FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1987

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1987

JULY 23, 1987

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1987

THURSDAY, JULY 23, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m. in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Shelby, Graham, Garn, Heinz, D'Amato, Bond, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

This morning we are here to listen to the second report for the year on the Federal Reserve monetary policy and this is a different kind of a hearing because, as I understand it, Mr. Chairman, this may be the last time we will have an opportunity to have you come before us. I certainly hope not. I hope you will be able to come back before you leave office and I certainly hope that after you do leave office you will give us the benefit of your great experience and your wisdom because I'm sure we will need it.

Now I would like to just also ask you, maybe after you have completed your remarks, if you could give us your advice on how the banking committees of the Congress and the Congress itself can work more effectively with the Federal Reserve Board in the future. You can look back on it now with 8 years of experience and while I think we have had a very good relationship and a very productive relationship, and I think the Federal Reserve Board has done a fine job, I think it can be improved.

One of the areas that concerns me is the selection of Governors of the Board. As I understand it, the Governors of the Board are paid something like $82,500 and you're paid $89,500. Other people in positions that are far less demanding and authoritative are paid substantially more in the Federal Reserve System itself.

I think if we're going to be able to attract the most competent people in the country to serve on this extraordinarily important Board, we're going to have to pay them better. You get what you pay for.

I also think I'd like to hear your views on the possibility of having some kind of a modification of the present method of selecting Board members. The constitution requires, of course, that the President makes the appointments and he should have that capability. On the other hand, it is very important that we have a situation where the Chairman of the Board is able to provide effective leadership and in order to do that it seems to me that the Chairman ought to have some kind of input on the selection of Board members.

This is no reflection on the people who are on the Board now. There are a number of people who are extremely well qualified. There is no way we can constitutionally require the President to modify his power. On the other hand, it seems to me that if the Chairman of the Federal Reserve Board would be required to comment to the Congress, to the Banking Committee, on the nominees, it would be an exacting, difficult, painful position because he would have to work with the people who were appointed, but on the other hand, if he could somehow find a way of giving the committee his views, because as you know, it's almost automatic. It's been a long, long time since anybody has been rejected for the Board.

We are not in a position to appraise the qualifications of the people without the advice of the Chairman and without his giving us some indication of how that would affect his ability to do his job as Chairman of the Board.

So I think that if we could get your views on that—I'm asking a lot I know—but you don't have to worry about serving on the Board a great deal longer with the people—nobody is going to be appointed before you leave I'm sure or confirmed, so I would hope you could help us with that.

Maybe the length of the term should be changed somehow, but I think a situation where one person is able to appoint all the members of the Board is not what Congress had in mind when they in their wisdom set up the Federal Reserve Board, and if there is some way we can change those terms or the length of the terms, I think that that would be very helpful to hear that, too.

Needless to say, as I've said many times and others have said and you heard it in the House and you will hear it here I'm sure this morning from others as well as myself, you have done a really marvelous job. We are in your debt. You have been a great figure in American finance at a time of real trouble and complexity. So go right ahead.

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

Mr. Volcker. Well, Mr. Chairman, I appreciate your comments and I'm not going to be able to answer all of your very difficult questions to my satisfaction or to your satisfaction, but I will try to make some comments about them.

On the substance of my testimony, you have not encouraged long written statements in the past. I have a statement which I would like to submit for the record.

What we actually decided upon at the Open Market Committee of course has been announced for several days and is no longer news. We didn't change any of these ranges for this year, and we made a small reduction for next year in the M2 and M3 ranges, and that's the guts of our decision making in July.

I conclude my statement by pointing out areas where I think some considerable progress has been made. We begin to restore a better balance to the economy with an improvement in the real trade balance which now seems to be in train.

We had a lower rate of increase in domestic consumption which I think is good because that's been part of the imbalance—we've been consuming too much—if it is replaced by other sources of strength, and so far it has been on the external side, and the employment situation has continued to improve.

We have a considerable improvement in the budgetary situation this year. I think we have a better situation in the exchange markets. We certainly have some international consensus and the international debt situation has continued to evolve in a reasonable way amid a lot of strains.

I think the crucial thing is that faced with a bulge which is inevitable in prices in the first half of this year due to oil, due to the exchange rate question, can we get through that bulge and restore more stability in the future?

