McCANDLESS. We had a seminar a while back. There were six of the leading economists from various categories in town in a forum. They seemed to agree it would take four to six quarters before something were actually felt.

Mr. VOLCKER. I agree with your basic point the exchange rate change alone produces results over a longer period of time than one likes to contemplate, and four to six quarters is certainly not an unreasonable estimate. Some of it will take longer than that.

But if all else is equal, an exchange rate change also has some difficulties. If you perceive that a good part of the problem and a good part of the sluggishness in our trade position is related to the relatively slow, particularly domestically oriented growth abroad, an exchange rate change itself puts us in a better competitive position and tends to increase ordering in the United States as compared to elsewhere.

It also has the effect of potentially slowing growth abroad. I think we have seen some of that in recent months and recent quarters. Japan and Germany in the first quarter of this year actually declined in their GNP partly because their export sector was doing less well than it had done earlier. That was an important factor in both of those countries.

Now—as I see the picture—we have got to really see an important improvement in our trade balance. The exchange rate changes that have taken place have to be supplemented by a reversal in growth patterns, in domestically generated growth patterns at least. We have had a pattern over recent years in the United States of generating a lot of internal demand even during this period of slowdown. It is not as rapid as it was in the first couple of years of recovery, but on domestically generated growth, ours has been around 3¾ percent, as I remember the figure, over the last 18 months. Not too bad a figure. Faster than our GNP.

The domestic generated growth abroad has been at a rate of maybe 2½ percent. Until those kinds of relationships get reversed, it is difficult to see a marked improvement in our trade balance. They should have faster domestic growth as their trade surpluses diminish, as they get reduced stimulus—in fact, a drag—from abroad.

If our trade deficit is going to be reversed, the implication is inescapable that surpluses abroad have to go down, those economies are going to be restrained on the external side. They are going to make up for that on the internal side.

The reverse applies to us. As we get more stimulus from abroad, hopefully, from the trade balance, then we can expect our growth to be in excess of our domestic growth. That implies some pretty difficult adjustments.

Mr. McCANDLESS. On the one hand, Mr. Chairman, we have a situation where we are trying to improve our trade balance with Japan; on the other hand, we have nations that pegged their currency rate to the dollar, South Korea, Hong Kong, et cetera.

As we improve in bilateral situation with Japan, are we going to offset this by worsening the position we have with Canada, Hong Kong, South Korea as far as the dollar is concerned?

Mr. VOLCKER. I don't really think so. There may be a problem with respect to some of those countries, but as our competitive posi-

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tion improves relative to the other industrialized world, countries like Taiwan, Korea, Hong Kong, Singapore, whatever, have an incentive to export more to those other industrialized countries relatively and less to the United States and they should find our exports more competitive than Japanese exports, German exports, whatever. That process takes place without any change in their exchange rate at all.

But they will shift their importing and their exporting to currencies that have appreciated very sharply vis-a-vis their currencies, even assuming that their currency has remained unchanged relative to the dollar.

Mr. McCANDLESS. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Hubbard.

Mr. HUBBARD. Thank you, Mr. Chairman, for being with us.

Commerce Secretary Malcolm Baldrige, speaking to a group of businessmen in Tokyo today, said that the U.S. trade deficit with Japan will again widen this year to over $60 billion after last year's $50 billion trade deficit. Secretary Baldrige also said the total U.S. trade deficit will be about as large as last year's $148.5 billion.

The Members of the House and Senate last year, realizing how bitter our constituents are about being outfoxed by Japan, Korea, and other countries in our trade with them, passed a textile quota bill. The President has vetoed it. The House will take up on August 6 whether we can override the President's veto.

Now, in a truly statesmanship way, you have said today that we certainly need to deal with this trade deficit problem energetically. I refer to page 10 of your comments, where you say that:

> I also know the clear lesson of experience is that a protectionist retreat for the United States, the world-leading economic power, would invite recrimination and escalation. The most effective and promising avenue for dealing with the trade complaints on all sides will be in the planned round of multilateral trade negotiations rather than a tit-for-tat process of mutual retaliation.

But knowing how our constituents feel about these "multilateral trade negotiations," we continue to see our trade deficit widening. Even today, I repeat, Secretary Baldrige is telling people in Japan our deficit has increased $10 billion with the Japanese.

How long are we going to finance this trade deficit? How long can we finance it?

Mr. VOLCKER. That is a very large question. We financed it so far relatively easily. I think it would be wrong to assume we can do it indefinitely so easily.

I have been saying for several years that we ought to deal with the underlying problems so that we are not at the mercy of this continued and rising amount of financing, because—while it has come very easily so far—the day may come when that is not true.

Mr. HUBBARD. The underlying problem is?

Mr. VOLCKER. The underlying problem is in an immediate sense, the trade deficit and then the really underlying problem is what lies behind that.

We have had a big exchange rate correction. Nobody knows whether that is just right at this level. But we know there has been

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a big correction, and I think the emphasis now is probably on the kind of growth considerations that I was just talking about earlier.

Mr. HUBBARD. Mr. Chairman, the House and Senate, of course, have passed Gramm-Rudman-Hollings. The country has realized that we are in the process of reducing the deficit and that somehow by 1991 we will have no deficit, that we will have a balanced budget.

In fact, wouldn't you agree that the United States actually at this time is still falling deeper into debt? I am criticizing Congress.

Mr. VOLCKER. Yes. The only reason I hesitated, certainly that is true in any arithmetic sense. I hope it is not true looking ahead in terms relative to the size of the economy; but certainly, we are still falling into debt, whatever the rate of speed, whether it is slowing down a little bit. We are still falling into debt at a pretty good rate of speed.

Mr. HUBBARD. You say on page 13 of your testimony, "Only as our huge Federal deficit is cut can we comfortably contemplate less borrowing abroad and provide assurance against renewed inflation."

As one who would like to see our national debt reduced substantially and by 1991 have our deficit removed—although I doubt we will really do that, because I have seen too often where we have failed to vote for a 1 percent or 5 percent decrease in spending—can you tell us while you are here with us how serious it is, in warning Congress once again in your own words, that we are running out of time for being serious about reducing this national debt.

Mr. VOLCKER. You just read my words. I don't know how I can amplify them and reflect even more strongly my feelings about the risks that are being run.

I think one aspect of it is precisely the point that you raised yourself in beginning this questioning: How can we count on this flow of funds? I would tell you, not indefinitely. It has come very easily so far, but the larger our budget deficits are, the more you undercut the conditions that produce that ease of capital inflow.

If we did not have that capital inflow and had to finance a deficit of this size, then the prospects for pressures on our internal financial markets would be very great. That is not what we want to see at this point, quite clearly, and we are just running that risk with each passing day.

Mr. HUBBARD. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Chairman Volcker, right now the House and Senate conferees are considering the tax bill. I have pretty much concluded that neither the President nor the Congress are going to engage in the concerted type of activity which is going to bring about a reduction in expenditures in a meaningful way to significantly reduce the deficit. That is the conclusion that Dave Stockman reached in his book. I believe that is the basic reason he resigned, because he could not get the President to change his point of view.

You have attempted in your tenure to be extremely cooperative with both the President and the Congress—I am wondering if too cooperative. Isn't it time for the Chairman of the Federal Reserve

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Board to say that the time has come to increase revenues? You have been waiting for the President and the Congress to choose your first alternative, that is to reduce expenditures, but maybe it is just getting beyond that point, Mr. Volcker, and you should be encouraging the President to get off his intransigence?

Mr. VOLCKER. It is very difficult for me after this passage of time to see how we can deal with that basic structural deficit without an increase in revenues. The answer to that ultimately is in your hand.

Mr. LAFALCE. It is not necessarily in our hands alone. It is in the hands of the Congress and the President.

I think there is a tremendous disposition on the part of the Congress to increase revenues, even though most Members might be silent about it. Although some Members, such as Senators Dole and Domenici, have not been silent. They are Members of the President's party.

Because of the 1984 election, when that was an issue, my question is: Have you said to President Reagan, we have reached the point of no return, Mr. President: You must start acting responsibly and talk to the American people about the need to increase revenues?

Mr. VOLCKER. I have not had that conversation with him.

Mr. LAFALCE. I can't hear you, Mr. Volcker.

Mr. VOLCKER. I have not had that conversation with him.

Mr. LAFALCE. Do you think you should in order to discharge your responsibilities faithfully as Chairman of the Federal Reserve Board?

Mr. VOLCKER. I want to consider that, yes.

Mr. LAFALCE. I would hope you would consider it very soon. You may have reached the point of no return, too, on that type of conversation.

Something else, Mr. Chairman. Right now the Senate and the House are fixed on coming up with a revenue neutral bill. If we pass this revenue neutral bill, will we have reached the point of no return on being able to raise revenues to reduce the deficit?

I say that not philosophically but pragmatically, because once we eliminate or reduce most of the so-called tax loopholes or tax expenditures or tax incentives, about the only way we would be able to raise revenues in the fourth quarter would be by restoring the rates from their 27 percent level to 38 percent or 50 percent or what have you, or by going to some other type of tax, such as a value-added tax. Are you concerned about a major overhaul of the Tax Code that proves at best to be revenue neutral?

Mr. VOLCKER. That is a judgment I really can't make, Mr. LaFalce. Whether that makes it easier or harder seems to me is basically, a question of political judgment, where my judgment is that I don't think I have anything to add.

Mr. LAFALCE. I am disappointed in that, but I can accept it.

Let me go on to the next point. Last Friday, the Joint Economic Committee came out with a study which showed that the concentration of wealth within the United States had increased significantly within the past 20 years using data 20 years ago, I believe, that was prepared by the Federal Reserve Board.

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They now said that the super-rich in America, the top one-half of 1 percent, had accumulated 35 percent of the wealth of America. That is a tremendous increase from 20 years or so ago.

At the same time, we are considering lowering the highest rate in our Tax Code from 50 percent to perhaps as low as 27 percent.

No. 1, are you concerned about the concentration of wealth in America? Do you have any data within the Federal Reserve Board that would bring up to speed the 20-year-old study that I believe you have?

And do you think that lowering the cap from 50 percent to 27 percent makes much sense when confronted with this far greater concentration of wealth in the past 20 years than we have ever had before?

Mr. VOLCKER. I am not familiar with the concentration of wealth figures and I have not seen the study to which you refer.

I would make a rather obvious response that I suspect some of the leading concentrations of wealth have been swallowed by the amount of loopholes in the existing Tax Code. I don't think there is any direct or clear relationship——

Mr. LAFALCE. We ought to close the loopholes and keep the rates where they are.

Thank you, Mr. Chairman.

My time has expired.

The CHAIRMAN. Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

Mr. Chairman, we are pleased to have you here today. I am very pleased to be able to follow up on Mr. LaFalce's question which has gotten you, I believe, to indicate that you may have a conversation with the President.

However, I would simply distinguish myself from Mr. LaFalce to advise you or respectfully request that when you have that conversation with the President, that you also point out that there is still a great need for adjustments in the structural deficit on the spending side as well and that we should not only look at the tax side. We have just begun down the Gramm-Rudman road, and I would hope that you would be just as assertive on the structural spending side.

Mr. VOLCKER. That has been my consistent position, Mrs. Roukema. I would like to get that in the record.

Mrs. ROUKEMA. I would love to be there when that conversation takes place.

Let me ask you a question that has been asked you in one way or the other several times today. You do address it in your written statement; but I have to ask the question in my own way, because I truly don't understand how we go beyond the rhetoric and get some results. Now, I am referring to the trade balance question as it relates to the growth rates in Japan and Germany and some other industrialized countries.

I hear what you are saying, that they should increase their economies, but why in the world should they? Why should they do us this favor? What is in it for them specifically, and if you will, I think—I would like to hear you explain why you think they have been dragging their feet thus far and have been reluctant.

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Mr. VOLCKER. That is a good question. I think sometimes this gets put in the context of this as something they ought to do for us. I would say it is something they ought to do for themselves.

I would think the answer to part of your question is self-evident, that when they have a lot of unemployed resources, and particularly a high rate of unemployment, that growth ought to bring some clear advantages to their own people, their own employees, so that they don't have to look any further than that for the justification.

I am afraid to some extent they have gotten used to looking abroad for the stimulus. So long as the stimulus is there, sometimes that is easier than taking steps at home to produce the growth.

I think what has to be understood here is that in any circumstance that I can foresee, that stimulus from the United States is no longer going to be there. We cannot continue to increase our trade deficit even if we could do it economically, which I don't think we can do for long. The political pressures which are reflected in this committee and elsewhere are not going to permit it in terms of protectionist action.

I do think they have to look elsewhere for sources of growth and that sometimes is difficult.

From their perspective, of course, they have a very legitimate and understandable concern about maintaining the very great progress they have made toward price stability. They don't want to do anything that calls that into question in the future.

Mrs. ROUKEMA. Their fears of igniting inflation in their own country?

Mr. VOLCKER. Yes. I understand that has been a very powerful influence on their own policy making.

At the same time, with the combination of declining oil prices and appreciating currencies, they have gotten such a lift toward that particular objective, I think it raises more pointedly the question of the growth side of the equation: Whether they can't get a better balance between growth and price stability, which is what obviously they would like to have, and everybody would like to have. Whether that opportunity doesn't exist now much more greatly than it existed 6 months or a year ago.

Mrs. ROUKEMA. My time has expired, Mr. Chairman.

I do wonder what vehicles you or Treasury will use to persuade the Japanese and Germans of the wisdom of this source of action.

Mr. VOLCKER. I don't think we have any vehicles other than going about our business.

I would repeat what I said earlier, that part of the reasoning of some of these countries will be in their own estimation, they are going to grow substantially more rapidly. As I said before, a lot rides on that judgment.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

Mr. Chairman, first I want to thank you particularly for one of the things you have in your testimony. One of the metaphors that has bothered me these past few years has been the one with regard to the economy, the rising tide lifts all boats. We have heard that ad infinitum.

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In your second paragraph, you say, "There have been marked contrasts in the economic performance of different sectors and regions of this country."

Further on, "As a consequence, activity has advanced rather strongly, while severe adjustments"—that is nice for real trouble—"are taking place."

I hope you have sunk beneath the waters the metaphor about the rising tide lifting all boats which has been an excuse for inaction.

Mr. VOLCKER. I must say, Massachusetts is one of those that has been rising.

Mr. FRANK. That is right.

The point is you get differential impacts in this economy. This absolutely misleading metaphor has been an excuse for ignoring some very real sectors in distress. That is part of our protectionism problem.

I must say I never understood one thing John Kennedy said, and since he is the one who used the metaphor, I have to say something nice that he said or I can't go home again. He said once, Franklin Roosevelt could be a good neighbor abroad because he was a good neighbor at home. I think it has been the neglect of the boats or people standing on tip-toes when the tide rose that is part of the problem with protectionism.

I believe it is important that we give some attention to what we do about sectoral things. I want to lead to my question with that.

I was pleased when you indicated to Mr. Cooper that you thought the $144 billion—I am sure this is what you said—the $144 billion in deficit target for this first full year of Gramm-Rudman was unrealistic. I believe that is the case, that we reach it—that was a number that was hidden in—taken out of the air in December 1985. Wherever it came from, it was based upon economic growth figures which simply are not there.

To reach $144 billion, you said you didn't think it would be wise to cut more than we have cut in the budget. The budget we passed will not reach the $144 billion. Either we raise taxes by $15 billion or so, or make more cuts.

I take it explicitly you are saying, given the expectations of the performance of the economy we now have and have had for the first 6 months of this year, the $144 billion for fiscal year 1987 is not realistic.

Mr. VOLCKER. Given the starting point, I fear that it is beyond reach, yes.

Mr. FRANK. I think that is very important. The fact it is rationally beyond reach is not going to prevent a lot of my colleagues from trying to reach it.

I think in the course of that, we could damage some of the areas——

Mr. VOLCKER. I guess the problem I have is that if a lot of your colleagues don't try to reach it, they won't do anything.

Mr. FRANK. Trying to reach something you can't reach is silly. If we can't reach the $144 billion, we shouldn't try to reach $144 billion.

We ought to try to reduce the deficit. But pretending to ourselves that we are going to take both feet up in the air at the same time

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and stand there for 30 seconds isn't particularly useful. That doesn't mean recognizing that the economy's erosion in these past 6 months makes the $144 billion unreachable, as you have—and I am stating, as you have frankly acknowledged—that doesn't mean we shouldn't try to reduce the deficit. It does mean it was unrealistic in December of 1985 to try to put these fixed numbers out there.

What about a tax increase to reach the $144 billion? Would that be a reasonable alternative?

Mr. VOLCKER. Depends on what you do with your spending.

Mr. FRANK. If we kept expenditures as they are now, we reached the level of the budget based upon the economic assumptions extant at the time of Gramm-Rudman, to the extent there has been a shortfall in reaching that target, would you recommend we raise taxes to get to $144 billion?

Mr. VOLCKER. As I remember it, the kind of budget resolutions that the Senate at least——

Mr. FRANK. We have a joint one now. One came out of conference.

Mr. VOLCKER. That has revenue increases in it.

Mr. FRANK. Small ones; $10 billion.

Mr. VOLCKER. Relatively small, that is right. But if you could carry through on that kind of program and it actually materialized, you not only passed it but it materialized, I think you would have made a substantial step.

Mr. FRANK. The budget resolution passed by the House and Senate will not meet the $144 billion.

Mr. VOLCKER. From the present base, I think that is correct.

Mr. FRANK. You would not make drastic changes in that? Let me get my last question in. Given we passed it, if we could carry that one out, the fact that would not reach $144 billion because of the erosion in the economy in and of itself would not be a serious problem?

Mr. VOLCKER. If it did not reach the $144 billion simply because of the erosion in the economy, I think that would be comprehensible and understandable.

Mr. FRANK. Thank you I am going to quote you frequently on the floor.

Mr. VOLCKER. My skepticism will be whether you will carry out the full range involved in that resolution.

Mr. FRANK. Mr. Volcker, we will have to leave with our skepticism about our ability to carry things out.

Mr. VOLCKER. If the shortfall is simply because of slow and unexpected economic activity, that is one thing. Failure to carry through the thrust is another thing.

Mr. FRANK. Mr. Volcker seems loath, I think, to live with the consequences of what you are saying. That is precisely what I am saying. If we carried out that budget resolution, and it stayed at $144 billion, went beyond $144 billion, that would not be reason for lamentation?

Mr. VOLCKER. Under current economic projections.

The CHAIRMAN. Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

Chairman Volcker, I would like to echo Chairman St Germain's request that the issue of money laundering be placed on the

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agenda of central bank meetings. Money laundering and narcotic trafficking can never be halted unless we have the full cooperation of the central bankers. I would call your attention that the bill we reported out of this committee last week calls for both the Secretary of the Treasury as well as yourself to work with your counterparts in other parts of the world toward the elimination of money laundering.

I would urge you to put that high on the agenda of matters that you discuss. I know you have other serious matter like monetary policy and fiscal problems. This narcotics trafficking is destroying the integrity of society. It certainly deserves that it be placed high up on your considerations.

Yesterday's Wall Street Journal had an opinion column entitled "Outlook, What Is So Bad About Social Growth?"—you may have read the column. If I may quote, it says,

> When the pace of expansion is minimal as of late, the attitude for healthy stimulation to business activity tends to be broad. There is less likelihood, for instance, a policy of monetary ease will drive up prices. In boom times, conversely, there is relatively little room to maneuver. Although we have no boom, we have no bust.

It concludes that the arrival of a bust seems less likely with the current lackluster performance of the economy. Would you agree with that premise?

Mr. VOLCKER. I certainly agree with that in important respects. As I said earlier, we don't have the normal precursors of a recession. You don't have the kind of boom that refers to. You don't have pressures on capacity. You don't have rising prices. You don't have rising interest rates.

All of that is very much on the favorable and supportive side. You have rising real incomes growing out of the oil situation. So there are a lot of reasons to support the idea that the economy will continue growing, perhaps not at the ebullient rate of speed some people were predicting earlier. They had solid reasons for suggesting continued growth. I think those reasons still exist.

Mr. WORTLEY. In your crystal ball how much further can you see in terms of an expanding economy?

Mr. VOLCKER. I am not going to present a crystal ball too far ahead. I think we have a combination of very favorable conditions, fundamentally. I am repeating myself. Progress has been made on prices, better financial market conditions, lower energy costs, higher stock market prices, that kind of thing.

I think there are fundamental adjustments we must make or sooner or later we will be put in jeopardy. Again, they relate largely to the international dimension. I don't think we are on a solid footing with a rising trade deficit.

I would focus the attention right there. Unless we have policies and unless other countries have policies that are consistent with moving the trade deficit lower, then questions arise as you expand the horizon of your forecast or crystal balling or whatever. There are quite obvious questions.

Mr. WORTLEY. Of course, the trade deficit troubles us a great deal. The decline of the value of the dollar will contribute to improvement in that direction. Do you think the value of the dollar has bottomed out? Do you think it is about to stabilize? Do you think it is about to retreat from its decline?

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Mr. VOLCKER. Well, I am not going to project that either with any precision. What I will say is I think the outlook for the dollar is much better if we have a more balanced growth picture around the world. It seems to me evident the emphasis now, as a policy matter should be in that direction rather than on changes in the dollar.

Mr. WORTLEY. Thank you very much for your testimony. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Chairman Volcker, thank you for your testimony. I have just a few quick questions. You covered the primary things with Mrs. Roukema concerning the need to stimulate domestic demand, particularly in Japan and West Germany. I understand the importance of the unemployment problem in West Germany, but the Japanese are fond of reminding us that they have a higher debt, public debt per capita. Isn't part of the answer to them that there are many other ways to stimulate domestic demand other than appropriation actions?

Mr. VOLCKER. There certainly are other than appropriations actions, yes. I very much agree with that.

Mr. BEREUTER. It seems to me one of the areas they have the greatest latent demand is in housing construction. Yet there are so many local impediments to collecting enough land for housing construction. What kind of arguments additionally should we throw up to the Japanese in urging them to increase domestic demand?

Mr. VOLCKER. I think the choice has to be left to them. I think there are many avenues by which that could be stimulated. You can reduce taxes instead of increasing expenditures to the extent you look at the fiscal equation. There are, I think, impediments in the structure of their economy and the structure of their society that particularly affect housing and related expenditures. There is the question of monetary policy.

I think, again, the Japanese might argue that they are going to see this growth more or less spontaneously or with the actions they have already taken on the monetary side. All I would say is, again, a lot rides upon that judgment but there are many avenues which can be taken. I fully agree with your comment.

Mr. BEREUTER. For Business Magazine, in their editorial this month suggests that our major industrial competitors, our trade competitors generally have been cutting their profits very substantially but they are at the end of the line. Now they have to raise prices and that this will have a major positive effect upon our trade balance. Is that logical?

Mr. VOLCKER. Yes.

Mr. BEREUTER. Are they at the point now of having to increase prices?

Mr. VOLCKER. I think you already see some increasing prices. As this situation goes on, I think inevitably you will see more of it. The profit margins of some of those exporters were very swollen when the dollar got very high. Thus the rise in their currencies could be absorbed in their profit margins for a while, but it didn't last forever. You see that in industries in different countries now.

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Mr. BEREUTER. In the area of our major trade competitors, the areas where we have major imbalance today, we have got the countries that pegged their currencies on the dollar. We don't hear much about Canada, although we have our second largest trade imbalance. Then there is Hong Kong, Taiwan, South Korea.

The possibility of a substitution to the fact that we can bring down our trade imbalance with the Japanese and the EEC countries, we may well just lose additional ground with respect to trade balance to these countries.

How do we deal with these countries? The Canadian dollar actually is—we are worse off with respect to the Canadian dollar than we were several months ago or a year ago.

Mr. VOLCKER. But Canada is in a different situation than some of the European countries and Japan. They have not got a big current account surplus. They have a big trade surplus, but they have a lot of minuses on interest and other services. They have not been piling up the big overall surpluses those other countries have been piling up. Indeed, the comments I make about growth in the United States are paralleled by Canada. They have had a lot of domestically originated growth as well.

Their external position has actually been deteriorating some, which helps account for the fact their dollar has not behaved strongly relative to the U.S. dollar.

Mr. BEREUTER. You make a good point on Canada. I really should emphasize Taiwan and South Korea.

Mr. VOLCKER. Even those countries differ. Taiwan has an enormous surplus. They have a large reserve buildup. I don't think there is much doubt that Taiwan should reduce its surplus, although one might wonder whether exchange rate changes, are the most effective vehicle. They could do a lot more importing considering the size of their external surplus. It is one of the largest external surpluses in the world. It is a relatively small country or economic area.

That situation, I think, is quite different from Hong Kong, Singapore, and Korea, none of which have the same kind of surpluses and the same relative absence of external debt that Taiwan has. But, again, as I indicated in my colloquoy with somebody else, I think the exchange rate changes among the industrialized world should divert the trade of those countries in a way that is helpful to us, that they should do more exporting to the Japanese and the Europeans, less to us, and more importing from us and less from those countries simply assuming the exchange rate changes in the industrialized world are effective.

The CHAIRMAN. Mr. Levin.

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

Mr. Chairman, this is the fourth year I have had the privilege—and it really is that—to hear your reports and to share some back and forth. If I might, let me just share an observation that you walk a number of tightropes. One of them is in these discussions as well as others in the Congress.

If you are too specific, it can have too much of an impact outside of Government on the markets of varying kinds. But I think the other side of it is that if you are too vague, it has too little impact

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here, and as I read your testimony, the hardest thing for me to glean is the intensity level of these problems.

On page 3, you summary statement is that some fundamental economic adjustments must be made within our economy in the months and years ahead. It's hard to decipher from that, and I think the rest of your testimony, the dimensions. Do you know what I mean? You state the problem so well, but it is hard to know how pressing you think they are.

Mr. VOLCKER. I know exactly what you mean. Part of the dilemma is the one you suggest, but another part of the problem, perhaps more relevant in this particular case, is I cannot—I don't think anybody can—tell you with any certainty just when the trigger is going to be pulled on some of these problems in a way that creates a very large problem for economic policy in the United States and the rest of the world.

I would not have thought, frankly, that we could be as comfortable in attracting a large amount of capital from abroad as long as we have. If you had asked me that a couple of years ago, I think I probably indicated that in some of my testimony. Maybe it can go on for another year, 2 years, 3 years. The quicker we make that adjustment the better. That is the only way you can make it in an orderly way.

I think our time for making an orderly adjustment is running out on us. I can't tell you how long that time is. The longer we delay, the greater the difficulties are.

Mr. LEVIN. Let me press you a bit when you say time is running out. This statement about some fundamental economic adjustments, I didn't go back to your previous testimony of these 4 years, but my guess is there is a similar sentence in each of——

Mr. VOLCKER. I suspect so, yes.

Mr. LEVIN [continuing]. Each of the statements. I think as a result it is hard for us to assimilate, to react effectively to the testimony. It becomes in a sense—it is not routine. Your appearance here is never that. It is kind of more of the same.

Mr. VOLCKER. More of the same but things don't change.

Mr. LEVIN. How much urgency do you feel? Be as graphic as you can.

Mr. VOLCKER. I think there is a great deal of urgency. Look at it on the trade side, which I think really requires some fundamental measures to deal with. The urgency of the situation is apparent, I think, in the protectionist pressures that you are under. I do have in mind this textile bill that you are either going to pass over the veto or not.

You don't have to take very many of those measures to set the world in a very fundamental way on a kind of downward spiral of protectionism. I think we are very close to the edge of that. We are close to the edge of that because the underlying problem hasn't been dealt with.

We collectively don't have the hope, the vision, the evidence that things are fundamentally moving in a better direction. So long as we don't, we are put in fairly immediate jeopardy, I would say, on the protectionist side.

Mr. LEVIN. Our dilemma is unless we move on those specifics, we get no action on the underlying problem from the administration.

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Mr. VOLCKER. I don't know about that. I wish some of that urgency was transferred over to the budgetary question.

Mr. LEVIN. My time is up. I would just hope you, in your statements, could give us as much as possible your sense of time, because when you talk about months and years ahead, I think that formulation takes the heat off more than it applies it.

I must say that respectfully. Thank you very much.

The CHAIRMAN. Chairman Volcker, just within the past few days we read in the press that the San Francisco regional bank spent $45,000 in travel expenses and other costs for various functions honoring the retirement of the bank management. Then they spent $6,772 for functions honoring the outgoing president and his successor. Then San Francisco laid out $60,000 for travel to Hawaii and Alaska for the nine-member board of directors.

The bill for a single San Francisco directors meeting in Laguna, 9 of them, is $5,959. They must have been eating something imported and very, very elegant. Then they had a more modest dinner in Las Vegas for $1700 and then $373 to rent a boat to have an official off-site planning meeting.

The Chicago board spent $600 to meet in Callaway Gardens in Pine Mountain, GA. I guess they felt there were no facilities in Chicago that would fit the bill.

The Dallas board went to New York and they spent $16,000 but one of the items was $3,293 for a dinner for the nine-member board and their guests. You know, I entertained 200 people, cocktails, roast beef, and chicken dinner with salad and shells at the Bacci Club in Winsocket for $3,100. That is 200 people. Here the board of directors, it costs them $3,200. The Cleveland board spent $6600 on a dinner for the bank employees and guests.

Mr. Chairman, you keep suggesting and recommending, and we agree and we are trying to reduce the deficit, and the Fed has been on the lead on that to watch spending very carefully. Now, I understand that the memo that went out on this from the Fed here to the regional banks was that some Reserve banks have—the memo stated—have commented that the policy is too restrictive in today's economy. That is, the policy of trying to cut down expenditures. Reviews of Reserve bank expenditures by headquarters examineres have resulted in concerns that some Reserve banks may either not fully understand or have at times disregarded the policy.

Are these the people, some serve on the Open Market Committee? I can't understand that policy. Inquiries on expenditures continue to demonstrate congressional interest in the efficiency of reserve bank operations.

Mr. Chairman, you came up with great phraseology this morning that reversed the downward trend, or something like that, of interest rates. You had a great one for Marge Roukema too. Those were fine in the testimony. Do you think perhaps the next memo to the regional banks on these expenditures might say: Cool it, guys and gals, you are not setting a very good example?

Here we are in Washington preaching to the Congress, watch the deficit, watch the spending, and do as I say, not as I do.

Mr. VOLCKER. Well, we have had some hearings on this recently. I think we have nothing to apologize for in our overall spending targets or our performance or efficiency. I have the suspicion that

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while we are not covered by Gramm-Rudman, we may be the only agency in Government that meets the targets for next year.

I would note in response to your comments that this arose because of a memorandum written within the Federal Reserve Board precisely to raise questions about these expenditures. It covered a period of time when these were all questionable expenditures. They are obviously a matter of concern as reflected in the mere fact that that memorandum was written.

I can give you, I think, reasonable explanations for most or all of those expenditures, which I would be glad to put in the record. Let me just indicate some of them. This meeting in New York, for instance, we do encourage occasional joint meetings of Federal Reserve bank boards of directors with their counterparts. In this case it was Dallas going to New York, meeting with the New York bank and examining issues of common interest, and there were some 40 people at that dinner for $3,000. That is not the cheapest dinner in the world, but it is not out of sight by New York standards either, I think you will agree.

The rest of those expenditures were largely in terms of transportation and hotel expenditures for the Dallas board of directors, including some officers of the Dallas bank in traveling to New York. The expenses of the Chicago was not a board of directors meeting in Atlanta. They had a committee interested in improving their efficiency that went nearby to Atlanta because the Atlanta bank happens to have the best record of efficiency within the Federal Reserve System. They wanted to exchange views with the Atlanta bank.

The CHAIRMAN. That was Calloway Gardens.

Mr. VOLCKER. I don't know where it is. I am told it is quite close to Atlanta, which made it convenient.

The CHAIRMAN. When I went to Atlanta, with all due respect to Atlanta, I have been there on a Sunday and it was the pits. I didn't get to go to Calloway Gardens.

Mr. VOLCKER. I do not know——

The CHAIRMAN. I went there to make a speech and was sorry.

Mr. VOLCKER. I do not know whether Calloway Gardens is less or more expensive. I don't know Calloway Gardens.

The CHAIRMAN. Bo Calloway was a Member of the Congress. Let's go to San Francisco.

Mr. VOLCKER. I assume it is very economical.

The CHAIRMAN. Let's go to San Francisco.

Mr. VOLCKER. That was one of the big expenditures you cited. They fall basically into two categories. There were a series of events including some travel around the district by a retiring president where the employees had luncheons for him. Apparently the bank paid for the luncheons. There was also a dinner where all directors and ex-directors were invited that added up to some expense.

The CHAIRMAN. Excuse me. The dinner—is this erroneous? A bill for a dinner for directors, in Laguna, was $5,959. That is for nine directors. Is that an accurate——

Mr. VOLCKER. That expenditure includes transportation costs to that meeting as well as the overnight lodging and the meals.

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The CHAIRMAN. The report is inaccurate then because it wasn't just for the meal?

Mr. VOLCKER. That included everything, the meeting expenses, the accommodations, the travel to the site. The Las Vegas for $1,700, I don't know how they did it that cheaply. There were two more expensive meetings, as you pointed out, in Hawaii and Alaska where the directors and officers went to Hawaii and Alaska as part of a program to meet in the various States that are included in that Federal Reserve district. They did it twice in one year. They went to two States. In that particular year, which is what raised the question, within the Federal Reserve whether that was appropriate to go to two States in one year.

The CHAIRMAN. Thank you very much.

Mr. Carper.

Mr. CARPER. Thank you, Mr. Chairman. Mr. Chairman, welcome.

Mr. VOLCKER. I can provide a more detailed response for the record.

The CHAIRMAN. That would be wonderful. You certainly realize that Members of Congress, if they go to Alaska—not Alaska—I guess a lot of people like to go, but to Hawaii, it gets played up. The eyes of the press are upon us. Now the Fed has joined us in the scope of their interest.

Mr. VOLCKER. I would like to point out again precisely those kinds of questions are why questions about these expenditures arose for review in the first place.

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

PAUL A. VOLCKER
CHAIRMAN

September 12, 1986

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

This is the additional information that I indicated would be provided for the record in response to questions about certain Reserve Bank expenditures that were raised by Committee members during my testimony on July 29, 1986.

Federal Reserve policy on expenditures states that "the System as a whole is responsible for carrying out its responsibilities in the most effective and economical manner feasible, taking cognizance of the government's residual interest in the earnings of the System." Reserve Bank directors and management are charged with primary responsibility for ensuring that internal "discretionary" expenditure policies continue to be maintained and enforced in a manner consistent with the System's public nature while allowing sufficient flexibility to meet the needs of each District and to recognize community practices, when warranted and appropriate. The Board's examiners are instructed to review Reserve Banks' internal policies and expenditures for consistency with System policy, for the adequacy of controls, and for appropriate documentation of the business purpose.

Generally, we have found Reserve Bank expenditures are fully consistent with System policy and the public responsibilities of the organization. We do, however, keep the matter under review, and in the course of Reserve Bank examinations take care to review the record for any borderline or questionable items. The questions arising at the hearing were, in fact, derived from information contained in a memorandum from the Board's examiners to Board members serving on the Reserve Bank Activities Committee, describing certain Reserve Bank expenditures that were questioned during annual examinations of all Districts over an eighteen month period. The specific expenditures referred to

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were flagged by our examiners precisely because there was a question in the examiners mind as to whether they were fully in the spirit of one or another of the review criteria mentioned.

Following is a description and evaluation of the expenditures cited by Committee members:

Meetings of the Board of Directors of the Twelfth Federal Reserve District. The Twelfth District regularly schedules off-site meetings of its boards of directors in states that constitute its territory. This provides the opportunity for the directors and Bank officials to meet with community leaders to exchange views on local and national economic conditions. The most common vehicles for this exchange are community luncheons and dinners attended by Reserve Bank officers and directors and by community leaders. District management believes that these luncheons provide effective forums for beneficial exchanges of information and done without lavishness and at suitable intervals appear to be a reasonable use of Bank resources.

Expenses listed here differ in some cases from those reported previously by the examiners generally because they include the full amount of expense on each meeting, including travelers from all Twelfth District offices. In some cases the figures gathered by the examiners reflected only the cost for travel to the meeting from the office under examination.

Joint Meeting of the San Francisco and Seattle Boards of Directors in Anchorage, Alaska, on August 8-9, 1985. Total cost of the meeting was $29,719.52--$5,096 for lodging, $17,577.51 for travel, and $7,046.01 for meals, meetings rooms, and other expenses associated with the meeting activities. The meal expense included $4,587.06 for the cost of a community dinner which was attended by 125 local community and business leaders and the Federal Reserve group and $590.79 for the cost of a directors' dinner which was attended by 9 directors and officers and 4 community guests.

Meeting of the San Francisco Board of Directors in Honolulu, Hawaii, on December 11-12, 1985. Total cost of the meeting was $36,181.43--$18,672.14 for travel, $8,612.75 for lodging, and $8,896.54 for meals, meeting rooms and other expenses. The meal expense included $3,859.75 for the cost of a community luncheon which

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was attended by 214 local community and business leaders and the Federal Reserve group and $2,163.20 for the cost of a directors' dinner attended by 37 people.

Meeting of the Board of Directors of the Los Angeles Branch at Las Vegas, Nevada, on October 21-22, 1985. The meeting was held at a non-gambling hotel at a total cost of $4,918.24--$1,735.74 for travel, $1,118.15 for lodging, and $2,064.35 for meals, meeting rooms, and other expenses. The meal expense included $1,352.40 for the cost of a community dinner which was attended by 18 local community and business leaders and the Federal Reserve group.

Meeting of the Board of Directors of the Los Angeles Branch at Laguna Niguel, California, on November 25-26, 1985. Total cost of the meeting was $9,176.73--$510.24 for travel, $1,782 for lodging, and $6,884.49 for meals, meeting rooms and other expenses. The meal expense included $4,508.60 for the cost of a community luncheon which was attended by 228 local community and business leaders and the Federal Reserve group and $1,712.12 for the cost of a dinner for directors and community guests.

Expenditures associated with the retirement of the Bank president in the Twelfth Federal Reserve District. The District spent $45,131 for two official receptions and a District-wide employee luncheon to honor the retiring president. One reception was held off-site and was attended by 164 directors, officials and spouses at a cost of $16,073. The second reception honoring the retiring and the new presidents was held at the San Francisco Bank, attended by District officials and 13 spouses from branch offices, and cost $6,772. The employee luncheon provided meals for 2,139 District employees at a cost of $22,286. The extent of this recognition for the retiring official is questionable in relation to System expenditures policies and will not be repeated.

An additional $375 expense was incurred for a boat rental in connection with a Los Angeles officers off-site planning meeting at Newport Beach. This small expenditure was inconsistent with System policy.

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Joint Meeting of the Boards of Directors of the Cleveland, Cincinnati, and Pittsburgh offices of the Fourth Federal Reserve District on September 12, 1984. In connection with the board meeting, $6,609 was expended for a dinner at the Cleveland Bank and for associated activities to acquaint attendees with progress made by the City of Cleveland since its financial crisis of several years ago. The dinner and activities were planned for 61 directors, District officials, System officials, and spouses, with a per capita expense of $100 for the cost of food and the services and supplies associated with the displays and presentations on Cleveland. The expense of the dinner was $3,303 and the expense of the Cleveland presentations and supplies was $3,306.