The omens are good on the wage-cost side. That's terribly important, but of course it will require eternal vigilance on the monetary policy side as well.

There is a list I could make of problems and difficulties and risks and, indeed, I make such a list in my statement. That includes the fact that the budget may look better this year, but unless we get through this political impasse, it will relapse in future years.

The internal debt situation doesn't make me entirely happy and there are other matters that pose real risks. So there's going to be a lot to do.

I do make a little plea at the end of my statement along the lines of your opening remarks about the importance of the independence of the Federal Reserve and the manning of the Federal Reserve. I don't know whether at this stage you want me to make a stab at some of those questions you raised straight off the top of my head and begin a dialog here.

The Chairman. I certainly do. I think it would be very helpful. I would like very much to hear it.

[The complete prepared statement of Paul A. Volcker follows:]

Testimony by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

July 23, 1987

Mr. Chairman and Members of the Committee:

I appreciate this, my last, opportunity to appear before you as Chairman of the Federal Reserve Board in connection with the semi-annual review of monetary policy. You have the official Report of the Board of Governors before you and I will be blessedly brief in touching upon some of the main points.

As you know, the economy has continued to grow this year, carrying the expansion well into its fifth year. At the same time, however, the inflation rate has accelerated appreciably relative to the low rate prevailing in 1986.

A change in that direction had been widely anticipated in response to the rebound in oil prices and the depreciation of the dollar. Nevertheless, the size and pervasiveness of the price increases -- which have included many non-energy materials as well as services -- affected the psychology and expectations in financial markets, particularly in April and early May. Recurrent concerns about the dollar internationally also at times affected the mood of domestic markets, and interest rates rose rather sharply for a time.

Through the early part of the year, Federal Reserve operations placed minimal pressure on bank reserve positions. As reported earlier, however, beginning in late April definite but modest steps were taken to increase reserve pressures somewhat. Perceptions of that action appeared to help calm concerns about the future course of the dollar and inflation.

Most interest rates, long- and short-term, have retraced part of the earlier rise. However, long-term interest rates and prices of sensitive commodities, some of which had been deeply depressed, remain well above their levels of earlier this year.

The approach of the Federal Reserve toward the provision of reserves has not changed since May. However, growth in the

various monetary aggregates slowed further in the second quarter. A reduction in the rate of growth of those aggregates from the relatively high levels of 1986 had been both anticipated and desired by the Federal Open Market Committee, as reported to you in February. However, it is also true that, with institutional and market developments importantly affecting the relationships between the various measures of money and the variables we ultimately care about, judgments about the appropriate growth of the aggregates have become both more difficult and more dependent on prevailing economic and market circumstances.

For that reason, the Committee did not set forth a particular target range for M1 this year in February. That judgment was reaffirmed at the meeting earlier this month. M2 is currently running below, and M3 around, the lower ends of their 5-1/2 to 8-1/2 percent ranges established in February. The Committee decided not to change those ranges for 1987. In doing so, however, there was agreement that, depending on further evidence with respect to emerging trends in economic activity, inflation, and domestic and international financial markets, actual growth around the lower ends of those ranges may well remain appropriate.

In judging appropriate monetary growth during the course of the year, or from year to year, account needs to be taken of the apparent increase in the sensitivity of demands for money, and for money-like assets, to absolute and relative changes in market interest rates. Interest rates administered by institutions, especially those on transactions accounts, tend to lag market rates both when interest rates are rising and when they are falling (of course, no explicit interest can be paid on demand deposits). At the same time, the cost and effort involved in shifting funds between types of accounts, or into and out of market instruments, has greatly diminished. Experience suggests that, as a result of these factors, demand deposits, NOW accounts, and money market deposit accounts all tend to grow relatively slowly, if at all, when market rates are rising (as during the second quarter) but much faster than normally as market rates fall, as during 1985 and 1986. Those differences in growth rates in money will tend to be reflected in inverse movements in the velocity (that is, the measured rate of turnover) of money rather than commensurate changes in economic activity or prices.