Joint Meeting of the Boards of Directors of the Dallas, El Paso, Houston, and San Antonio offices of the Eleventh Federal Reserve District at New York City on October 17-18, 1984. The meeting was held in New York for the expressed purpose of promoting the directors' knowledge of Federal Reserve operations, specifically, System Open Market Account operations which are conducted at the New York Bank on behalf of all Federal Reserve Districts.

Expenses associated with the meeting totaled $16,311, which included $5,686 for travel, $4,369 for hotel, and $6,256 for functions and meals associated with the trip. The $6,256 included $3,293 for the costs of a dinner meeting for 40 people where the directors heard a presentation by the President of the Federal Reserve Bank of New York on economic conditions and the related operations of the System Open Market Account. The balance of the $6,256 included: $563 for a breakfast meeting of the Dallas District attendees, $504 for other miscellaneous meals, and $1,896 for other miscellaneous expenditures including registration fees for several Dallas officials to attend an American Bankers Association meeting in connection with their trip to New York.

Meeting of the Pricing Committee of the Chicago and Detroit offices of the Seventh Federal Reserve District at Pine Mountain, Georgia, on April 17-19, 1985. The meeting was held at this location, approximately 40 miles from Atlanta, in order to meet with Atlanta Reserve Bank management to discuss operational enhancements for the Chicago Reserve Bank because of the Atlanta Bank's outstanding record of operations performance. A site close to Atlanta was selected so that the Atlanta management could conveniently attend the meeting. Chicago representatives advise that the cost of this site compared favorably with

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that of downtown Atlanta hotels. Total expenses for this meeting were $6,618--$3,469 for travel, $1,840 for lodging and $1,309 for meals and meeting rooms.

I should point out once again that each of these expenditures were identified by the Board's own examining staff as part of our continuing efforts to assure that Federal Reserve Bank expenditures comply with guidelines laid down by the Board. The fact that, among 12 Reserve Banks and 24 branches, only 8 incidents, some involving small amounts, were deemed worthy of review, and these were for understandable and legitimate purposes, suggests problems are not common. Steps have already been taken to prevent a repetition of those few expenditures that appear, because of their extent, questionable in relation to System policy. I must again emphasize that it is the position of the Federal Reserve Board that Reserve Banks should conduct their business in a manner that is above reproach.

Sincerely,

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Mr. CARPER. Chairman Volcker, let me say I appreciate your comments on page 14 and page 20 on the international debt problem. I share with Senator Bill Bradley and other Members of the Congress a continuing uneasiness about the debt burdens of lesser developed nations where we seem in some instances to be providing additional loans to those countries so that they can service their existing debt.

Senator Bradley, I think, outlined in Switzerland a plan to reduce, for the banks to reduce by about 3 percent the interest that is charged on some of that debt and to ask the banks to write down by 3 percent per year the principal over the next 3 years. In turn, the LDC's would make certain kinds of changes along the lines you have outlined in your statement with regard to restoring competitiveness in their private sector, denationalizing certain industries, and beginning to buy some imports from countries that included the United States.

Senator Bradley's proposals have not been greeted with a great deal of warmth within the financial communities. It does, I think, have some interest here on the Hill. I would welcome your constructive comments on his plan and maybe some ideas of how we might make it better.

Mr. VOLCKER. I think, as you suggest, the approach is aimed at the same basic objectives of restoring growth and restoring the viability of those economies and not just incidently restoring them as a market of raw goods and the goods of other countries. The difference lies in what promises to be the most effective approach toward that end. Senator Bradley's approach, as you indicated, involves some interest forgiveness and debt forgiveness.

I have two rather basic questions in that connection. One is whether that is really the best approach toward the common objective when it seems inconsistent with the idea that those countries can get back and stand on their own feet and operate in time in markets normally which includes some reliance on bank credit over a period of time.

When you have that kind of negotiation default, I suppose you would call it, I think you raise some basic questions about their creditworthiness, not just in the short run but in the long run. There is a question as to the amount of assistance which is most effective in the short run. I suppose Senator Bradley would say that his numbers are negotiable and could be changed country by country, but I would point out in the specific case of Mexico, which I discuss in the statement, the amount of relief that they would get from a mechanical application of his plan anyway would be significantly less than the amount of resources that they would obtain assuming the success of the approach that is on the table at the moment.

That is related to a rather fundamental, I suppose, political as well as economic question. I don't think you can fit the approach that Senator Bradley describes without generalizing it. He almost assumes in one respect it will be generalized, as I read his proposal, in that everybody will be the beneficiary.

Of course, he would like to attach policy conditions to it. I would have to question the ability to attach reasonable policy conditions under the enormous political pressures that would arise among all

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countries. Where do you draw the border line to get a little debt relief? If that is an accepted practice in international finance, where do you stop it? Why stop at 3 percent? Why stop at 3 percent for this country when some other country, in different circumstances, following different policies, is going to certainly urge very strongly they are only going to pay 3 percent less than contract rate? So I think there are some very serious difficulties with that approach, and I tend to believe the present approach is more promising, although the objective is certainly a common objective.

Mr. CARPER. In our tax reform legislation currently before the conference committee, the conferees are addressing the issue of the deductibility of loan loss reserves. Could you take a moment and give us some of your thoughts on how we should treat that area, particularly in light of Senator Bradley's proposal?

Mr. VOLCKER. I do think in connection with the loan loss reserve specifically that a method of accounting for banks that permits some anticipation of loan losses is a proper accounting approach in banking and logically should be recognized in the tax system. So I would favor something like the present approach toward that problem and particularly in the current circumstances think it would be counterproductive to radically change the rules in a way that discouraged timely taking of or recognition of potential future losses in the banking system.

There was another aspect that is affected by tax reform that goes directly to both Senator Bradley's proposal and what is going on currently, and that is the question of tax credits that are available on lending to these countries. The Senate bill picks that up by deferring for quite a period of time the taking away of those tax credit benefits for countries that are affected by this debt situation. I also think that is important to give a long period of time for that adjustment to be made, given the circumstances that we have at present where these countries are dependent upon continuing amounts of bank credit being available.

Mr. CARPER. Thank you for your response.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Volcker, you alluded to economic development in our trading partners, but without fair access to their marketplace, which has not been the standard, that is to say—and of course it is arguable, but isn't that equally important? What good is economic growth going to do us if some of their own production would be consumed? What good is economic growth if we don't have a fair access to these marketplaces?

Mr. VOLCKER. That is a very important question, but quantitatively, I do not think it is as important in correcting our trade balance as these questions of general economic policy and development. Let me illustrate that simply by saying it wasn't very many years ago that we were close to balance in our trade position, were in balance roughly on our current account position. I don't think there have been tremendous, radical changes in our ability to access foreign markets during that period.

Mr. VENTO. I think that is arguable. I just think you cannot—all the economic growth or the realignment of the bloated U.S. dollar—and that is not universal, as you pointed out, with

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Canada—and so forth does not, unless we get free access to these markets. It has become, I think, increasingly apparent that there are a lot of nontariff barriers that exist and will continue to exist.

Mr. VOLCKER. There is absolutely no question there are a lot of these barriers. But simply in terms of relative importance, I think the underlying economic circumstances outweigh the amount of intensity of those barriers. There may have been some changes.

Mr. VENTO. I don't think any of us would disagree with that. The fact is unless you have access, you have real problems.

Are we going to come back, Mr. Chairman?

The other concern I have is that you allude to and there has been studies that have recently come out that point out the impact of foreign debt to LDC's and the impact that that has had in terms of the domestic market and the availability of credit and of course the price of that credit availability and obviously with the emphasis being that domestic credit prices have been appreciably higher on account of the foreign debt.

You know, with respect to the foreign debt and the amount that U.S. banks have taken responsibility for, the fact is that at one time I can recall we talked about the U.S. banks acting as conduits to access OPEC dollars. Today, of course, those excess OPEC dollars are not present. My question is twofold:

One, what is the source now of the credit that is being extended today currently? It obviously isn't exclusively OPEC dollars or largely OPEC dollars as it once was.

Two, what is the effect on domestic credit, specifically on the farm economy and others that have experienced it? We have maintained the interest rate, the disparity even with the reduced interest rates is still significantly higher, with, then, the inflation rate we have something less than 3 percent.

Mr. VOLCKER. The first comment I would make is with respect to Latin America there has been very little credit extension over the last 18 months. It may have gone down.

Mr. VENTO. What is the source of that, though? Is it still OPEC dollars?

Mr. VOLCKER. OPEC dollars are diminishing. The United States is an enormous capital importer. We are importing something like $150 billion a year of foreign capital. So the balance of capital movements now is enormously in favor of the United States and that is a very significant factor in interest rates being as low as they are and financial market conditions being as easy as they are in the United States now. We are a huge net beneficiary of foreign capital.

Mr. VENTO. The point is you say we have to keep our interest rates at a higher level to attract that capital today?

Mr. VOLCKER. The point I was making is the opposite. Our interest rates would be at a higher level if foreign capital was not available to us. There may be a point—we don't seem to have reached it—where it could present some limitation on how far our interest rates can go down because the foreign capital wouldn't come in. We haven't seen evidence of that, happily, so far. Certainly the reverse is true. Without that foreign capital, we would have far more difficulty in our domestic capital markets.

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Mr. VENTO. I have to go vote. You are familiar with the Joint Economic Committee study in terms of interest rates on the domestic scene visi-a-vis the Third World debt. Do you have any comments?

Mr. VOLCKER. I guess I am not familiar with that study. One might argue that at the margin some interest rates in the United States are higher because of the actual prospective losses the banks fear on the international debt. There are a lot of domestic credit problems that are also present that would move in the same direction. I am not sure that that influence is very detectable.

I think if we didn't manage the situation successfully, there could well be a repercussion on American interest rates and the availability of credit in the United States. That is one reason why it is so important to maintain management of this situation in an orderly way.

Mr. VENTO. Mr. Chairman, I have to vote. Thank you

Mr. FAUNTROY [presiding]. Thank you.

Mr. Chairman, I never miss the opportunity to remind you that while many of my colleagues have gone over to the House floor to vote, I remain to conduct the hearing. That is because while I represent more citizens who pay taxes, who are affected by these policies than any single Member of the House, and while I represent more people than elect 14 Senators, my constituents alone in America are subjected to the tyranny of taxation without representation. I hope that you will keep that in mind as you travel about the country and that those who are aware of that will put pressure on the Congress to correct this horrible situation.

But, Mr. Chairman, in your written testimony, you discussed the need for Americans to increase their savings rate at the same time as you state that the growth in consumer spending is what is keeping the economy going. Yet the growth of consumer spending is largely to blame for the current lack of savings as well as the need for foreign capital to bolster this void. How do you reconcile these positions? Last year you railed in eloquent terms—and I quoted you all over the country—telling us Americans are "borrowing more than we save," and "buying more than we sell," "by piling up debts abroad in amounts unparalleled in our history." Yet this seems to be what is keeping the U.S. economy going.

Ultimately, as I indicated in my opening statement, the piper must be paid. Insofar as consumer spending has been essential to this economic recovery, is economic growth now dependent on the tremendous buildup of debt? What long-term implications do we see in this Faustian bargain?

Mr. VOLCKER. I don't think it was dependent on the buildup of debt. It has been dependent on the short-term horizon on the strength of consumer spending. The only way I can reconcile that with the higher savings was maintaining the economic growth, quite obviously, by other changes taking place at the same time so that that source of spending and strength of the economy, in the short run sense, is replaced by other sources of strength that in fact will be more beneficial over time.

Specifically, you come back to the trade picture which has been a major drain on the economy and look toward some strengthening there, but not just because of the direct effects of the improved

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trade picture. They are important, but that should spread out into a better investment picture generally, and of course better investment over time, if we don't have the foreign capital, will require more savings than we have been able to generate or a lower Government deficit, probably more of the latter than the former, if that is going to be successful. All of these things have to adjust together, to use the not very enlightening jargon of the economists.

Mr. FAUNTROY. As you know, during the past several years I have become increasingly concerned about the effects of international competition on the structure of employment and wages in the United States. Given the proliferation of international competition, are there any measures the United States can take to lessen our dependence on international markets without resorting to protectionism? Can we become increasingly self-sufficient and gain a measure of insulation from the international economy? Or, are we bound to witness the gradual deterioration and polarization of our economy as financial, speculative, and other service industries experience a boom while the productive and industrial activities continue to deteriorate?

Mr. VOLCKER. I think the answer is we cannot go to self-sufficiency without building protectionist walls which would be very adverse to our basic interests over time. The absence of self-sufficiency does not and should not imply those other bad things you were saying. It can be quite consistent and must be consistent with reasonably balanced trade over time so that we can enjoy healthy growth here and certainly better growth than if we turned protectionist consistent with a reasonably strong external position. That involves a change in competitive position, and involves a change in trends in the world economy, but does not involve self-sufficiency.

Mr. FAUNTROY. My time has expired. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

I thank the Chairman of the Federal Reserve for not hurrying out so those of us on the bottom row here have a chance to ask questions. I have a few. The first is related to the falling dollar, and the question is: Let's assume that Germany and Japan do not act as you and Secretary Baker have been urging them to and the dollar continues to fall. How far are you willing to let the dollar fall?

Mr. VOLCKER. First of all, I reject the implication that I can prevent it or reverse it or whatever all by myself. I presume you mean the Federal Reserve and I will extend that comment to the Federal Reserve.

I think you can't evaluate how dangerous that is or how desirable or undesirable it is, in the absence of other circumstances. Again as a matter of emphasis, I think we would be better off, and I think other countries would be better off, if these growth patterns shifted rather than relying—at this stage—so heavily upon changes in the dollar to shift our trade balance. It's a matter of degree.

Mr. SCHUMER. But assuming that Japan and Germany do not do anything in terms of revving up their economies and creating more growth, do you not think the Federal Reserve at some point has to do everything it can to prevent the dollar from falling below a certain level?

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Mr. VOLCKER. Well, at some point it would give us real problems, but you must always evaluate that in the context of what else is possible. It is a potential restraint. On the other hand, you can imagine conditions in which that would be a lesser evil, so to speak.

Mr. SCHUMER. The next question is this: Since May, long-term interest rates have actually increased. Do you believe that increase is technical or structural?

Mr. VOLCKER. I don't believe it is structural I don't quite know what you mean by that. We had colloquy earlier which led to, I think, a consensus that long-term interest rates are still high in real terms if you assume a reasonably favorable inflationary outlook, as I would. So in that context, I would think there is plenty of room for long-term rates to move over over time, but it does rest upon that premise.

Mr. SCHUMER. But you do not think that the fact that long-term interest rates have gone up since May has meant that the markets have lost confidence in our fight against inflation? That was what I meant by technical and structural.

Mr. VOLCKER. That would be a very important question in consideration. I do not sense that. But if that were true at some point, it would present a very important problem.

Mr. SCHUMER. The next question relates to debt. We have heard lots of talk, and correctly so, about public debt and the Federal deficit, as you, I think, mentioned in a previous question. It would be very important for Congress to enact this budget resolution and turn the debt situation around.

Mr. VOLCKER. Correct.

Mr. SCHUMER. But much of the debt that has been incurred is private debt. Private debt has increased in great amounts. Do you see that as a great problem or as greater a problem than public debt? What would you recommend, if anything, be done about it?

Mr. VOLCKER. Well, I certainly think it is a problem when—as Mr. Fauntroy and others pointed out—the expansion of the economy seems to be so dependent upon increasing consumer and other debt, I think you have a potential problem down the road. Again I sound like a broken record, I realize, but it all fits into a larger pattern.

Part of that pattern of debt creation grows out of our very heavy dependence on domestic sources of growth, particularly consumption now. I think we would have a better balanced picture and expect to see less debt growth if we dealt with that external problem effectively. I don't think that is the only factor. We are certainly seeing just a straightforward retirement of equity in the business sector of some size to be replaced by debt. I think the implication of that is a weaker financial structure and various shorter term as well as a fundamental longer term tax incentive moves in that direction.

I think that is unsustainable as well. We can't go and continue to retire equity, or borrow or more leverage and thinner margins. I think that that basically undercuts the prospects for the kind of sturdy, continuing growth we would like to see over a period of years. You can quite obviously absorb that for a few years, but that

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trend can't continue without being very disruptive in terms of economic stability.

Mr. SCHUMER. I am taking the liberty to ask a follow-up question. Outside of tax structure, do you think there is anything that Government, the executive and legislative branches, could do to change that trend around?

Mr. VOLCKER. Well, that is a tough question. We took some very limited steps, as you know, in the merger area 6 months ago. I think some of it comes back to, most fundamentally, outside the general economic policy area, to the behavior of lenders as well as borrowers. You always have borrowers who are willing to extend themselves. Why are the lenders so acquiescent in permitting this extension beyond the point that is healthy.

That comes back to a supervisory job in the banking world and the savings and loan world and elsewhere. We are at work on that, and I think the attitudes are changing and conditions are changing, but there is a lot of momentum built into those behavior patterns that help give rise to this phenomena.

You can see we are now beginning to pay the price in the commercial real estate area. Again, that is not entirely separate from the tax situation, because there were a lot of tax benefits that helped boost this whole process. That doesn't fully answer the question why the lenders went ahead so eagerly. I am afraid in the savings and loan area, in particular, we have seen extreme examples in Maryland and Ohio of this kind of behavior being aided and abetted and facilitated by a combination of real estate development and banking, in effect.

I don't think that is entirely limited to the State insurance systems in Ohio and Maryland. I think we see symptoms of that elsewhere too. That is one of the reason—if I can get in a quick comment here—why I wish this committee and the Congress would get to work on banking legislation broadly speaking, depository institution legislation, to help us deal with some of these problems.

Mr. SCHUMER. Thank you, Mr. Chairman.

Mr. FAUNTROY. I thank you as well, Mr. Chairman. That might be one of the things you talk to the President about in the discussion that we hope you will have with him about both taxes and spending levels.

Mr. VOLCKER. You know what his answer is on the tax side.

Mr. FAUNTROY. We hope that you will convey our feelings to him, at least what some of the sentiments of the Members here are with respect to that pending tax legislation, especially since the current bill is apparently going to be revenue neutral.

Mr. Chairman, thank you again for another marathon appearance before the full committee on our Humphrey-Hawkins hearings—2½ hours this time. For that we are grateful. We always appreciate your skill, your information, and your candor, at times, in answering our questions.

With that, we will call the Humphrey-Hawkins hearings to a close.

Mr. VOLCKER. Thank you

[Whereupon, at 12:30 p.m., the committee adjourned.]

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APPENDIX

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

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

TUESDAY, JULY 29, 1986 — 10:00 A.M.
2128 RAYBURN HOUSE OFFICE BUILDING

I welcome you, Chairman Volcker.

Over the past several years, we have experienced a substantial increase in the amount of domestic and international debt owed others by the United States. Last year we became a net debtor nation, and within several years we will have accumulated more debt than any other country in the world. While we continue to enjoy the fruits of strong economic growth since World War II, for the first time in American history, we may well be facing a secular decline in the standard of living.

The budget cuts and other fiscal decisions of the Reagan Administration have finally begun to hit home. The New York Times quoted one professor as stating that he wondered whether Reagan will be viewed as a President who "stored up problems for the future." This "mortgage on the future", namely the sizable deficit spending of the Reagan Administration, largely responsible for spurring economic growth in 1983 - 1984, has now begun to exact its price.

Other related problems in the economy include:

** The record size of the trade deficit and its implications on manufacturing and agriculture;

** The seven percent unemployment which has lingered with us over the past two years with particularly adverse and increasingly negative effects on minorities;

** The international glut and subsequent deflation in commodity prices;

** A lack of business investment in the United States and the shifting of production overseas;

In light of these problems, one can become skeptical in addressing whether continued economic growth is possible in the short-run. If we are facing a slowdown in the rate of economic growth, what will the implications be for minorities, for trade sensitive industries, for Third World countries, and for future economic growth? Can economic slowdown be forestalled through measures other than those increasing the debt position of the United States?

In a New York Times article dated July 27, 1986, Robert D. Hershey stated the problem well. He writes:

> "The United States is importing far more goods than it sends abroad, and the industrial countries from whom it buys are piling up huge surpluses of cash that for lack of investment opportunities at home is sent back here to support an artificially high American standard of living. At the same time, the third world cannot sell enough of its raw commodities in sluggish world markets to service its huge debts."

In essence, we are living on both "borrowed time and borrowed money." The manner in which we as a people address this issue will likely determine both short and long-run prospects for the citizens of the United States. While I join my colleagues in welcoming Chairman Volcker, I do so in the hopes of receiving direct answers to how we might better address these problems.

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 29, 1986

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I appreciate the opportunity to report once again on the conduct of monetary policy. I would first like to place that matter in the larger context of the performance of the United States and the world economy.

As you know, there have been marked contrasts in the economic performance of different sectors and regions of this country. Consumption has been strongly maintained, and there have been large increases in employment in the broad service sector. Housing is being built at a high rate. But industrial activity and business investment, which had leveled off last year, have declined over the last six months, and the agricultural and energy industries are under strong pressure. As a consequence activity in some areas of the country has advanced rather strongly, while severe adjustments are taking place in the energy and agricultural belts.

The net result is that the overall economic growth rate in the United States moderated to about 3 percent through 1985 and early 1986, and apparently slackened further in the second

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quarter of this year. Moreover, growth in other major industrialized countries remained slower than in the U.S. during 1985 and the early part of this year.

Throughout this period, sizable increases in employment have continued in this country; the unemployment rate has remained generally at a little over 7 percent and, relative to the size of the working age population, more people are employed than ever before recorded. In Europe, unemployment has also remained relatively steady, but at much higher levels.

After more than three years of economic expansion, the process of disinflation has continued, reinforced for the time being by sharply lower prices of oil, by far the most important commodity. With industrial prices steady, the average level of wholesale prices has been declining here, and even faster in key countries abroad whose currencies have been sharply appreciating relative to the dollar. Interest rates here and abroad have also declined appreciably,

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reflecting both the sense of progress against inflation and the fact that growth has been proceeding well within capacity restraints.

The large decline in U.S. interest rates and the sharply higher stock market over the past year suggest the cost of capital has declined. The fall in oil prices has helped bolster the real income of consumers. Meanwhile, the substantial depreciation of the dollar has placed our industry in a decidedly better competitive position vis-a-vis other industrial countries. As many have suggested, these underlying forces should help sustain an economic expansion that has already lasted longer than most.

But I would be remiss in failing to emphasize much less satisfactory aspects of the U.S. and world economic situation. There can be no evading the fact that some fundamental economic adjustments must be made within our economy in the months and years ahead.

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The clear challenge is to find the ways and means to work through those adjustments in a context of sustained growth while also consolidating and retaining the progress toward price stability. The conduct of U.S. monetary policy is obviously relevant to that process. But that single policy instrument cannot itself provide the answer. Complementary approaches in the fiscal, trade and other policies of this country, and in the approaches of other countries, will be required as well. The hard fact is that, while the need for complementary actions to achieve the necessary adjustments in the United States and world economy seems to be more widely recognized, progress in coordinating action toward those aims has been limited.

Disequilibrium in the Industrial World

Some obvious imbalances have developed in the economies of the industrialized world. That is evident most of all in the enormous deficit in our external trade and current accounts, and in the counterpart surpluses of a few other countries. Unless dealt with effectively and constructively,

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growing market and political pressures will, sooner or later, inevitably have much more disturbing consequences.

The problem first clearly emerged some time ago. The powerful thrust of the strong U.S. economic expansion in 1983 and 1984 had spilled out abroad in the form of sharply rising imports, aided and abetted by the exceptional strength of the dollar internationally. There were, for awhile, benefits on all sides. At a time of slack demand at home, exports to us helped Europe and Japan to restore and maintain their growth. The United States also absorbed a disproportionate share of the necessary external adjustment efforts by the heavily indebted countries of Latin America. Those countries have sharply curtailed their imports since 1982, and they have become more competitive in markets for manufactured goods.

At the same time, the United States began to be the recipient of a growing flow of capital from abroad. That inflow, which pushed the dollar so high in the exchange markets

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until early 1985, had the practical effect of relieving potential pressures on our internal financial markets even in the face of the massive and growing federal deficit. Consequently, private investment and construction could expand. At the same time, the competitive pressure from imports encouraged strong cost-cutting and productivity efforts in the industrial sector. That has been one powerful factor accounting for the near stability of prices of manufactured goods over the past year or more.

We cannot, however, build a lasting foundation for sustained growth and stability on massive international disequilibrium -- huge and rising trade deficits in the United States and counterpart surpluses abroad. Nor can we count on satisfying indefinitely so much of our own needs for capital by drawing so heavily on the savings generated elsewhere in the world -- savings that have been so freely available in part only because internal growth in Europe and Japan has been relatively slow.

Today the imbalances and strains are clearly showing. The forward momentum of our economy has been sustained almost

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entirely by consumer spending and housing construction, both of which have been accompanied by unsustainably heavy borrowing. Savings meanwhile have remained at a relatively low level, even by past U.S. standards. For more than a year, industrial production in the United States has not grown appreciably, and there has been some decline in 1986. The pace of business investment has slackened.

Some of the relative weakness in industrial output and investment over the past six months can be attributed to temporary factors and to developments peculiar to the United States. For instance, some investment orders were speeded up late last year in anticipation of tax reform, and the debate on the nature of that reform has apparently led to some deferral of ordering this year. The boom in spending for computers has subsided and commercial construction, in response to large and growing vacancies of office space, is predictably declining. Probably much more important in recent months have been very sharp cutbacks in domestic oil exploration and investment,

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driving energy producing states into recession-like conditions and affecting production of steel and equipment elsewhere as well.

But a large part of the difficulty stems from the continuing imbalances in the world economy. On the average, growth rates in major European economies and Japan were about 3/4 percent less than the reduced growth path of the United States during 1985 and the first quarter of 1986. However, the more disturbing contrast lies in the source of that growth.

In the United States, the rate of growth in domestic demand, while slowing in the third year of expansion, continued to average about 3-3/4 percent through that period. Domestic demand growth in the industrialized countries of Europe and Japan was significantly less -- about 2-1/2 percent. In the early part of this year, when their exports slackened, those countries grew not at all.

The plain implication is that our overall GNP growth rate was reduced by continuing deterioration in our trade and current account balances. With our current account

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deficit reaching a record $135 billion annual rate in the first quarter of this year, industrial production and investment were restrained. Meanwhile, foreign surpluses continued to build through much of the period, and as their exports have slowed, internal demand has not yet, in most of those countries, picked up the slack.

Prospects for investment and for manufacturing activity in the United States are heavily dependent on an improved trade outlook. The sharp decline in the dollar since its peak in early 1985 should help set the stage for such an improvement. There is evidence that U.S. producers find themselves in a stronger competitive position. However, the deterioration in actual trade in manufactured goods has slowed little.

The decline in the dollar is both relatively recent and from a very high level so the absence of a stronger response in trade so far is not entirely surprising. What is of concern is that the domestic markets of our major industrial competitors have remained so sluggish, raising a question as to the buoyancy of the markets for our exports and of their own growth prospects.

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You are well aware that the present imbalance among industrial countries is reflected in strong protectionist pressures in the United States. Yet, as the President has so strongly emphasized, to abandon our tradition of relatively open markets would surely be to invite an unravelling of the international trading order. We would then have less trade and more inflation. With that, prospects for sustained growth both here and abroad would clearly be placed in jeopardy.

I know of the complaints about "unfair" trading practices of other countries. We need to deal with them energetically. But I also know the clear lesson of experience is that a protectionist retreat by the United States, the world's leading economic power, would invite recrimination and escalation. Certainly, the most effective and promising avenue for dealing with the trade complaints on all sides will be in the planned round of multilateral trade negotiations rather than in a tit-for-tat process of mutual retaliation.

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Moreover, I believe it is demonstrable that, as a matter of relative importance, much more fundamental imbalances in the world economy than unfair trading practices are responsible for the present pattern of trade deficits and surpluses. Those underlying imbalances can only be dealt with by complementary economic policies, not protectionism.

Quite clearly it is in no one's interest -- not the United States or other countries -- that we seek better balance in our external accounts by deliberately restraining further our own growth rate. But it is also true that as things now stand, stronger domestically generated growth in the United States will not reduce the international imbalances. Taken alone, it would aggravate our trade deficit further, posing an even more difficult adjustment problem later.

As I suggested, the recent exchange rate changes can help us to escape that dilemma -- they should work to improve our trade position and reduce the surpluses of others. In fact, faced with a combination of appreciating currencies and slower growth in overseas markets, exporters in both Japan and

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some European countries are experiencing reduced profits and more sluggish orders from abroad. However, in the absence of offsetting internal sources of expansion, those same pressures could dampen their own prospects for growth.

That is one of several reasons we should not rely on exchange rate changes alone to produce the needed international adjustments in the world economy. Over a number of years, we in the United States will certainly need to shift more of our resources into exports, and into recovering domestic markets where import penetration has been so high. That, very broadly, implies relatively more growth in manufacturing; relatively less growth in services, in governmental spending, or in other sectors; and more savings and less borrowing. For some of the rest of the world, the opposite shift will need to be at work -- less reliance on exports, and more on domestic sources of growth.

Much still needs to be done to ease the way for those adjustments. For one thing, we in the United States are not

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prepared for a really large improvement in our trade balance. Our financial markets remain dependent on the large capital inflows from abroad that are a necessary counterpart of our trade and current account deficits. Moreover, taken by itself, depreciation of our currency in an effort to redress the trade deficit poses a risk of renewed inflation.

Only as our huge federal deficit is cut can we comfortably contemplate less borrowing abroad and provide assurance against renewed inflation. Put another way, in a growing economy, reductions in the federal deficit will be necessary to release the real and financial resources necessary to improve our trading position in a way consistent with rising investment.

In a few foreign countries, such as Germany, some signs of stronger internal growth have appeared in recent months. But such signs are far from uniform among key countries abroad, and most projections of their growth for this year have been lowered, not raised, as exports have slowed.

With rising currencies and falling oil prices, some of those countries after years of effort have now successfully

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achieved virtual stability in consumer prices. Moreover, their wholesale prices have declined sharply and are appreciably lower than a year ago.

All of us -- and certainly this central banker -- can appreciate the importance of maintaining a broad framework of stability and appropriate financial disciplines to sustain that progress. What is at issue for some countries is their ability to achieve and maintain vigorous internal growth at a time of high unemployment and ample resources as external stimulus fades away, as it must if international equilibrium is to be restored. The appreciation of their currencies and the strong deflationary influences of low oil and other commodity prices would appear to offer a prime opportunity for reconciling those goals of domestic growth and stability.

The International Debt Problem

Four years after the international debt problem broke into our collective consciousness in 1982, when Mexico abruptly lost access to international credit markets, that threat to our

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mutual prosperity remains. The renewed difficulties of the oil producing countries today should not, however, obscure the progress that has been made. Collectively, the heavily indebted countries of Latin America and elsewhere have made an enormous effort to adjust their external accounts; in fact in 1984 and 1985 they were in rough current account balance, in contrast to an aggregate deficit of about $50 billion in 1982.

To be sure, that effort for a time was accompanied by sharply lower imports, recession, and lower standards of living as they brought their spending more in line with their internal resources. But it is also true that many of those countries are again growing, in some cases with vigor, as is the case with the largest single debtor, Brazil. Helped by the reduction in world interest rates, external interest burdens have been reduced appreciably in some countries relative to exports or other measures of capacity to pay. A number of Latin American countries have also made striking progress in dealing with ingrained inflation for the first time in many years, in the process gaining political support. There has been considerable, if uneven, progress toward liberalizing

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their economic structures in ways that should encourage more growth and productivity over time.

In the midst of this progress, the sharp decline in oil prices over the past six months has had an enormous adverse impact on the oil-exporting heavily indebted countries -- Venezuela, Nigeria, Ecuador and Mexico. At current oil prices, for instance, Mexico would lose about a third of its 1985 exports, perhaps as much as 15 percent of its government revenues, and the equivalent of some 5 percent of its GNP. Inevitably, that situation poses a new and severe challenge for Mexico -- a challenge that will require strong new efforts to make the necessary economic adjustments and to improve the structure of their economy. There is no large cushion of external reserves to buffer the shock. Consequently, a large amount of financial resources will have to be marshalled from abroad to help ease the transition, to maintain continuity in debt service, and to provide a solid base for renewed growth.

That combination of adjustment, structural change, and appropriate financing is, indeed, the essence of the approach announced by the Mexican Government earlier this week. In

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cooperation with the IMF and the World Bank, Mexico is undertaking a wide range of efforts to deal with both its short- and longer-range economic problems. To my mind, their efforts, in the midst of crisis to move toward a more open, competitive economy, are particularly encouraging. They have joined GATT, import restrictions are being rationalized and liberalized, a good many state-owned enterprises are being made available for sale (or, if too inefficient, shut down), subsidies are being reduced and eliminated, and procedures for approving foreign investment eased. If carried through effectively, those measures promise to work toward fundamental improvement in the efficiency, competitiveness, and creditworthiness of the Mexican economy, thereby enhancing prospects for longer-term growth.

Today, that country is in recession. But the program clearly contemplates economic recovery in 1987 and 1988. Certainly, sizable amounts of financing from abroad will be

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required to support that effort. About half of that can be committed by the IMF, the World Bank, and the Inter-American Development Bank. But Mexico is calling upon commercial banks, with so much already at stake, to play a large role as well.

In assessing that situation, I would note that the Mexican exposure of commercial banks appears not to have increased for some 18 months. Indeed, there has been little net new lending to Latin America as a whole over the past year.

Taking the entire period since mid-1982, the exposure of American banks to the heavily indebted countries of Latin America relative to their capital has declined appreciably. That ratio fell from about 120 percent of the capital of lending banks to less than 75 percent at the end of last year, a decline of 38 percent. No doubt, there has been a further reduction by now.

Those exposures, in relative terms, are actually considerably less than in 1977 when the data were first collected. For some time, the pace of lending has, in fact,

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been well below that contemplated by Secretary Baker when he set out a framework for a growth-oriented approach toward the international debt problem at the IMF meetings last autumn.

That initiative -- essentially contemplating a combination of strong adjustment efforts and structural reform by the indebted countries with reasonably assured financing by international institutions and private banks -- is now being tested. It is being tested in difficult circumstances not foreseen at the time -- the sharp break in oil prices. But the basic community of interests among borrowers and lenders -- and the world at large -- in a coherent, cooperative approach is as strong as ever.

The debtor countries themselves have an enormous stake in maintaining their creditworthiness and in seeking solutions in the framework of open, competitive markets. We all have a strong interest in international financial order -- all the more when there are other points of strain in the banking system. And, of course, relationships beyond the purely economic are at stake, for the United States most of all.

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The challenge is large, but with cooperation, also manageable. Indeed, the same oil price decline that has undermined the budgetary and trading position of Mexico and other large oil exporters has relieved the pressure on those importing oil. Interest rates have declined. A number of borrowing countries will require significantly less, rather than more, financing than was contemplated a year ago. Given the enormous progress made in adjusting external positions, most of the borrowers can look toward more balanced expansion in their imports and exports as they grow -- among other things, providing renewed opportunities for American exporters.

But I must also emphasize one essential ingredient for success beyond the capacity of the indebted countries to manage. Only a stable, growing world economy, with markets open to the developing world, can provide an environment conducive to economic expansion, more normal interest rates, and orderly debt service by the borrowers. That ingredient is plainly the

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responsibility of the industrialized world alone. It is one of the reasons why we must collectively deal with the obvious imbalances among us.

Monetary Policy in 1986

These larger issues were the background against which the Federal Reserve has conducted monetary policy in 1986 and reviewed its objectives for growth in money and credit this year and next. The results of the review by the Federal Open Market Committee of target ranges for money and credit for 1986 and tentative ranges for 1987 were discussed in the Humphrey-Hawkins Report published and sent to the Committee at the end of last week. That report also sets out projections for real activity and prices of FOMC members and Reserve Bank presidents.

As indicated in the Report, the posture of monetary policy remained broadly accommodative over the past six months. The discount rate has been reduced in three steps this year by 1-1/2 percent, in part responding to and in part facilitating

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declines in short-term interest rates of similar magnitude. Long-term interest rates also moved lower, extending the sharper drops in the second half of last year. The general structure of interest rates is now as low as at any time since 1977.

The reductions in interest rates in 1985 and 1986 have clearly helped support the more interest-sensitive sectors of the economy, reflected in part in the highest level of housing starts since the late 1970s. The declines have also helped ease the debt servicing costs of businesses, farmers, developing countries and the U.S. Government itself.

On the other side of the ledger, as interest rates have declined, the rate of growth in debt has remained at disturbingly high levels, although there are at least faint signs of a slackening in the rate of debt creation after a burst around the turn of the year. The declines in interest rates also clearly helped induce the general public to increase its holdings of its most liquid assets, including demand deposits and NOW accounts included in the narrow measure of the money supply, M1. That reaction

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was undoubtedly amplified by the fact that interest is paid on NOW accounts, which are now the favored form in which transaction balances are held by individuals. With interest rate spreads currently quite narrow between NOW accounts and other liquid assets, those accounts no doubt have served increasingly as a repository for liquid savings as well as for money held for transactions purposes.

Similarly, there are some indications of a greater willingness of businesses to hold demand deposits at a time of lower interest rates, partly because, with interest rates down, a larger balance is necessary to compensate banks for a given amount of services. To some extent, an environment of more stable prices may also be encouraging larger money holdings.

None of that was predictable with any precision, and the rate of growth in M1, which ran at almost 13 percent over the first half of the year, was far above the FOMC's target range. Action to restrain that growth within the target range -- which

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would have required reducing the provision of reserves and a significant increase in pressures on bank reserve positions -- was not deemed desirable in the light of other important considerations.

One of those considerations was that growth in the broader measures of money -- M2 and M3 -- remained well within their respective target ranges of 6-9 percent, ending the second quarter close to their mid-points. That and other evidence suggested that much of the growth of M1 reflected a shifting of the composition of liquid assets rather than excessive, and potentially highly inflationary, money creation. That judgment was, of course, reinforced by the moderate rate of growth for the economy overall, the absence of indications of a strong acceleration as the year progressed, evidence of greater stability in prices of manufactured goods, and declining commodity prices.

In looking ahead, the Committee decided to retain the existing ranges of 6-9 percent for M2 and M3 this year. The

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range of 3-8 percent set for M1 early in the year was not recalibrated because of the uncertainties as to the behavior of that aggregate at present. Certainly the inflationary potential of excessive money growth remains a matter of concern. But in current circumstances, the Committee decided that the significance of changes in M1 could only be judged in the context of movements in the broader aggregates, and against the background of movements in interest rates and the economy generally. Taking account of those factors, growth in excess of the target established at the start of the year will be acceptable.

In circumstances of greater economic, price, and interest rate stability, more predictable relationships between M1 and the economy may reemerge over time, although the trend of M1 velocity -- the ratio between GNP and M1 -- will likely be different than earlier in the postwar period. However, a firm conclusion concerning the nature and stability of future velocity characteristics may take years of experience in the new institutional and economic setting. For the time being, in

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looking to next year, the Committee set out a highly tentative range of M1 growth of 3-8 percent on the assumption that velocity changes will be within the range of most postwar experience. However, that judgment -- and indeed the weight to be given any M1 range for 1987 -- will be carefully reviewed at the start of next year.