That sensitivity of velocity to changes in interest rates makes it more difficult to judge the appropriate rate of monetary growth -- particularly over periods as short as a quarter or a year -- and impossible without reference to the stream of available evidence on economic activity, prices, and other factors. This year, too, concerns about the international performance of the dollar have at times had a significant bearing on operational decisions. Specifically, the tightening of reserve availability in the spring was related in substantial part to the desirability, in the light of the substantial cumulative depreciation over the previous two years and other economic policy undertakings here and abroad, of maintaining reasonable stability in the external value of the dollar. That judgment is, as you know, shared with the Administration and the finance ministers and central bank governors of other leading industrialized countries.

Looking ahead to 1988, the Open Market Committee decided tentatively to reduce the target ranges for M2 and M3 by 1/2 percent to 5-8 percent. While recognizing the inevitable range of uncertainty I referred to earlier, some reduction in the target ranges clearly appeared appropriate in recognition of the importance of assuring that the temporary bulge in price increases foreseen for this year not become a base for a renewed inflationary process. The appropriate range for 1988 will, of course, again be reviewed with care at the start of the year.

More broadly, policy has to be judged against progress toward the more basic goals of growth and stability -- and it seems to me fatuous to think the first could long be

sustained without the latter. At the same time, now and for some years ahead, we will need to work to narrow and ultimately correct the large imbalances in our internal and external economic positions -- adjustments that necessarily have implications for the policies and prospects of other countries as well. What is at issue is whether we can make those necessary adjustments while sustaining progress toward the broader goals.

In some areas, developments in the past six months have been strongly encouraging in that respect.

-- The evidence by now is pretty clear that, in real terms, our trade balance is improving, even in the face of continuing sluggish growth, high unemployment and excess capacity abroad.

While growth in domestic consumption has slowed -- one essential part of the adjustment process -- the expansion of domestic output and employment has been well maintained, and unemployment, at close to 6 percent, has dropped to the lowest level in this decade. Manufacturing has picked up and prospects for business investment may be improving.

- Helped by some large unanticipated capital gains tax receipts, this year's budget deficit will apparently be driven even below earlier expectations, and thus very substantially below the fiscal 1986 level. Internationally, leading nations are not only agreed upon the desirability of greater exchange rate stability but appear to be working more effectively to that end.

In another area demanding a high level of international cooperation, the basic approach for dealing with the international debt problems has continued to be implemented with substantial success despite doubts and challenges by some.

Of central importance, there has been continuing evidence of restraint and discipline on costs and wages in much of American industry, offering the prospect of lower rates of inflation in the months ahead. Over time, that must be an absolutely essential element in maintaining our international competitivness as well as in restoring domestic stability after the bulge in prices this year.

At the same time, it would be nonsense for me to claim that all is safely and securely on path. The remaining risks and problems are apparent.

Even the otherwise satisfying fall in the unemployment rate this year implicitly has a discouraging aspect. Outside of manufacturing, the statistics suggest productivity growth is quite dismal -- so slow, in fact, that I cannot dismiss the thought that the reported statistics may partly reflect measurement error.

But no error of measurement can entirely explain away that our private saving, in historical or in international context, remains so low, or that our federal deficit remains so large, or that we, the putative leader of the western world, are so dependent on other people's capital. Despite the better news on this year's federal deficit, some projections of future deficits assuming current programs are being raised rather than reduced and the political impasse over doing something about it apparently remains. In the circumstances, the Gramm-Rudman-Hollings targets are threatening to become pie in the sky.

The already slow growth in other industrialized countries appears to have slowed further this year, working against the adjustments needed in trade and current account positions among Japan, Western Europe and the United States. And, in that environment the dangers of protectionist trade legislation and a breakdown in the servicing of international debts are enlarged.

For all those reasons and more, my very able successor, and the Federal Reserve generally, will have challenge aplenty.

But, I, as I have spelled out earlier, would like to think there is something upon which to build as well.

Finally, Mr. Chairman, I would like to acknowledge specifically the usefulness from my standpoint of these regular semi-annual hearings on monetary policy.

You and I are both conscious of the special position of the Federal Reserve System within the overall framework of government. The long terms of members of the Board of Governors, the participation of the Regional Federal Reserve Banks in the policy process, our budgetary autonomy, and the professionalism of our staff are all designed to provide some insulation, in deciding upon money creation, against partisan or passing political pressures.

In our system of government, however, insulation cannot be equated to isolation, and particularly isolation from reporting and accountability to the Congress and to the public.