The tentative 1987 ranges for M2 and M3 were lowered by one-half percentage point to 5-1/2 - 8-1/2 percent. That modest reduction, consistent with the long-term objective of achieving a rate of monetary growth compatible with price stability, is judged to be entirely compatible with a somewhat greater rate of economic growth next year, provided that growth is not accompanied by a marked increase in inflationary pressures.

The actual price statistics for some months have, of course, reflected the precipitous drop in the price of oil, and consumer prices have dropped slightly this year. But equally clearly, the price of oil will not continue falling so fast, and at some point could well rise again. More

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predictably, the large depreciation of the dollar will bring in its wake an increase in import prices of manufactured goods. That impact has been moderated so far by the narrowing of the earlier wide profit margins of many of those exporting to us and by the availability of imports from developing countries, few of which have had any appreciable appreciation of their currencies vis-a-vis the dollar.

The rate of increase in costs of housing and of many services, which account for a large proportion of the economy, has decelerated little if at all in recent years. With demand strong, measured productivity gains limited, and compensation increases in service occupations continuing to average 4-1/2 percent or more, those areas continue to lend a chronic inflationary bias to the general price level.

Those underlying forces are reflected in the projection of FOMC members and Reserve Bank presidents that the overall inflation rate is likely to be somewhat higher next year. That prospect underscores the need for vigilance in the conduct of

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monetary policy. We want to assure maintenance of the remarkable progress toward stability as the economy grows more strongly and as a large amount of resources are shifted back to manufacturing industries as our trade balance improves. Without such assurance, there would be no firm basis for expecting the level of interest rates to remain for long at lower levels or to decline further.

In looking toward growth in the 3-3 1/2 percent range next year, considerable emphasis was placed by Committee members on the potential contribution to that growth of a stronger trade balance. As I emphasized earlier, that shift, if it is to take place in the context of sustained and stronger world growth, will require appropriately complementary policies here and abroad. Significant progress toward dealing with our own budget deficit seems to me a key ingredient in that overall policy "mix."

The timing of another important domestic policy instrument -- discount rate cuts -- has been influenced by

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international financial and exchange rate considerations. A substantial realignment of the excessively strong dollar exchange rate has been a necessary and constructive part of achieving the necessary adjustment in external trade. But there are clear dangers in placing excessive weight on that approach.

History demonstrates all too clearly that a kind of self-reinforcing cascading depreciation of a nation's currency, undermining confidence and carrying values below equilibrium levels, is not in that nation's interest or that of its trading partners. Among other things, such a movement of the dollar now could transmit strong inflationary pressures to the United States and inhibit the free flow of capital from abroad at reasonable interest rates. Moreover, other countries would find it more difficult to sustain their forward momentum.

In the light of all these considerations, the discount rate reductions in March and April were timed to coincide with similar changes by one or more other key countries, minimizing

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any impact on the exchange markets and consistent with the desirability of some reduction in interest rates in the industrialized world generally.

Some Lessons of Recent Experience

Experience over the first half of 1986 underscored the difficulty -- I would say the impossibility -- of conducting monetary policy in current circumstances according to one or two simple, pre-set criteria. For instance, the rapid growth of debt and M1 clearly bear watching because of the potential for aggravating the vulnerability of the financial structure to adversity and because of the inflationary potential. However, the weight of the evidence strongly suggests that M1 alone during this period of economic and institutional transition is not today a reliable measure of future price pressures (or indeed a good short-term "leading indicator" of business activity). The more restrained performance of the broader aggregates, as well as the performance of the economy and prices themselves, point in a different direction.

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At the same time pressures on the oil industry, agriculture, and parts of manufacturing and the more general disinflationary process are reflected in strains on some depository institutions. Those strains emphasize the importance of dealing with factors more directly under the control of lenders themselves: excessive leveraging of borrowers and loose credit standards. A broad array of approaches by the supervisory and regulatory authorities has been necessary to deal with the particular points of pressure in a manner consistent with the stability of the entire fabric of financial institutions and markets.

The present situation certainly makes all the more pointed the need to provide a stronger sense of legislative direction about the evolution of the financial system over time. There are also urgent specific pieces of legislation

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before you to permit the FDIC and the Federal Reserve to facilitate interstate acquisitions of failed or failing banks and to supplement the resources of the FSLIC.

The difficulties of some financial institutions are one specific example of economic problems that cannot be effectively dealt with by monetary policy alone. It is indeed a strength of monetary policy that it can respond flexibly to changing circumstances. But it is equally true that that single, broad-brush policy instrument cannot, at one and the same time, be called upon to stimulate the economy, protect the dollar, restrain excessive debt creation, and shift resources away from consumption and back into investment, manufacturing and exports -- as desirable and important as all those goals may be.

Events of recent years have also heavily underscored how cumbersome fiscal policy can be, and the difficulties of achieving political consensus on such matters as tax reform and the appropriate legislative framework for financial

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institutions. On an international scale, achieving consensus on appropriate action can be still more difficult.

We have nonetheless come a long way toward restoring growth and stability in this decade. But my sense is that all that progress is in growing jeopardy unless we act -- we in the United States, we in the industrialized world, and we in the world as a whole -- in mutually supportive ways.

The main directions of that effort seem to me clear enough. The Gramm-Rudman-Hollings legislation is an expression of the sense of urgency surrounding our budgetary effort in the United States. The rest of the industrial world needs to achieve and maintain a momentum of "home-grown" expansion. With strong national and international leadership -- and with the cooperation of private and public lenders -- a constructive resolution of the economic crisis in Mexico can point the way to a wider resolution of the debt problem in a context of growth.

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Hard as it may be to carry through on those efforts, that is what needs to be done if the imbalances in the economy are to be effectively addressed. Then we will have a really solid base for sustaining the momentum of growth and the progress toward stability in the years ahead. Certainly, the Federal Reserve will play its part in that effort.

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For use at 4:30 p.m., E.D.T.
Friday
July 18, 1986

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 18, 1986

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Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 18, 1986

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1986 and 1987

Sharp contrasts among sectors and regions of the economy characterized economic developments during the first half of 1986. Reflecting in substantial part continuing strong competitive pressures from abroad and large spending cutbacks in the oil industry in response to sharply declining prices, industrial and investment activity were restrained. In contrast, activity continued to expand rather strongly in housing, the financial sector, and the broad service area of the economy. On balance, real gross national product remained on a rather sluggish growth path.

Although there are substantial uncertainties about the degree and timing of a pickup in economic activity, a number of positive economic and financial developments have occurred that should provide the basis for somewhat faster economic growth and some reduction in unemployment over the year ahead. Interest rates have moved lower, and, reflecting the decline of the dollar on foreign exchange markets, U.S. industry is in a stronger competitive position internationally. In addition, inflation has remained subdued, reflecting not only declines in the prices of energy and other basic commodities but also continued restraint on wages in many sectors. Much of the uncertainty about a pickup in growth turns on the strength of economic performance in other industrialized countries, and there also is some concern over the transitional effects of tax reform legislation.

What monetary policy has been able to do, during a period of greater overall price stability and adequate capacity relative to the demands actually placed upon it, is to accommodate demands for money and credit, helping to facilitate further declines in interest rates. Monetary policy by itself

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cannot eliminate or deal with the sectoral imbalances that are still troubling the economy. A reduction of the large deficit in the nation's external accounts is of critical importance over time, and this will be difficult to achieve in an orderly way without faster growth in key foreign economies. Agreement on tax reform also would remove a major source of uncertainty that probably has inhibited growth in the first half of the year; over time, substantial progress toward eliminating federal budget deficits is essential to achieving better balance in the U.S. and world economies. Overall, prospects for the economy appear to be favorable, but much will depend on the evolution of policy, both in this country and abroad.

Economic and Financial Background

The first half of this year saw a continuation of the reduced pace of economic growth that has prevailed since the middle of 1984. Although the service industries have been strong, manufacturing activity has been relatively sluggish in the face of strong foreign competition, and some sectors, such as energy and agriculture, are under strong pressure. The economy has generated a substantial number of new jobs this year, but the labor force also has grown rapidly and the unemployment rate has remained around 7 percent.

Perhaps the most significant economic event in the first half of 1986 was the plunge in world crude oil prices. Despite the potential longer-term benefits from this development, the initial impact on the U.S. economy was negative as, with less of an incentive to search for new sources of supply, oil exploration activity was cut back sharply. However, falling crude oil prices have been translated quickly into lower rates of inflation

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for a time, and in addition, they have damped expectations about future price increases. Consumer confidence has been high, and with purchasing power boosted by the decline in energy prices, consumer spending has been strong. By damping inflation expectations, the drop in world oil prices also spurred a rally in credit markets, further extending the decline in interest rates that had begun in mid-1984.

Against the background of relatively slow economic growth and little overall price pressure, monetary policy basically has accommodated strong demands for reserves to back deposits thus far in 1986, while responding to and facilitating the drop in market interest rates with three half-point cuts in the discount rate. At the same time, with the dollar under downward pressure in foreign exchange markets during most of the period and the economies of other key industrial countries somewhat weak early in the year, international economic and financial developments remained an important consideration in the conduct of monetary policy. Similar official interest rate changes in several major foreign countries, where growth also has been slower than expected, took place around the time of the first two Federal Reserve discount rate reductions this spring. The coordinated cuts helped avoid the potential for disturbing exchange market conditions.

Reductions in other short-term rates were generally in line with the 1-1/2 percentage point total decline in the discount rate since the end of last year. Yields on long-term credit market instruments fell by as much as 2-1/4 percentage points, encouraged not only by the revision of inflation expectations that seemed to be keyed to falling energy prices, but also by the sluggish performance of the economy and, early in the year, by the

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restraining effect of the Gramm-Rudman-Hollings legislation on expected federal budget deficits.

These and earlier declines in market rates had a particularly strong effect on the narrow monetary aggregate. By June, M1 had grown at a 12-3/4 percent annual rate from its fourth-quarter 1985 level, well in excess both of its 3-to-8 percent target range, and of the growth in the economy. Over the first half of the year, the velocity of the aggregate appears to have declined at a faster rate than the postwar record decline in 1985. The interaction of lower interest rates with the changed composition of M1 since deposit deregulation explains a good portion of this rapid velocity decline. The public apparently has been shifting a considerable amount of its savings into the NOW account component of the aggregate in response to relatively large declines in rates on competitive outlets for liquid funds. Growth in demand deposits also has been quite strong, likely related to the effect of lower interest rates on the balances that businesses must hold to compensate for banking services, as well as to a surge in financial market activity. Even after taking account of these factors, however, the strength of M1 appeared extraordinary in the first half.

The broader aggregates grew more moderately, ending the first half near the middle of their respective 6-to-9 percent target growth ranges. Nevertheless, the strong demand for liquid assets, generated by the relatively large declines in long-term rates, was evident not only in soaring M1 balances but also in the composition of the broader aggregates. For example, the more liquid components of M2 grew rapidly, while its time-deposit component increased only marginally. Over the same period, the debt of domestic nonfinancial

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sectors is estimated to have remained somewhat above its monitoring range, growing well in excess of GNP.

The substantial declines in long-term interest rates since the middle of last year has helped buoy interest-sensitive sectors of the economy. Activity in the housing market was quite strong in the first half of 1986, supported by the lowest level of mortgage rates in over seven years. The reduction in interest rates also was a factor in the strength of consumer spending, both by reducing the overall cost of credit and by raising the value of the household sector's security holdings.

Although the foreign exchange value of the dollar has fallen by a third from its 1985 peak, the depreciation apparently has not yet produced a substantial increase in the volume of exports or a reduction in the volume of imports. Adjustments of trading patterns to exchange rate movements take place over a number of years, and it is not surprising that a dramatic improvement in our large merchandise trade deficit has yet to occur. However, progress has been somewhat slower than might have been expected, partly because of the slow growth in other major industrialized countries. The continuing appreciation of the dollar against the currencies of many developing nations also has been a factor.

The influence of strong foreign competition remains pervasive. Agricultural products are in ample supply worldwide, reducing the export opportunities of our producers. In manufacturing, many industries continue to face weak foreign orders, while an increasing portion of domestic demand has been met from abroad in spite of price increases on some competing foreign products. With little observed pickup in demand, many firms have scaled back their expenditure plans, and capital spending remains weak as a result.

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Ranges for Money and Debt Growth in 1986 and 1987

The FOMC reaffirmed the 1986 ranges of 6 to 9 percent that had been established in February for M2 and M3; as noted above, the broader monetary aggregates ended the first half of the year near the middle of those target ranges. For 1987, the Committee tentatively decided that, consistent with its intention to achieve money growth at a rate consistent with maintaining reasonable price stability and sustainable economic expansion, the target growth ranges for both M2 and M3 would be lowered by 1/2 percentage point, to 5-1/2 to 8-1/2 percent, measured from the fourth quarter of 1986 to the fourth quarter of 1987. Those ranges were felt to be consistent with a pickup in economic growth.

The rapid rise in M1 over the first half of the year underscored the degree of uncertainty surrounding the behavior of the aggregate and, in particular, about its behavior relative to GNP. The nature of the relationship among M1, income, and interest rates appears to have been significantly altered by the changed composition of the aggregate in recent years, as well as by the prospects for greater price stability. The precise implications of these developments for the future are not yet clear, given the limited experience to date. In these circumstances, the Committee decided that growth of M1 in excess of the previously established 3-to-8 percent range for 1986 would be acceptable and growth in that aggregate over the balance of the year would continue to be evaluated in light of the behavior of the other monetary aggregates. Developments in all the aggregates will be judged against the background of developments in the economy and financial markets and potential price pressures.

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With respect to 1987, the Committee expressed the preliminary view that the current range for M1--3 to 8 percent--should provide for adequate money growth to support continued economic expansion, assuming that a greater stability reemerges in the link between M1 and income in a more stable economic, price, and interest rate environment than has existed in recent years. However, in the context of the experience of the past several years and keeping in mind the exceptional uncertainties in predicting the behavior of M1, the Committee at the end of this year will review with particular care the appropriate range and weight to to be placed on M1 in 1987.

Ranges of Growth for Monetary and Debt Aggregates
(Percent change, fourth quarter to fourth quarter)

	1986	Tentative for 1987
M1	[3 to 8]*	[3 to 8]**
M2	6 to 9	5-1/2 to 8-1/2
M3	6 to 9	5-1/2 to 8-1/2
Debt	8 to 11	8 to 11

* While no new range was specified for 1986, growth in excess of the established range would be acceptable.
**Indicative of likely range if more stable velocity behavior shows signs of reemerging.

As shown in the above table, the FOMC did not change the 1986 "monitoring" range for the credit market debt of domestic nonfinancial sectors and tentatively retained the same range for next year. It was anticipated that the debt aggregate might exceed the 8-to-11 percent monitoring range for 1986 as a whole, given its rapid growth around the beginning of the year, but as in the past, the Committee felt that raising the target would create an inappropriate benchmark for evaluating longer-term trends in debt growth.

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Economic Projections

The Committee believes that the monetary objectives it has set are supportive of a strengthening of economic activity in the second half of the year. However, the uncertainties associated with the economic outlook appear to be quite large, and continued vigilance and flexibility in the conduct of policy clearly are needed. As is summarized in the table on the next page, the central-tendency forecast of Committee members and nonvoting Reserve Bank Presidents is for growth of 2-1/2 to 3 percent in real GNP this year. Such an increase in output would be expected to generate appreciable further gains in employment, but the unemployment rate might not drop below 7 percent before year-end. With the decline in energy prices more than offsetting effects from the depreciation of the dollar and with pressure from domestic labor and product markets restrained, the inflation rate for the year is generally projected at between 2-1/4 and 2-3/4 percent, as measured by the implicit deflator for GNP.

In 1987, which would be the fifth year of the current expansion, real GNP is projected by most participants to increase by 3 to 3-1/2 percent, and unemployment is expected to decline moderately. A significant portion of the increase in production next year is expected to come from the external sector, with the lower value of the dollar expected to restrain the growth of imports and stimulate exports. However, with energy prices leveling off, exchange-rate-related increases in import prices are expected to cause an acceleration in inflation to the 3 to 4 percent range next year.

The forecasts of the Committee members and nonvoting Reserve Bank Presidents assume that the Congress will seek to achieve the Gramm-Rudman-

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Economic Projections for 1986 and 1987*

	FOMC Members and Other FRB Presidents	
	Range	Central Tendency
1986		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	3-3/4 to 6-1/2	4-3/4 to 5-3/4
Real GNP	2-1/4 to 3-1/2	2-1/2 to 3
Implicit deflator for GNP	1-1/2 to 3-1/4	2-1/4 to 2-3/4
Average level in the fourth quarter, percent:		
Civilian unemployment rate	6.9 to 7.2	[illegible]
1987		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	5 to 8-1/4	6 to 7-1/2
Real GNP	2 to 4-1/4	3 to 3-1/2
Implicit deflator for GNP	1-1/2 to 4-1/4	3 to 4
Average level in the fourth quarter, percent:		
Civilian unemployment rate	6-1/2 to 7	Around 6-3/4

* The Administration has yet to publish its mid-session budget review document, but spokesmen have indicated that there will be revisions to earlier forecasts. As a consequence, the customary comparison of FOMC forecasts and Administration economic goals has not been included in this report.

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Hollings deficit reduction targets. Progress in reducing the federal deficit is seen as crucial in maintaining financial conditions conducive to balanced growth and to an improved pattern of international transactions.

A number of factors point toward a reacceleration in growth, although the exact degree and timing remain uncertain. Despite their initial effects on investment, lower energy prices should help support economic activity, primarily by bolstering real consumer income. The lower level of interest rates also is expected to give some impetus to consumption while, at the same time, maintaining the strength in the housing market. Business spending on new plant and equipment is projected to pick up somewhat over time, but the degree of improvement will depend in part on the character of tax reform legislation.

A critical element in the expected improvement in economic performance is progress towards reducing the size of the merchandise trade deficit. As noted above, with import prices rising as a result of the depreciation of the dollar, the growth in imports is expected to slow, and the increased price competitiveness of U.S. goods should bolster export growth. However, a substantial improvement in our trade performance will require satisfactory growth of demand in other countries. Moreover, it will require open access to foreign markets, which underscores the critical importance of avoiding protectionist measures here and abroad.

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Section 2: The Performance of the Economy during the First Half of 1986

The economy continued to expand in the first half of 1986, but apparently no more rapidly than in 1985. The overall increase in output during the first six months of the year generated slightly more than one million new jobs, and the civilian unemployment rate held near 7 percent. At the same time, the dramatic decline in world crude oil prices caused a substantial slowing in inflation.

The combination of the lingering effects of the high foreign exchange value of the dollar during 1984 and 1985, the slow growth abroad, and the initial impact of lower crude oil prices played a key role in inhibiting any acceleration in overall economic activity. Industrial output declined noticeably over the first half, with activity reflecting the continuing intense competition from foreign producers in the manufacturing sector and also the sharp cutbacks in energy-related investment. U.S. agriculture confronts growing world supplies of many farm products, and many farmers continue to be squeezed by a heavy debt-servicing burden and falling land values. The drop in oil prices has caused substantial adjustment problems in the short run. Oil drilling has been reduced drastically, and a number of high-cost wells have been capped. More than 100,000 jobs have been lost in the oil industry since the turn of the year.