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These hearings are an important element in that discipline. I have welcomed the opportunity they have provided for us to consult with the Congress, and to explain our purposes, our approaches, and our problems in dealing with a complicated, changing economic environment. And I want to express my appreciation as well for the many courtesies you have extended me personally over these past eight years as we have worked together to foster economic stability and growth.

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Mr. VOLCKER. You asked for advice on how to work more effectively with the Congress. I am in the position of having made a little talk yesterday at Arthur Burns' memorial service. One of the things I called attention to there was the effort that he had made—and I realize that was largely in cooperation—I used the word cooperation—with you, consultation, sometimes antagonism I suspect, in working out the present reporting relationship. In fact, that is the legislation under which provisions I am appearing today and you are appearing today.

My feeling is that that has worked pretty effectively and that is a pretty good balance between our responsibilities to the Congress, our responsibilities to the public, both for information, for consultation, for accountability, and retaining the basic discretion that I think inherently has to lie in the central bank and in the Federal Reserve. And I don't have any particular suggestions as to how that can be improved.

I think going through this process twice a year at least, a minimum of twice a year, is about the right intervals. When something comes up, obviously we can always be called upon to testify and explain.

I think the Federal Reserve has always tried to be fulsome and straightforward in response to inquiries we get from the Congress about factual or policy matters and it certainly should be. So I'm not sure that I have any new suggestions to make there.

SALARIES ARE A PROBLEM

You raised a question of pay and you say you get what you pay for. I'm in the peculiar position of hoping that you got a little more than you paid for in the last round, but I do think that salaries are a problem.

I am very conscious of the fact that it's very hard to do something about Federal Reserve Governors' salaries where you have this anomaly that the Governors get less than some of the people in the banks and the staff members. It's very difficult to do something about that and there are other incentives without raising questions about pay in Washington generally, which is a problem. But if you are able and willing to take some initiative with Governors' salaries, I would obviously be warmly in support of that because I think there is a point when the salary should not be an inhibition on good people coming to Washington. I'm afraid it is now, depending upon the financial circumstances that they are individually in. And that should not be the kind of consideration that deters you and the President from getting the right kind of people. So I certainly think something should be done there.

There is a small point on the method of selection that is an old point, but I just bring it to your attention. There is a requirement that each of the Governors come from different Federal Reserve districts, which is fine except if it was an inhibition when it came time to appoint the Chairman. I think it would really be a ridiculous situation if the President in looking around the country and had to appoint a new Chairman could not appoint the man he wanted to appoint and you couldn't approve the person you wanted to approve because he happened to come from a Federal Reserve district that was already filled by another Governor. That's a rather technical change, but I wish you could find a vehicle sometime for making that change.

We have discussed before the appropriate term of the Chairman, as opposed to the Governors, and I have taken the position—you've expressed some doubt I know in the past that there may not be any ideal time to appoint a Chairman, but it's always seemed to me that about the best time would be about a year after a President took office, not to force that appointment right when he's taking office in the midst of a lot of other political appointments, but reasonably early in his term. I would continue to think that that's a good idea.

I don't know what you can do about the terms of the Governors themselves. If you're worried about the independence of the Board and one President appointing the whole Board of Governors, which I think it's true was not the design of the Federal Reserve System with the 14-year terms we have now. I could hardly conceive of making those terms longer and that is not the problem, of course. What has happened now, by combination of events, is you have had a series of resignations. It wasn't anything to do with the terms of the Governors and you can't force people into indentured servitude when you put them on the Board of Governors, so I don't know how you can deal with that problem by technical changes in the law.

COMMENTING ON FUTURE APPOINTMENTS

I must say I shudder at your proposal that a Chairman would have to come up here and write a letter to the committee commenting on a Presidential appointment of a future colleague. It seems to me a position that I hardly imagine a Chairman would want to be in. If he consulted with anybody, I would think he should consult at an earlier stage in the nomination process, which would mean with the President rather than with the Congress. I think at that stage it would be too late in a sense even if he had strong feelings about it.

I don't know what the constitutional inhibitions would be on requiring that kind of consultation, but as a matter of practice—I don't think it takes a question of law—as a matter of practice, I think it's a good idea and not always observed.