At the same time, however, some of the benefits from the drop in oil prices did begin to emerge in the first half. The lower price of crude oil was reflected fairly quickly in the prices of finished energy products, which caused consumer prices to register their largest three-month decline since the beginning of 1949. This lower price level has given a substantial boost

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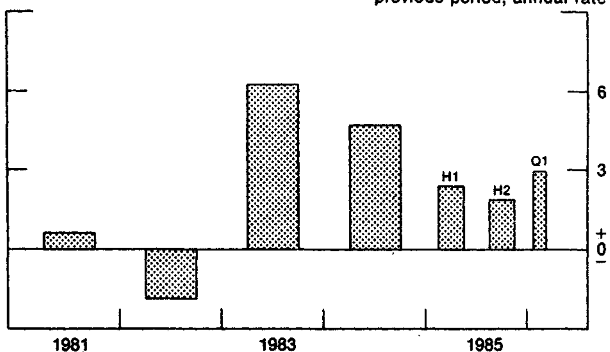

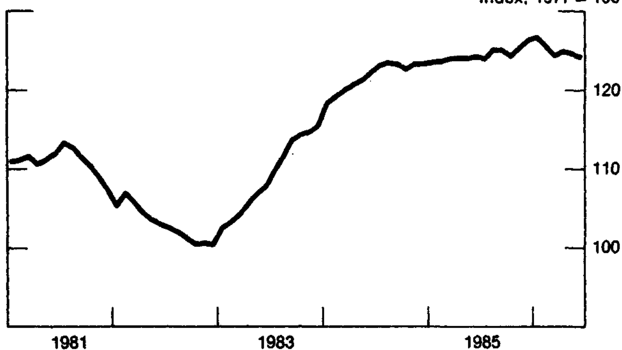

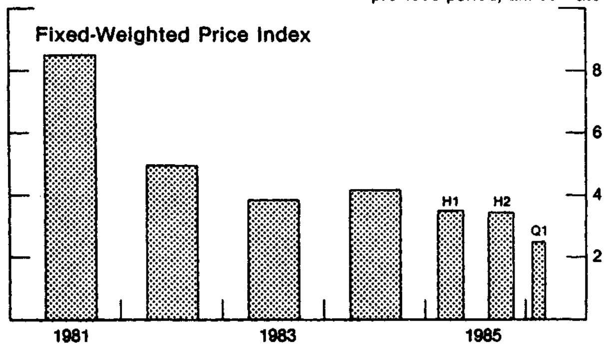

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to the purchasing power of consumers and has helped to support higher levels of spending. Although the volume of oil imports will rise, the sharper decline in price is an aid in reducing the large deficit in our trade account.

A potentially more significant longer-term influence on our balance of trade is the lower value of the dollar. The prices of foreign goods are rising in dollar terms and should begin to shift expenditures from imports to domestic products. At the same time, U.S. goods are more competitive on world markets, although we have yet to experience a sustained improvement in exports. The rather moderate improvement in export volume to date reflects, in part, the effects of the dollar's earlier rise and the slow pace of economic activity abroad. Growth in the major industrialized nations was particularly weak in the first quarter of 1986, although there appears to have been some rebound in the second quarter. Meanwhile, the drop in oil revenues reduced import demand in some developing countries, most importantly Mexico.

Another factor affecting the economy this year has been the changing fiscal-policy environment. It now appears that the deficit in the current fiscal year may exceed earlier plans, but the Congress has moved to implement the spirit of the deficit targets contained in the Gramm-Rudman-Hollings legislation in acting on its fiscal 1987 budget. The prospect of lower federal budget deficits in the years ahead, coupled with the drop in oil prices, encouraged sizable reductions in long-term interest rates at the beginning of 1986, which have begun to stimulate the interest-sensitive sectors of the economy. The most notable result has been in the housing sector where lower mortgage rates have led to substantial gains in building activity. Investment in new plant and equipment has not shown a similarly positive

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response to lower interest rates, however; apart from the negative effects of the oil drilling decline, business spending has been damped by the existence of a sizable overhang of office and factory space and by continuing uncertainties about sales trends and tax reform.

With the decline in energy prices, further progress has been made in reducing the inflation rate. Continued moderation in wage increases and abundant supplies of agricultural commodities and industrial raw materials also were important factors in restraining price increases in the first half of 1986. These favorable developments worked to offset the inflationary tendencies associated with the depreciation of the dollar and the continued rapid rise in the prices of services.

The Household Sector

Consumer expenditures were quite strong in the first half of 1986, supported in part by rapid income growth. Real disposable income increased at about a 5-1/2 percent annual rate, boosted by high levels of farm subsidy payments and the energy-related slowdown in inflation. In addition, survey information indicates that consumer confidence remains high, and many households consider it to be a good time to purchase big-ticket items such as a car or new home. Under these circumstances, consumers have been willing to spend the bulk of their income gains, and the personal saving rate has remained at an historically low level.

The increase in consumer spending was widespread. Purchases of nondurable goods, such as apparel, were particularly strong in the first quarter, while outlays for services also grew briskly. The demand for new automobiles also remained quite high after the large sales increase in 1985.

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New cars sold at an 11 million unit annual rate in the first six months of this year, with important support coming from a series of below-market finance incentive programs for many domestic models. Foreign automobiles continued to sell at a fast pace even though sticker prices generally have increased more than 10 percent in response to the exchange rate changes.

Activity in the housing sector also has been strong this year. Stimulated by the decline in mortgage rates, sales of new single-family homes hit a record high in March and remained generally strong throughout the second quarter. Production responded to this increase in demand, and during the first half, single-family units were begun at a 1-1/4 million unit rate, the highest since 1979. Despite elevated rental vacancy rates, construction apparently was maintained in the multifamily sector by the large volume of mortgage revenue bonds issued by many state and local governments at the end of last year. However, as these tax-exempt funds were depleted, activity in the multifamily market began to taper off in the spring. In addition, concerns about the treatment of income properties under tax reform may have begun to restrain the construction of multifamily dwellings.

Indicators of the financial position of the household sector were mixed in the first half of the year. Although the growth in consumer credit slowed from its rapid pace in 1985, the ratio of consumer installment debt to disposable income edged up to a new high. The rallies in the stock and bond markets strengthened the asset side of the household sector balance sheet, and many homeowners took the opportunity presented by the decline in interest rates to ease their debt-servicing burdens by refinancing mortgage loans. However, increased strains also were evident, as personal bankruptcies

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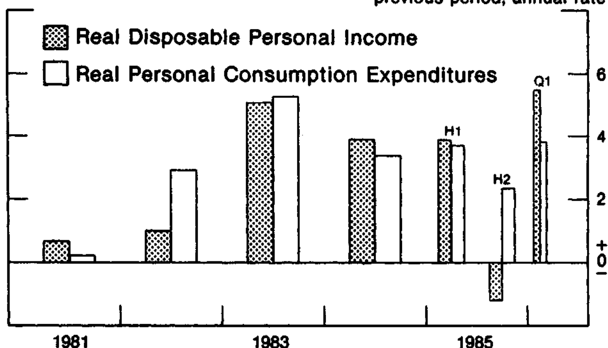

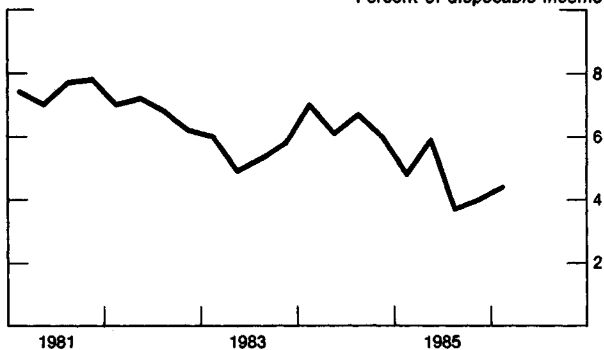

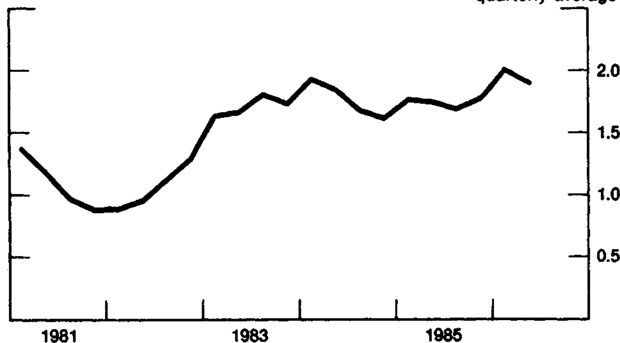

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rose to record levels and mortgage delinquency rates remained historically high.

The Business Sector

The financial position of the business sector improved a bit in the aggregate during the early part of 1986, albeit with considerable diversity across industries. Economic profits in the corporate sector rose at an $11 billion annual rate in the first quarter, and the share of after-tax economic profits in GNP remained at the highest level since the late-1960s. Financial conditions in agriculture and manufacturing remained weak, however. Agriculture continued to be hurt by excess supply conditions worldwide, and farm loan delinquencies rose to a postwar high. In manufacturing, intense price competition from foreign sources squeezed profit margins, and with little growth in demand, capacity utilization moved lower.

Business spending on plant and equipment was weak in the first half of the year. This poor performance partly reflected a "payback" after very strong capital spending in the fourth quarter of 1985. Firms apparently accelerated their spending at the end of last year to take advantage of investment incentives that were targeted for scaling back or elimination under proposed tax reform legislation; expenditures then dropped off in the first quarter of 1986. In addition to these tax-anticipation effects, the demand for computers and other high-technology equipment remained subdued, after increasing rapidly in the first two years of the recovery. Spending on nonresidential structures was down substantially, partly as a result of the cutback in oil and gas well drilling, which was large enough to reduce real GNP growth by one-half percentage point in the first quarter and perhaps more

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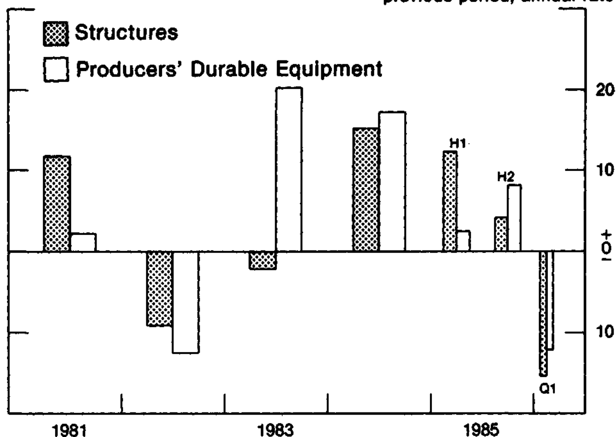

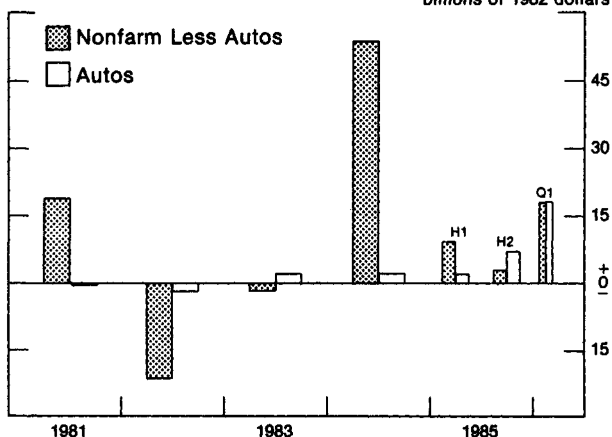

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in the second quarter. However, a correction also began in the construction of office buildings in response to past overbuilding and high vacancy rates.

Much of the change in business inventories in the first half of this year was associated with fluctuations in automobile dealers' stocks. Domestic car production outpaced sales in the first quarter, and this resulted in a substantial build-up of auto inventories. Assembly schedules were scaled back in the spring, which helped dealers reduce their excess inventories, although stocks remained high. Outside of the auto area, inventory investment remained moderate overall, but the pattern differed markedly between manufacturing and trade. Manufacturers continued to trim their stocks, preferring to keep inventories lean until there was firm evidence of a resurgence in demand. In contrast, inventory investment picked up at trade establishments, even though merchants continued to hold an historically high level of stocks relative to sales.

With the declines in capital spending and the slow pace of inventory investment, internal funds in the aggregate were adequate to meet almost all of the basic financing needs of nonfinancial corporations. However, the drop in long-term interest rates to the lowest levels since 1978 prompted businesses to issue massive amounts of bonds; the proceeds were used not only to finance new investment but also to retire outstanding bonds and stocks and to pay down short-term debt.

The Government Sector

Despite congressional action to slow the growth of spending, the size of the federal budget deficit in fiscal 1986 may match or exceed the record $212 billion of fiscal 1985. Revenue growth has slackened in

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association with the slower pace of nominal income growth. Expansion of corporate tax receipts has slowed significantly, while excise tax revenues also are down as lower oil prices virtually have eliminated the receipts from the "windfall profits" tax.

Federal purchases of goods and services fluctuated widely in the first half of 1986. They dropped substantially in the first quarter, in part reflecting a slowing in the purchases of farm products by the Commodity Credit Corporation (CCC), after a record increase in the fourth quarter of 1985. Excluding CCC purchases, real federal outlays were down slightly, as a result of lower defense spending.

Purchases of goods and services by state and local governments in real terms increased at a 2.8 percent annual rate in the first quarter of 1986, about the same pace as in 1985. After a large increase in the first quarter, construction spending remained strong in the spring, while employment rose further. However, a number of states, particularly those dependent on agriculture and the oil industry, continued to experience a substantial deterioration in their financial condition. A significant portion of tax revenues in many oil-producing states are tied directly to the value of oil output, and the drop in oil prices has induced a concomitant decline in receipts. In addition, the secondary effects on energy-related businesses are tending to reduce revenues further. To restore fiscal balance, many states have announced expenditure cuts or tax increases.

The External Sector

Continuing the decline that began early last year, the dollar depreciated further against the currencies of foreign industrial countries

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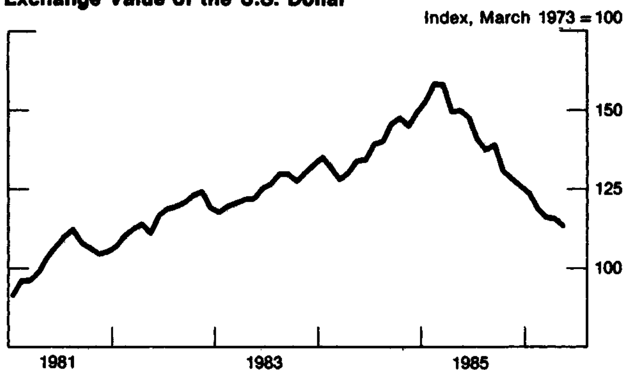

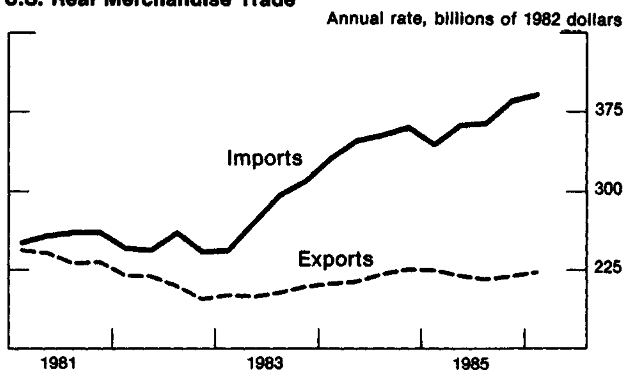

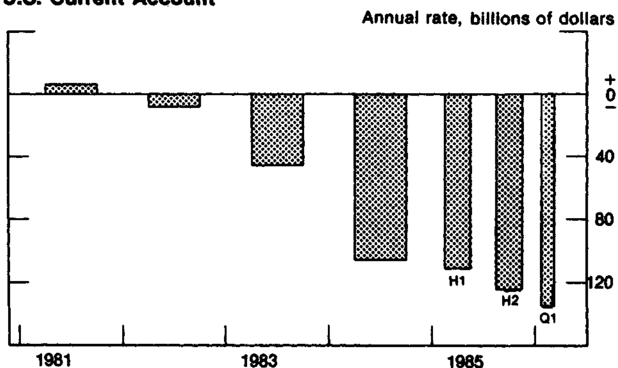

* Federal Reserve index of weighted average exchange value of U.S. dollar against currencies of other G-10 countries plus Switzerland. Weights are 1972-76 global trade of each of the 10 countries.

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during the first half of 1986. On balance, the trade-weighted value of the dollar has fallen more than 30 percent from its February 1985 peak, about one-third of which has occurred this year. Associated with the depreciation was a narrowing in inflation-adjusted interest rate differentials between the United States and the other major industrialized countries, as interest rates declined both here and abroad.

Although a substantial correction has occurred in the dollar's value, at least against the currencies of the major industrialized countries, the nation's current account deficit was unchanged in the first quarter from the high $135 billion rate of the fourth quarter of 1985. This lack of improvement was the result of large increases in nonpetroleum imports while exports grew more slowly. The failure to date of the dollar's decline to slow import growth reflects, in part, the relatively slow pass-through of the depreciation into import prices. Because profit margins of foreign exporters expanded during the period of dollar appreciation, they are able, for a time, to absorb the reduced receipts without raising prices; slack markets at home also have held down price increases. In addition, the dollar has continued to rise against the currencies of many developing countries, which account for about one-quarter of U.S. nonpetroleum imports. However, nonpetroleum import prices now are increasing, led by large increases for automobiles, other consumer items, and capital equipment.

The decline in the dollar also improved the price competitiveness of U.S. goods in foreign markets. However, exports have been slow to pick up, in important part because of the sluggish pace of foreign economic activity. Real gross national product declined in both Japan and West Germany in the

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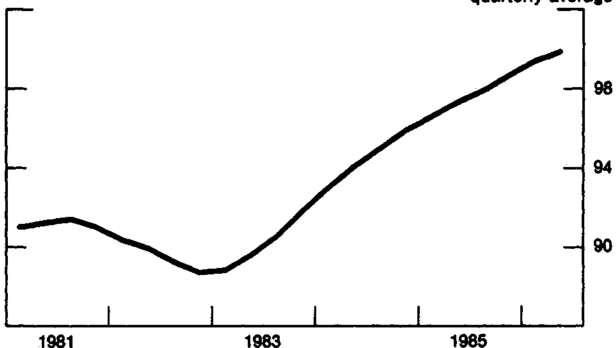

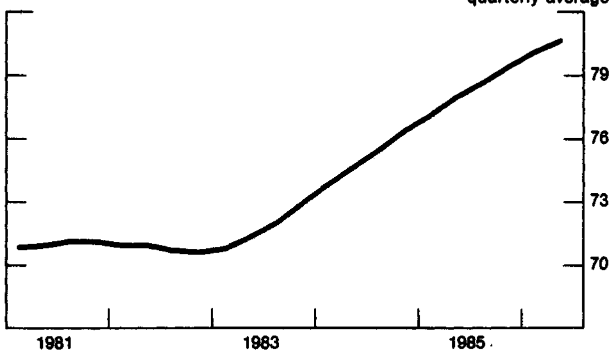

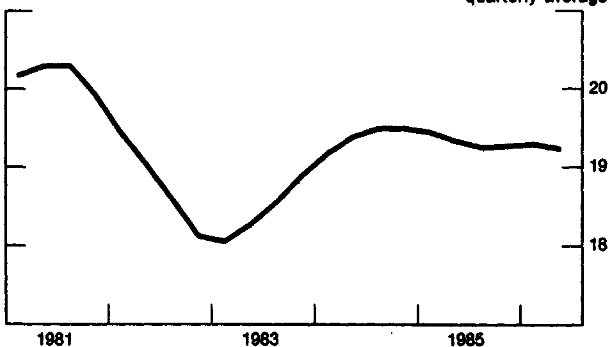

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first quarter, but economic growth appears to have been somewhat stronger in the spring.

Economic growth also has been sluggish among many of our major trading partners in the developing world. Like other oil-producing countries, Mexico is adjusting its spending to lower oil revenues, and this has reduced the demand for U.S. products. Falling world commodity prices also have aggravated the financial difficulties of other developing nations, including members of OPEC.

Reflecting these influences, the volume of U.S. merchandise imports rose 1-1/2 percent in the first quarter of 1986, as nonpetroleum imports continued to grow rapidly while oil imports declined. The largest increases were in machinery, with smaller advances registered for some consumer goods. The volume of merchandise exports was up somewhat in the first quarter, with a 3-1/2 percent decline in exports of agricultural products offset by increased U.S. nonagricultural exports.

Labor Markets

Nonfarm payroll employment expanded in the first half at an average pace of roughly 175,000 per month on a strike-adjusted basis, down from 230,000 in 1985. Continuing the trend of the past few years, gains at trade and service establishments were quite strong and accounted for most of the overall employment increase. Hiring also was brisk at construction sites through much of the period, buoyed by the strength in homebuilding. However, manufacturing payrolls contracted somewhat, with weakness in the motor vehicle, metals, and machinery industries.

The civilian unemployment rate averaged somewhat higher over the first half of the year than at the end of 1985. The continued expansion of

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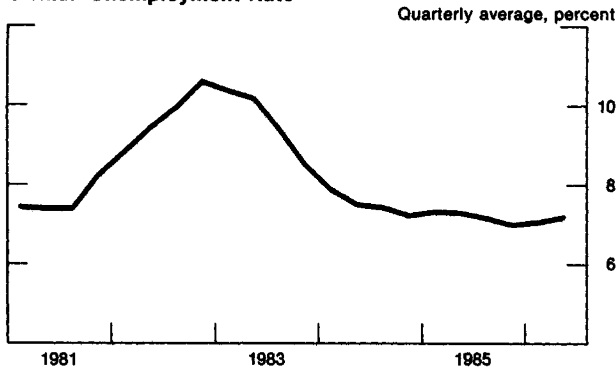

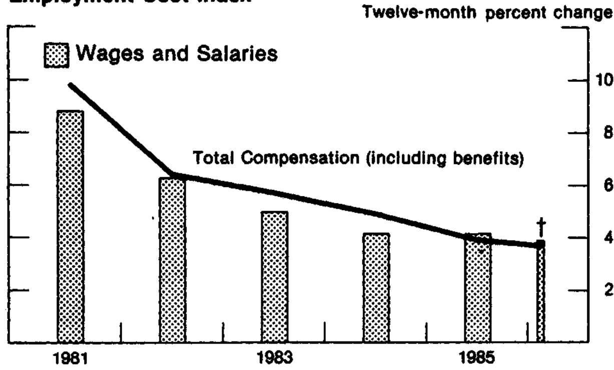

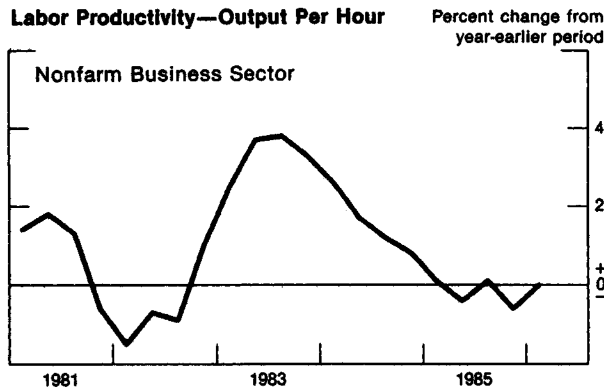

* Employment cost index for private industry, excluding farm and household workers.

† March 1986

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job opportunities about matched the rise in the number of individuals entering or reentering the workforce, and labor force participation reached a new high by midyear. However, the weakness in the industrial sector was reflected in a rise in the number of workers separated from their last job.

In view of the continued slack in labor markets as well as lower price inflation, wage growth remained moderate. The employment cost index, a broad measure of overall compensation trends, rose 3-3/4 percent in the twelve months ending in March, down from 4-1/2 percent over the year ended in March 1985. Most of the slowing was the result of smaller increases in the cost of employee benefit programs, reflecting in part efforts to contain medical insurance expenses, while wages and salaries rose at about the 4 percent rate experienced in 1985. Continued moderation in union wage gains also was evident in the collective bargaining agreements reached in the first half of 1986.

After declining at the end of 1985, labor productivity in the nonfarm business sector rebounded in the first quarter of 1986. However, the gain largely reflected erratic movements in hours worked by self-employed workers, and productivity has been essentially flat over the past year after rising substantially early in the recovery. Productivity in manufacturing has increased somewhat faster during this expansion, as intense import competition has forced many producers to modernize their factories and streamline work rules. As a result of the first-quarter bounceback in productivity, unit labor costs in the nonfarm business sector fell during that period, but they were still up about 3 percent from a year earlier.

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Price Developments

Falling energy prices were largely responsible for a significant slowing in measures of aggregate inflation during the first half of 1986. A broad measure of prices--the GNP fixed-weighted price index--increased at a 2-1/2 percent annual rate in the first quarter, down from a 3-1/2 percent rise in 1985. Consumer prices actually declined over the February-to-April period, but they still were up 1-1/2 percent over the twelve-month period ended in May. The drop in prices was greater at the wholesale level, where weakness in the industrial sector added to the downward pressure from energy prices.

The speed and magnitude of the decline in world crude oil prices this winter were dramatic. Over the January-to-April period, crude oil prices fell by more than $15 per barrel to their lowest level since 1978. Prices of refined petroleum products responded quickly to the drop in crude oil prices, and retail gasoline prices fell 25 percent, or about 28 cents a gallon, over the January-to-May period. Charges for electricity and natural gas, which compete with fuel oil as a power source, responded more slowly to the lower crude oil prices but by the end of May had fallen about 1 percent.

The prices of industrial raw materials continued to decline in the first half. Prices were depressed by abundant world supplies of many primary commodities; debt-servicing obligations led many developing countries to maintain or expand their output. Sluggish industrial activity in the United States and other large economies contributed to the softness of commodity markets.

Outside of the energy area, further progress was made in reducing the inflation rate during the first half of the year. Retail food prices

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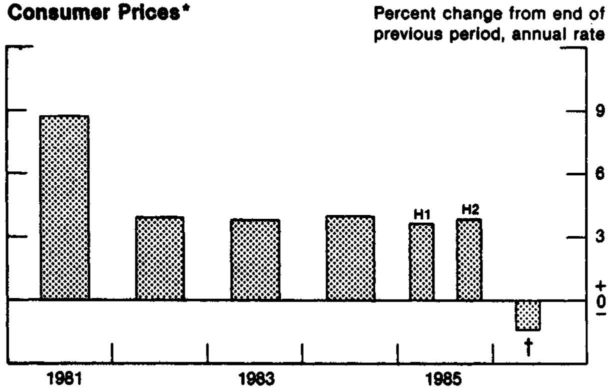

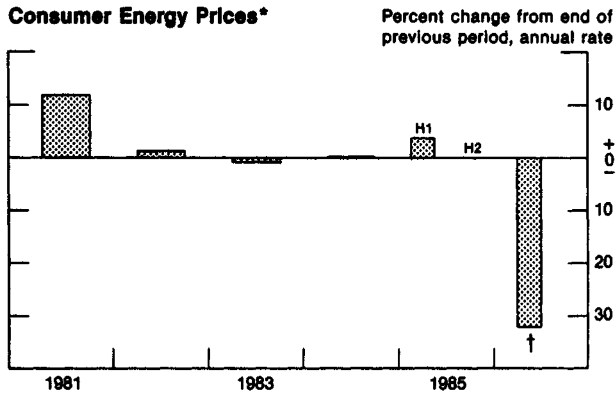

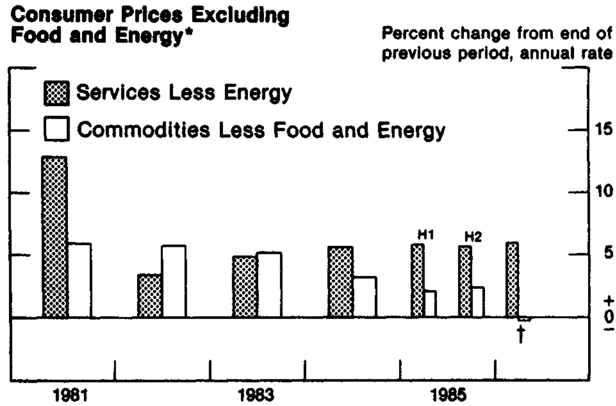

* Consumer Price Index for all urban consumers.
† Percent change from December 1985 to May 1986

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rose at only a 1 percent annual pace through May, held down by falling meat prices. A small decline in the prices of consumer goods was responsible for the slowdown in the CPI excluding food and energy to a 3-1/2 percent annual rate of increase from its 4-1/2 percent rise during 1985. In contrast, the prices of nonenergy services continued to increase at a 6 percent annual rate, boosted by rising housing costs and by higher premiums for most types of insurance.

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Section 3: Monetary Policy and Financial Markets in the First Half of 1986

The Federal Open Market Committee at its meeting in February of this year established target growth ranges, measured from the fourth quarter of 1985 to the fourth quarter of 1986, of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3. The associated monitoring range for growth of the debt of domestic nonfinancial sectors was set at 8 to 11 percent. As compared with the ranges for 1985, the M2 target was unchanged, the upper limit for M3 was reduced one-half percentage point, and the debt range was lowered one full point; the M1 target remained the same as that set last July for the second half of 1985. It was expected that growth of money and credit within these ranges would be adequate to encourage sustainable economic expansion consistent with progress over time toward reasonable price stability and an improved pattern of international transactions.

In retaining the comparatively wide target range for M1, the FOMC recognized continuing uncertainties about the behavior of that aggregate. Moreover, the Committee agreed that, in view of these uncertainties and the unexpectedly rapid growth of M1 relative to GNP in recent years, the behavior of the narrow money stock would be evaluated in light of growth in the broader monetary aggregates, developments in the economy and financial markets, and the potential for inflationary pressures.

In the event, rapid M1 growth reemerged early this spring, and by June the aggregate was far above its range. M2 and M3, however, ended the first half near the middle of their 1986 target ranges. This disparate pattern of money growth, as well as the modest expansion in economic output, ebbing inflation, and continuing downward pressure on the dollar in foreign

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GROWTH OF MONEY AND CREDIT
Percentage changes at annual rates

Period	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter 1985 to second quarter 1986	11.9	7.3	7.9	13.0[e]
Fourth quarter 1985 to June 1986	12.8	7.8	7.8	12.7[e]
Fourth quarter to fourth quarter				
1979	7.5	8.1	10.3	12.3
1980	7.3	9.0	9.6	9.6
1981	5.2(2.5)[1]	9.3	12.3	9.8
1982	8.7	9.1	10.0	9.0
1983	10.4	12.2	9.9	11.2
1984	5.4	8.0	10.5	14.3
1985	11.9	8.6	7.6	14.0
Quarterly average				
1985-Q1	10.1	11.7	10.2	13.6
Q2	10.5	6.3	5.5	12.0
Q3	14.5	9.5	7.6	12.9
Q4	10.7	6.0	6.5	14.6
1986-Q1	7.7	4.3	7.4	16.1
Q2	15.8	10.3	8.3	9.6[e]

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

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exchange markets, provided the setting for policy during the first six months of this year. In general, monetary policy was accommodative. As an operational matter, the degree of pressure on reserve positions of depository institutions remained limited, and the discount rate was lowered twice in the first half of the year, by one-half percentage point each time, in the context of sizable declines in market interest rates and similar actions by some other industrial countries. In early July, the discount rate was cut another half point, to 6 percent.

Money, Credit, and Monetary Policy

In 1985, M1 grew at a rate substantially above its target growth range in the first half, and it continued to do so over the remainder of the year, even after the range had been rebased and widened in July. Instead of the return to more normal behavior that the FOMC had looked for, M1 velocity--the ratio of nominal GNP to M1 balances--fell even more rapidly in the second half of the year than it had in the first. Taking the prevailing economic and financial conditions into account, the Committee decided in the latter part of 1985 that above-target M1 growth would be acceptable.

In light of the uncertainties surrounding the behavior of M1, in February of this year the FOMC set a 1986 target range for the aggregate that, while not providing for a drop in velocity as large as the 6 percent decline posted in 1985, was wide enough to allow for appreciable variation in velocity relative to historical trends. Nevertheless, the Committee recognized that the relationship of M1 to income had become increasingly difficult to predict, owing importantly to the changing composition of M1. An important share of the aggregate now consists of interest-bearing deposits,

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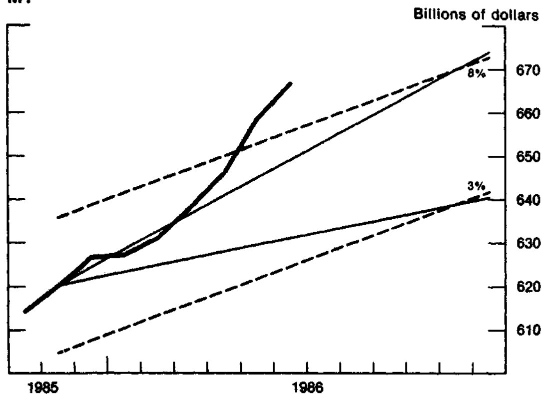
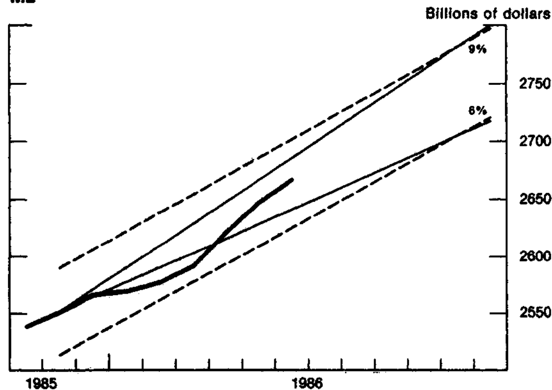
Ranges Adopted in February and Actual Money Growth



Annual Rates of Growth

1985 Q4 To 1986 Q2
11.9 Percent

1985 Q4 To June 1986
12.8 Percent



Annual Rates of Growth

1985 Q4 To 1986 Q2
7.3 Percent

1985 Q4 To June 1986
7.8 Percent

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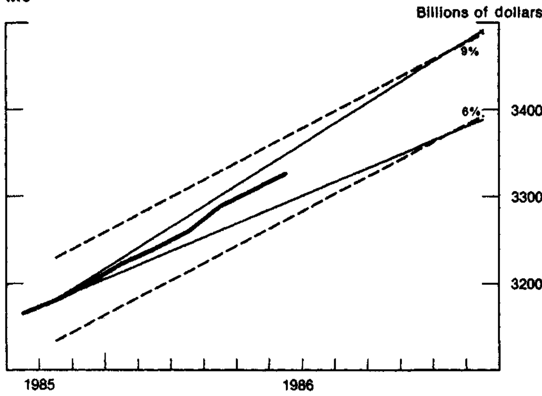
Ranges Adopted in February and Actual Money and Debt Growth

M3

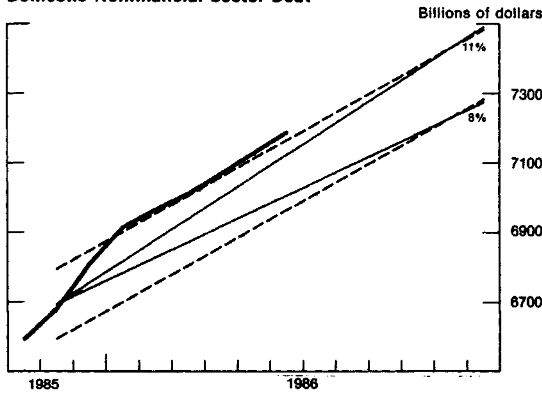


Annual Rates of Growth

1985 Q4 To 1986 Q2
7.9 Percent

1985 Q4 To June 1986
7.8 Percent

Domestic Nonfinancial Sector Debt



Annual Rates of Growth

1985 Q4 To 1986 Q2
13.0 Percent
(estimated)

1985 Q4 To June 1986
12.7 Percent
(estimated)

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which are potentially an attractive repository for savings as well as transaction balances, introducing an additional source of sensitivity to changes in interest rates and other economic variables. In these circumstances, the Committee emphasized that policy implementation would involve a continuing appraisal of trends in all of the money and credit measures, as well as of indicators of economic activity and prices, and conditions in credit and foreign exchange markets. Within this framework for policy and against a background of incoming data indicating moderation of inflationary pressures and a relatively slow pace of economic expansion--including weakness in some important goods-producing sectors--the Federal Reserve basically accommodated the demands for reserves associated with strong M1 growth over the first half of 1986.

Early in the year, reserves were provided slightly more freely, continuing the trend toward easier reserve conditions that had developed late last year. In the initial months of 1986, growth of M1 dropped off sharply from its rapid 1985 pace, and growth of M2 also slowed substantially, to a rate below its annual target range. There were signs of some sluggishness in economic activity, and steep declines in oil prices, which were improving the outlook for inflation, contributed importantly to a rally in long-term credit markets that picked up momentum in mid-February. At the same time, short-term interest rates edged a little lower, but the federal funds rate remained significantly above the Federal Reserve's discount rate.

In this context, a cut in the discount rate would complement the thrust of open-market operations and would accommodate the market tendency toward lower interest rates. However, an important consideration in the

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timing and extent of any rate cut was the risk posed by an excessive reaction in the foreign exchange markets, where the dollar remained under downward pressure during much of the period. Ultimately, on March 7, the Federal Reserve cut the interest rate charged for discount window borrowings by one-half percentage point to 7 percent, and the central banks of Japan, Germany and several other industrial nations took similar actions around that time.

Short-term rates in U.S. markets fell throughout March and much of April. Interest rates in long-term markets continued to benefit from the favorable effect of slumping oil prices on inflation expectations, as well as improvements in the federal budget outlook, with the Gramm-Rudman-Hollings legislation beginning to bite and official projections of the deficit being revised sharply downward. To an extent, declining rates also reflected the optimism present in the markets that, with economic growth remaining moderate, there was potential for a further easing of monetary policy. M1 accelerated markedly--moving above its target range in March--apparently in response to lower interest rates, but M2 and M3 growth were rather restrained, with M2 remaining below the lower end of its range throughout the first quarter.

On April 18, the Federal Reserve announced another reduction in the discount rate, to 6-1/2 percent. This change served primarily to catch up with and validate declines that already had taken place in market rates. Exchange rates and international interest rate considerations again played a role, and our discount rate cut coincided with a rate cut by the Bank of Japan.