The CHAIRMAN. Well, I understand that and when I asked that question I was just as concerned as you are. It would be extraordinarily difficult for a Chairman of the Board if somebody was appointed and he doesn't think they are qualified or doesn't think that they would provide the kind of balance and so forth that would make it possible for the Chairman to serve as effectively as the Chairman for him to say so publicly would make it more difficult.

But your proposal for advance consideration is something I think we ought to explore. I think it's varied with Presidents. I think when Arthur Burns was Chairman of the Board, I had the feeling—perhaps it was wrong, but I had the feeling that he had a lot to say about who was going to be appointed. He was consulted. Perhaps he took the initiative and persuaded the President to consult with him. One way or another, the President seemed to do that and I think Martin may also, although I wasn't as familiar with the Martin situation as with the Burns situation—at any rate, it is so important that the Chairman have Governors with whom he can work, Governors in whom he has confidence. This is such a vital, vital position. As I say, I think it's underpaid and I think it's extraordinarily important that we get people who will work with the Chairman so the Chairman can have a coherent, cohesive, consistent leadership position.

It's very hard when you have a situation when the Chairman and the Members can't agree. You've gone through it. Obviously you can't discuss that and I know you won't and perhaps you shouldn't.

But if you could give us some kind of guidance on some way that we could work this out I would appreciate it.

Mr. VOLCKER. I am not at all sure this is a kind of problem you can or should handle in a legislative way. Obviously problems can arise, but you have a basic dual question I think in any board. I think a Chairman needs a certain amount of room, as you suggest. He should have good relationships if he can with the rest of the Board Members. He's got to have room for a little initiative and all the rest.

On the other hand, in the end, the other Members are there partly to act as a check on the Chairman if he goes off the deep end, so to speak. I think that is why you have a board in the first place. You have a Board because you don't want to give everything to the Chairman and I think that's appropriate in this area.

How you have a precise balance between preserving some room for initiative and coherence—I would emphasize the word you used, coherence of policy, which you sometimes can't get in a board of people appointed by different people and all exactly equal—is the issue. How you get some coherence but nonetheless have the strength on the Board as a whole that acts as—in the last analysis, a good Board will act as more than this, but as a minimum—some kind of a check upon an excessive amount of discretion or initiative by a chairman is the question. You can't legislate that balance. It's going to be worked out differently in every Board of Governors.

I don't even know what the language in the present Federal Reserve Act exactly means and I don't think any other Board Member does. I don't remember the exact language, but it's something about the Chairman has executive responsibility for the administration—that's not exactly the right language, but it's some words to that effect, and I don't think anybody has ever known exactly what that meant in terms of his actual authority over the staff and over Board assignments and all the rest. But it seems to work, and I don't know how you legislate it any more precisely.

FORECAST A SLOW GROWTH OF THE ECONOMY

The CHAIRMAN. Let me ask you this, Mr. Chairman. Your statement indicates the Open Market Committee has reduced the 1988 money growth targets by one-half of a percentage point in their current levels. You also forecast a rather slow growth of the economy.

Was this decision arrived at unanimously or were there dissents?

Mr. VOLCKER. I think there was one dissent for the target for next year.

If I may say, you commented about rather slow growth of the economy and I think that's a common impression, but there is more than one way to look at economic growth. We've had a pretty good growth in employment and a pretty good decline in unemployment and that all raises a question the answer to which is not totally clear—how fast can you grow?

If we had had much faster growth and presumably much more rapid decline in unemployment and increase in employment, would that have been sustainable? Would that have been a situation that is really congruent with the aims of stability and sustainability over a period of time? I'm not so sure.

The problem, of course, is that productivity has been so low in the nonmanufacturing sector of the economy, if you believe the figures—and I'm not sure I quite believe them. We are getting no productivity growth essentially in the nonmanufacturing sector of the economy. But if the difficulty is the numbers, that means we are understating the GNP growth and it wouldn't look so relatively low as you described it.

The CHAIRMAN. Can you tell us who dissented and why?

Mr. VOLCKER. I don't think I have gotten into these names in the past and I don't think I want to create a new dissenter.

The CHAIRMAN. All right. Can you tell me why the dissent?

Mr. VOLCKER. Well, I think, as I recall it, the dissent was not to lower—the sense of the dissent was not to lower the range at all at this time anyway.

The CHAIRMAN. Why did they dissent?

Mr. VOLCKER. Because they presumably didn't want the range lowered. Now there was a lot of discussion at the meeting as to whether to lower the range more than that and it was decided, as I said in my statement, we would lower by a half now and take another close look at it next January or February.

The CHAIRMAN. They didn't give any other reason except they just thought it ought not to be lower?

Mr. VOLCKER. Well, I presume that's tied in with some judgment about where the economy is going and where inflation is going and all the rest, but that's true of everybody voting. Everybody else looking at those facts decided that they wanted it lowered by at least a half.

The CHAIRMAN. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Chairman Volcker, I have a prepared statement I'd just ask unanimous consent that it be placed in the record.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR JAKE GARN

Senator GARN. Chairman Volcker, I want to once again state publicly my great admiration for the job you have done as chairman of the Federal Reserve's Board of Governors.

Under your leadership the Fed's monetary policy has made significant contributions toward the economic achievements of recent years. Among those achievements is an economic expansion that will soon become the longest peacetime expansion in the postwar period.

You have also been one of the loudest and most consistent voices calling for action on the Federal budget deficit. No one has made a more persuasive case than you for the dangers to our economy of Congress' failure to act on that deficit.

Your contributions, however, have not been only in the realm of monetary policy. You have also been one of the strongest advocates of efforts to assure that our financial institutions remain strong and competitive.

To that end, you have urged Congress to expand the range of products and services that banks can offer to their customers; you have recommended paying interest on the reserves that financial institutions must keep on deposit with the Federal Reserve; and you have opposed legislated capital requirements of loan-loss reserve requirements for financial institutions.

Chairman Volcker, your contributions have truly been legion.

Mr. Volcker. Thank you very much.

Senator Garn. I would simply say to you that as this is your last hearing before this committee as Chairman of the Federal Reserve Board, I would just like to compliment you not only on the job that you have done over the last 8 years during a very, very difficult period of time—not only for that, but for your cooperation with me when I was chairman of this committee, with Chairman Proxmire, and with the entire committee. I'm sure I speak for the present committee members and many that have come and gone on this committee over the last 8 years.

Although we have not always agreed with you, I think the respect has been unanimous on both sides of the aisle and we think that you have done a superb job under very difficult circumstances.

So we wish you well as you proceed to whatever you will be doing. I've been reading the speculation but we will wait and find out what happens.

I just have one question today that I asked Mr. Greenspan the other day and that is, we've had a discussion over many years about the LDC debt problem. What is your current assessment of where we are with the LDC debt?

ASSESSMENT OF THE LDC DEBT PROBLEM

Mr. Volcker. Well, my assessment is we are progressing, progressing with difficulty. I think this is a long-term problem and it always has been, but I think when one looks back over the past 5 years now since it broke into the open, there has been substantial progress whether one looks at it from the standpoint of its threat to the international system, which is still real but diminished substantially from what it was 5 years ago, or whether one looks at it from the prospects of restoring some kind of sustainable growth in the borrowing countries. It's been a difficult process and far from satisfactory, but nonetheless, I think progress.

That progress has taken place despite the fact that growth in the world economy, which is an important dimension, has lagged below what I would have thought was a reasonable expectation some years ago and below what would be desirable from the standpoint of providing the best kind of environment for resolving this problem.

That is one of the reasons things are going more slowly than one might hope. There's a lot of impatience. There's a lot of frustration. Partly because things are, in my judgment, fundamentally better, the centrifugal forces among the banks, the borrowers, the countries, are greater than they were because the pressure to pull together rapidly diminishes when things are getting better. And that is, in itself, a threat.

And I am not about to suggest this is all smooth sailing, but I think we have continued by hook or by crook to proceed on a path, let's say broadly defined by the Baker initiative or broadly summarized by that initiative, that has worked and is workable. And you have to ask yourself how does it continue to work amid all the pressures that take place?

I would suggest to you that that basic approach responds to the basic needs of the borrowers and the creditors and the creditor governments and the IMF and the World Bank in a way that no other proposals that I have seen respond. And it kind of holds together amid slings and arrows of outrageous fortune because I think it is a well-conceived approach and it really does respond to the basic needs of the situation.