By this time, market interest rates in the United States had fallen 1 to 2 percentage points since December, to their lowest levels in eight or

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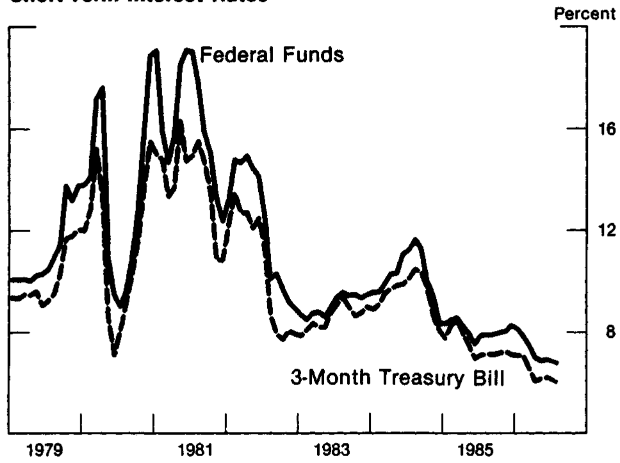

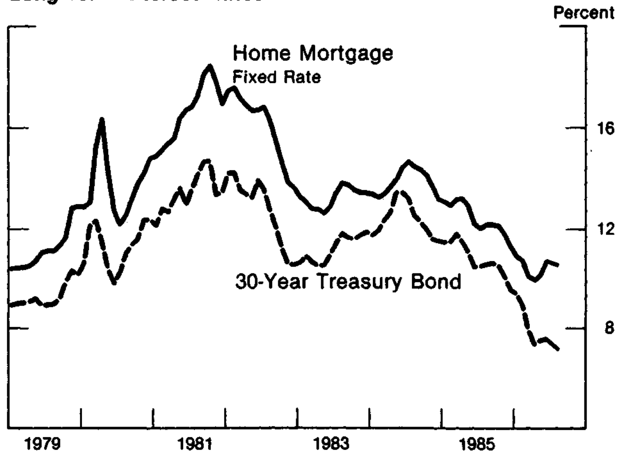

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nine years. Both short- and long-term rates then turned higher for a time, as some indications of stronger economic growth seemed to be developing and prospects for a further easing of monetary policy receded. Supporting the market's changed outlook were an acceleration in the monetary aggregates, strength in some incoming economic indicators, and the dollar's slide on foreign exchange markets, which continued through mid-May. The dollar subsequently recovered a bit, but most of the increase both in the exchange rate and in U.S. market interest rates was reversed before the first half ended, as indications of an expected strengthening of economic activity failed to materalize. With market interest rates falling, price pressures remaining subdued, and the economies of the United States and other industrial countries growing relatively slowly, the Federal Reserve again reduced the discount rate one-half percentage point, to 6 percent, effective July 11.

On balance since the end of 1985, the dollar has declined more than 10 percent, and short-term rates about 1-1/2 percentage points. Long-term Treasury yields fell as much as 2-1/4 percentage points, but yields on other long-term securities fell less; corporate and tax-exempt bond yields dropped about one point, and fixed-rate mortgages fell just 1/2 percentage point. The smaller declines in these other markets were due in part to the massive issuance of these obligations (including a large volume of refinancings) elicited by the drop in rates over recent quarters, to investor desires for call protection, and, in the case of tax-exempt securities, to concerns about tax reform.

Lower market interest rates have been an important factor in the rapid growth of M1 this year. The strong response of M1 to the decline in

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rates has reflected in part the cumulative effect of the deposit deregulation of recent years. In the first half of 1986, the final two installments of deregulation--the removal of minimum balance requirements on money market deposit accounts and Super NOWs on January 1 and the lifting of the ceiling on passbook savings rates on April 1--appear to have had little immediate effect on the growth of M1 or the other aggregates because relatively few institutions actually changed their deposit pricing practices. But the advent and expansion of interest-bearing checking accounts over the years has attracted more savings-type balances and has increased the responsiveness of M1 to interest rate changes. Since rates on the interest-bearing M1 accounts have adjusted sluggishly to changes in market rates, relatively wide swings in the incentives to hold these deposits have resulted.

Growth in NOW accounts surged in the first half of 1986, reaching around a 25 percent annual rate in the second quarter, as it responded to the lower overall level of market interest rates and the narrower spread between long- and short-term rates. The latter development seemed to spur shifts of funds from time deposits into shorter-term accounts, including NOW accounts. Demand deposit growth also strengthened as interest rates declined. In part, lower rates prompted increases in the compensating balances that businesses needed to hold in the form of demand deposits in order to pay for bank services. In addition, deposit levels may have been boosted to an extent by a sizable increase in financial transactions in the first half of the year, especially soaring mortgage prepayments and originations, which was stimulated by lower rates.

The velocity of M1 fell only moderately in the first quarter, but as money growth picked up and nominal GNP apparently failed to accelerate,

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velocity dropped at an extraordinary pace in the second quarter, resulting in a first-half rate of decline in M1 velocity that probably was somewhat faster than the average over 1985. Although the rapid M1 growth and falling velocity stemmed in large measure from interest rate declines, the size of the M1 increase was distinctly larger than what would have been expected based on historical relationships among money, income, and interest rates.

In contrast to M1, which grew at a 12-3/4 percent annual rate through June and exceeded its target by a large margin, both M2 and M3 grew moderately in the first half of the year and in June were near the middle of their respective ranges. Some of the more liquid components of the broader monetary aggregates, however, increased very rapidly, as part of the larger shift in investor portfolios toward short-term assets. This shift had much less effect on M2 or M3 than on M1, because the reallocation of funds took place largely within these broader aggregates. In addition to transaction deposits, money market deposit accounts, money market mutual funds, and ordinary savings deposits all expanded strongly during the first half of the year, while small time deposits grew only slightly.

Investors looked not only to the shorter-term components of the monetary aggregates, but also to stock and bond mutual funds (not included in the aggregates), which posted very attractive returns as a result of ongoing market rallies. Flows into such funds probably depressed M2 growth somewhat in the first half of this year, as they had in 1985. Even so, lower market interest rates and strong demands for short-term assets lifted M2 in excess of income, leading to an appreciable further decline in M2 velocity over the first two quarters of 1986. While M2 showed a fair amount of volatility in

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the first half, growth of M3 was comparatively steady from month to month, as banks varied their issuance of managed liabilities to compensate for fluctuations in core deposit inflows.

The debt of domestic nonfinancial sectors is estimated to have expanded at a more moderate rate over the first six months of 1986 than it had in some time, although still well in excess of the growth in income.[1] Bond issuance had surged in December in advance of the possible effective date of some provisions of tax-reform legislation, lifting the first-quarter level of the debt aggregate. Hence, when measured from its fourth-quarter-average base, the growth of domestic nonfinancial sector debt has remained above its monitoring range, coming in at a 12-3/4 percent annual rate through June. Measured from its level at the end of December, however, debt grew at an annual rate of 10-1/4 percent through the end of June.

To an extent, the lower rate of debt growth since the end of December represented a reaction to the inflated borrowing just prior to the end of last year, when special factors applying to particular sectors combined to boost debt issuance tremendously, far in excess of normal credit needs. For example, the pronounced slowdown of federal borrowing in the first quarter reflected the drawdown of substantial cash balances built up by the government before year-end. Indeed, federal borrowing picked up again in the second quarter, and, for the year as a whole, the huge federal deficit is likely to make a strong contribution to aggregate debt growth, as it has for the past several years.

Following the surge in their borrowing late last year, state and local governments showed a sharp drop in debt growth. This earlier borrowing

1. The appendix reviews some aspects of the recent behavior of the debt aggregate.

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and continued uncertainty about tax reform restrained tax-exempt debt growth in early 1986. Beginning in March, however, public-purpose and refunding issues increased again as rates declined further and views changed about the likely form and effective date of restrictions proposed in tax-reform legislation.

Borrowing by the household sector also eased somewhat from the heavy pace of recent years. After a surprising slowdown early in the year, net residential mortgage borrowing apparently expanded rapidly in the second quarter. Over the entire period, lower mortgage rates spurred a substantial pickup in total mortgage originations, but the high volume of refinancings reportedly strained the ability of lenders to process real estate transactions. Consumer credit growth rates this year have been substantially below those of last year, though still outpacing the growth of income. An increasing number of consumers seem to be experiencing difficulty in making timely payments on outstanding credit; delinquencies on consumer loans other than credit cards have risen moderately, but those on bank credit cards have surged in the past two years, and personal bankruptcy rates have soared.

The smallest degree of deceleration occurred in the debt of the nonfinancial business sector, which continued to be boosted by the wave of corporate mergers, acquisitions and share repurchases. While the stock market rally helped spur a substantial rise in gross equity issuance, net stock issuance remained decidely negative because of the mergers and restructurings. Most notable so far this year, however, was the strength of long-term debt issuance by businesses in response to steeply falling long-term rates; gross issuance of corporate bonds, especially strong in March and

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April, ran far in excess of previous records. Nonfinancial firms increased their short-term debt only slightly, however, and this was reflected in a decline in their commercial paper outstanding, as well as in slow business loan growth at banks.

The stresses evident in many parts of the economy left their mark on the books of banks and of other financial institutions. Asset quality deteriorated as a consequence of the sharp drop in oil prices and associated dislocations in the energy sector, overbuilding in commercial real estate, and the continuing distress in agriculture. Banks with relatively large amounts of farm loans outstanding, as well as other agricultural lenders, have been particularly hard hit recently; loan losses at these institutions have soared and their profitability has continued to slide. While banks in regions with economies heavily dependent on energy production were among the most strongly capitalized and profitable earlier, their financial position has eroded under pressure of surrounding economic difficulties. Bank failures in the first half of this year continued to run at about 1985's rapid pace, with agricultural banks again accounting for a disproportionate share.

Overall bank earnings began to improve in 1985, and the industry has added significantly to its capital and loss reserves, although the explosion in off-balance-sheet commitments and the clouded outlook surrounding the repayment of many bank loans may have made it more difficult to assess the level of risk in the banking industry. At savings and loan associations, overall profitability appears to be improving as interest rates have declined and mortgage origination activity has surged. However, a substantial number of these institutions continue to have severe problems

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owing primarily to losses on weak assets, prompting proposals to add to the financial resources of the FSLIC.

Concerns over loans to certain developing countries came to the forefront again this year as Mexico began to grapple with the additional economic and financial problems brought on in large part by dramatically lower oil prices. Banks have remained cautious lenders in the face of ongoing concerns about the economic and financial prospects of these countries. However, despite the weakness of global demand, some progress has been made in implementing appropriate macroeconomic policies and policies of internal structural reform. Financial support for such policies both from multilateral lending institutions and private creditors has been provided or is being negotiated, along the lines proposed by Secretary of Treasury Baker in Seoul last fall.

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Appendix

Some Aspects of the Behavior of Domestic Nonfinancial Sector Debt

After moving in rather close alignment for about a quarter of a century, debt growth in recent years has far outpaced expansion of nominal GNP. Chart A-1 illustrates that the ratio of debt outstanding to GNP began climbing late in 1981 and subsequently soared well above the range that had prevailed since the early 1950s, a development that extended through the first half of 1986.

The debt aggregate plotted in chart A-1 is derived from the Federal Reserve's Flow of Funds accounts. It contains the credit market debt of domestic nonfinancial sectors--households, nonfinancial businesses, state and local governments, and the federal government--whose spending accounts for the vast bulk of income and production. It excludes debt of the financial sector on grounds that funds raised by financial intermediaries are already counted in the debt aggregate at the point they are channeled to nonfinancial sectors. To include financial sector debt would lead to double counting.

Nonfinancial sectors also behave to a degree as financial intermediaries, raising funds in credit markets and using the proceeds, at least for a while, to acquire credit market claims on other nonfinancial units. In such cases, "double counting" may be said to exist, because the initial borrowing appears as debt of a domestic nonfinancial unit and the financial asset acquired has as its counterpart, either directly or indirectly, debt of another nonfinancial unit. For example, a substantial portion of the funds raised by state and local governments in 1985 was used to acquire claims on the federal government or mortgage claims on households. The federal government also issues debt and uses the proceeds to extend loans to private borrowers--obligations that appear elsewhere in the debt aggregate.

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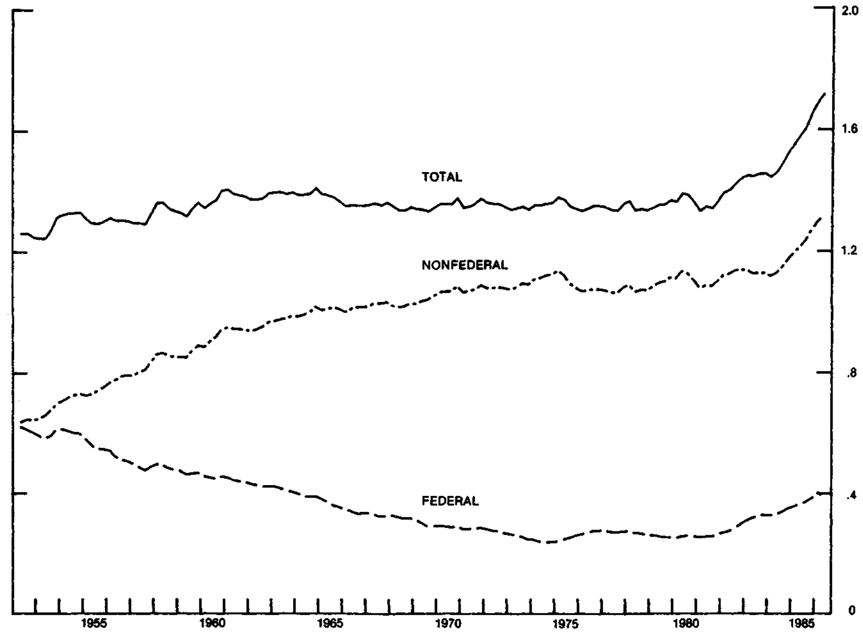
Chart A-1

Debt of Domestic Nonfinancial Sectors Relative to Nominal GNP

Quarterly



Note: Based on quarterly averages of debt constructed as averages of adjacent end-of-quarter levels.
Last observation plotted is an estimate for 1986:Q2.

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While nonfinancial sectors engage to some degree in these intermediary functions on a regular basis, a marked increase in such activity can act to boost measured growth in the debt aggregate. This was the case last year, when the proceeds of a large volume of debt issued by state and local governments with the intention of retiring outstanding obligations at a later time were placed largely in special nonmarketable securities of the federal government. In addition, debt growth has been lifted in recent years by a wave of corporate mergers, acquisitions, and share repurchases that has resulted in a massive retirement of equity, financed with credit.

To assess the degree to which this double counting and corporate substitution of debt for equity have acted to boost debt growth, the behavior of an adjusted debt measure and of an equity-augmented measure was examined. Chart A-2 presents debt and debt adjusted to remove readily identifiable double counting--in particular, that associated with the aforementioned state and local and federal government borrowing as well as with credit extended by nonfinancial businesses to the household sector. The resulting measure of adjusted debt is noticeably smaller in relation to GNP, but it has behaved quite similarly to the regular debt measure, rising sharply relative to GNP in recent years to well above the range prevailing since the 1950s.

Chart A-2 also presents the adjusted debt measure and this measure augmented by accumulated net issuance of equity, so that it encompasses funds raised in all markets. Although increasing less rapidly than debt or adjusted debt--for example, it rose by 12-1/2 percent in 1985 on an end-of-period basis, as compared with 14-1/2 percent for adjusted debt and 15 percent for debt--the augmented measure also has risen rapidly in recent years in relation

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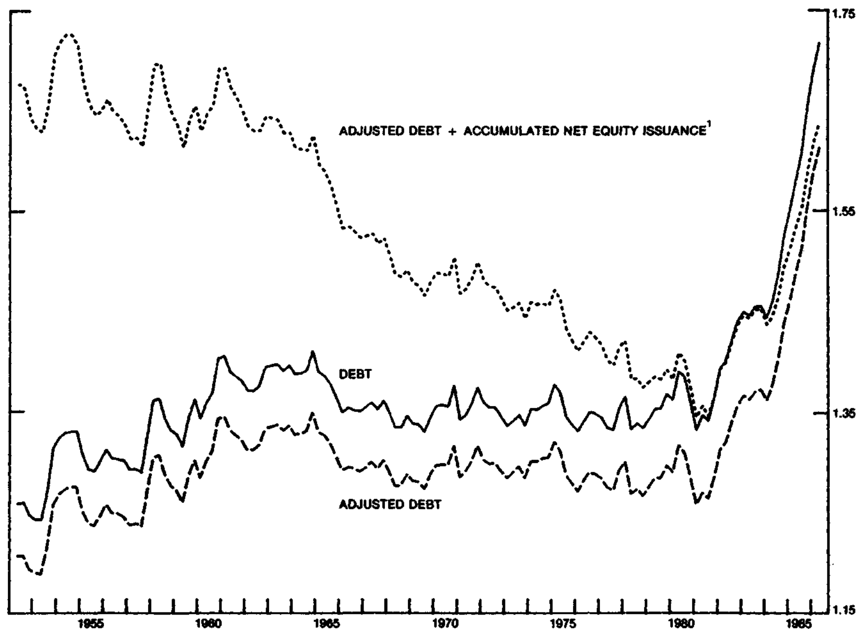
Chart A-2

Debt Measures Relative to Nominal GNP

Quarterly



Note: Based on quarterly averages of debt constructed as averages of adjacent end-of-quarter levels.
Last observation plotted is an estimate for 1986:Q2.

1. Equity is defined as historical-cost net worth of nonfinancial corporations in 1951 plus accumulated net stock issuance.

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to GNP, indicating that borrowing to retire equity explains only a small portion of the increase in the debt-GNP ratio. From a longer perspective, this measure has remained within its historical range, and its recent rise returns it, in relation to GNP, to the levels prevailing in the 1950s and early 1960s.

The evidence thus suggests that unusual behavior of the debt aggregate relative to GNP in recent years is related more to changes in underlying behavior than to the special factors just discussed. Chart A-1 illustrates that the unusual rise in debt relative to GNP in recent years has been in both the federal and nonfederal components of the aggregate. Growth in federal debt strengthened in the early 1980s and soared in 1982 with the widening of the budget deficit. After 1982, growth of federal debt slowed a bit in percentage terms while continuing to increase in dollar amounts and relative to GNP. Rising federal budget deficits have been associated with rising current account deficits and a growing gap between domestic purchases and output as net exports have contracted sharply. From one perspective, the growing federal deficit can be viewed as being financed by an inflow of funds from abroad--the counterpart to our current account deficit--which has enabled the federal government to increase its borrowing without curbing private spending and credit use to the extent that would be necessary in the absence of those external funds.[1] However, the erosion of our international competitive position, which is reflected in the current account deficit, certainly has greatly affected individual industries.

1. Not shown in the charts is the relation between debt measures and domestic spending (GNP less net exports). In recent years, debt growth has been somewhat more in line with growth in domestic purchases than output, but this ratio, too, has risen sharply.

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Debt of each of the nonfederal sectors--households, nonfinancial businesses, and state and local governments--also has increased relative to economic activity, even after removing the types of double counting mentioned above. In the case of households, the exceptional growth of debt has been evident in both mortgage and consumer debt and has been accompanied by a spectacular buildup of financial assets and a low personal saving rate. In other words, the household sector has been "grossing up" its balance sheet in recent years by heavy financial asset accumulation and borrowing. Financial deregulation and competition for household assets likely have contributed to this process by expanding access to market-related yields on deposits and other financial assets, while growing competition among lenders for market share and the trend toward securitization have added to sources of credit and put downward pressure on household borrowing costs. The corresponding narrowing of the spread between borrowing and deposit rates adds to the willingness of households to borrow rather than draw down liquid assets when spending rises relative to income. Demographic factors also appear to have contributed to household debt growth as the baby boom generation has moved further into the age bracket in which spending on housing and durables and borrowing tend to be high. In addition, households have benefited from the runup in stock market prices in recent years, and this boost to their net worth may have encouraged more borrowing. Even so, household debt growth has outstripped increases in net worth.

For nonfinancial corporations, most of the advance in indebtedness relative to output in recent years stems from the substitution of debt for equity, discussed above. The unevenness of the current economic expansion

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also appears to have boosted corporate borrowing, because some industries--especially those dependent on export markets and those competing with imports--have experienced protracted weakness, even though overall cash flows have been strong; thus, working capital and investment needs have been less closely matched with cash flows among firms than is typical, contributing to more rechanneling of funds through credit markets and more corporate borrowing. Finally, state and local government borrowing was especially heavy in 1985, even after removing the double counting factors mentioned above, as lower interest rates and the anticipation of tax reform also fueled a surge in tax-exempt bond issuance for purposes other than advance refunding and mortgage acquisitions.

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