Now there are immediate challenges. Brazil—how goes Brazil, the biggest borrower, in the next few months? Can they be brought back into the fold, so to speak, with continuity of debt service or not?

I think in the first instance that depends upon Brazilian programs. It has to be a program that is made in Brazil, responsive to their needs, but I think it's also important from their standpoint they do come back into regularization of the debt situation because they have a lot at stake in an orderly trading system and an orderly financial system.

Brazil, in my judgment, is not going to prosper in isolation. They have a potentially very dynamic economy, the most dynamic in Latin America, but that potentially dynamic economy, in my judgment, will not function well and will be crippled unless they are dealing in the rest of the world both in the financial system and in the trading system because ultimately they go together in a satisfactory way. So that is the major job right at the moment.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

OPENING REMARKS OF SENATOR GRAHAM

Mr. Chairman, I share the comments that have been made previously about the great public service which the Chairman of the Federal Reserve Board who is leaving us shortly has given this Nation.

There is a new book out on Harry Hopkins and it is entitled "A Story of an American Public Servant." I believe that that tradition of citizens who have served this Nation with great commitment, dedication and patriotism has been carried forward in this generation by Paul Volcker and I, as an American, wish to express my thanks and best wishes for his future.

Mr. VOLCKER. Well, you couldn't give me a nicer compliment, Senator. Thank you.

Senator GRAHAM. Mr. Volcker, in response to a similar question some months ago, you said that you did not stay up at night losing sleep over the fact that the Congress might cut the federal deficit too much.

We are going to be looking at this issue again in the next few days and apparently there is going to be a recommendation that we adopt a glide slope for that deficit reduction of approximately $35 billion a year.

What comment would you have as to the appropriateness of that level of budget deficit reduction?

Mr. VOLCKER. I don't know what the starting point of that is. Is this from something around $160 billion or latest estimates?

Senator GRAHAM. Yes.

Mr. VOLCKER. Part of my answer has to be that no arbitrary glide slope for the next 5 years or whatever is going to be precisely appropriate to economic conditions 3 or 4 years from now that we don't know about.

If you establish and could keep in general to a slope of that order of magnitude, it sounds about right to me, as well as one could do right now not knowing what the future may bring. If anything, it may be a little low, but not out of the right order of magnitude.

Senator GRAHAM. I would like to pursue the question that Senator Garn asked relative to Third World debt.

What do you think should be our standards of evaluating progress in terms of meeting the Third World debt, as to whether our current policies are satisfactory and should be modified? I asked the same question of your successor and his answer was that the milestone should be whether the marketplace and specifically the ability of the Third World debtor nations to go into the open marketplace and borrow money that if they were able to do that, then he would find that to be the measure of success of our management of Third World debt.

Mr. VOLCKER. I think that would be one test and a very clear and evident test for a kind of—nothing is final in this world—ultimate success in getting through this crisis anyway from the standpoint of finances.

Now I think in looking at progress, even before you get to that point, you have to look at two things very broadly. Are these countries successful themselves in growing and not just growing for a particular 6-month period or 1 year, but are they moving in a direction fundamentally in the structure of their economy that promises better future growth? That's one question.

The other question is, is that being accomplished in a framework of not disrupting the international monetary system unduly before you get to the point that Mr. Greenspan was talking about? Can you manage this in the context of a reasonably stable banking system and international financial systems?

So you look at it from both sides and while progress hasn't been perfect, as I was suggesting earlier, I think you can see some degree of success in both those efforts even though we haven't reached a point that you were referring to, which I agree is a good test of when the problem is in some sense over.

Senator GRAHAM. I see my time has expired. I would like to ask some further questions on the next round. Thank you, Mr. Chairman.

The CHAIRMAN. Fine. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

Mr. Volcker, we certainly thank you and commend you for your service to this country and your cooperation with the committee.

If there's no objection, Mr. Chairman, I would like to submit a statement commending Mr. Volcker for his independence and his expertise for the record.

The CHAIRMAN. Without objection, so ordered.

STATEMENT OF SENATOR CHRISTOPHER S. BOND

Mr. Chairman, I join with my colleagues in welcoming Chairman Volcker to his last appearance before the Banking Committee and commending him on his extraordinary tenure as Federal Reserve Board Chairman.

There are very few figures in Washington who are as universally respected. Paul Volcker has done his job well in the face of adverse circumstances and tremendous political pressure. We are in the midst of a sustained economic recovery with relatively low inflation, due in large part to his conduct of monetary policy. Certainly Congress' fiscal irresponsibility would have far more damaging consequences were it not for the leadership at the Fed.

Paul Volcker has served as a lighting rod for the frustrations of many groups and he has dealt with pressure from the White House and the Congress with great aplomb. All of us could learn something from his independence and willingness to stick his neck out for what he believed was best for the country. In addition, his expertise in dealing with international economic issues and bank regulation will be missed. We wish you well in all your future endeavours, and thank you for testifying before us today.

Mr. VOLCKER. Thank you very much.

Senator BOND. I would say, Mr. Volcker, it's a little disappointing to me as a cigar smoker that you are no longer smoking cigars when you give the testimony here.

Mr. VOLCKER. One holdout?

Senator BOND. Because the Adelphic smoke seemed to provide even greater effect to your very astute pronouncements and we will miss that.

One of the things that is of great concern to the Congress and I know that you commented on it in your previous testimony in the House is the FSLIC recapitalization bill.

Some have argued that the forbearance language is so strong and the amount of the bailout is limited in a way that will make this bill ineffective. On the other hand, there are those who argue that the insolvent S&L's will recover and we shouldn't give FSLIC too much money because it might cause the Federal Home Loan Bank Board to close too many.

COMMENTS ON RECAPITALIZATION

What do you think about the prospects for the industry and do you have any comments on the recapitalization portion of the bill as it now stands?

Mr. VOLCKER. Well, I think there are very large problems in the industry and I don't think we have to go into those in great detail. We could be here all morning. I think they are very well known. Some important segments of that industry are not solvent. Many of them will have to be closed, and I say that in a context—and I should emphasize that most of the industry is quite healthy, but the industry is bifurcated, to say the least. The mass of the industry is healthy. Many of them are quite profitable, some of them more profitable than they have ever been. Those are generally the more conservatively managed, but there was a segment in the industry that is off the deep end, so to speak, and is going to have to be dealt with and hence the relevance of this legislation.

I am certainly on the side where I would be happier if the amount in the FSLIC recapitalization was larger. I have some problems and have had some problems with the forbearance and supervisory provisions.

In the latest iteration, of course, the amount was increased which I think certainly goes in the right direction, and the supervisory provisions were made—how shall I describe them—tolerable, I believe.

So I do think from that standpoint the bill goes in the right direction. If you've got room to further improve forbearance and the amount, I would wholeheartedly support that, but I certainly think that the bill responds to a felt and clear need and should go ahead. There are other provisions in the bill—I think the provision on the nonbank bank issue is a basically constructive provision from the standpoint of setting down a basic rule that the Congress wants followed reiterating the existing rule or existing philosophy at least about separating banking and commerce. I think indecision on that issue has helped block banking legislation generally, so I like that part of the bill.

The part of the bill that puts a moratorium on powers is much more questionable, but I take a lot of heart from what this committee has said and the chairman and the ranking minority member have said that the moratorium means what it says; that it's a very short-term moratorium and it's just trying to give some breathing space for some constructive legislation and I would hope that if you can get this bill out of the way you immediately move to considering the reform of the banking powers area that's very urgently needed and has been stymied politically for years.

Senator BOND. Another issue which we are debating in this committee is the role of hostile takeovers. Many have pointed to the jobs that have been lost associated with the takeovers, yet there are companies that are not threatened with hostile takeovers that are also laying off workers.

What do you see as the cause of the current merger wave? Do you feel it would be beneficial to the economy if Congress were to act to reduce substantially the number of hostile takeovers occurring in the country today?

Mr. VOLCKER. I don't know how you do that. This is not an area in which I am a great expert, but I get uneasy about some of these takeovers, as many people do. From my professional responsibility, a part that makes me particularly uneasy is the way some of them are financed, and it's part of a more general tendency toward more leveraging in American business and the American economy in recent years. From the standpoint of our direct responsibilities, that's the point where we have some concern.

I don't know how you get the balance between protecting the rights of stockholders and the ability of stockholders to have their voice heard and demand the highest rate of return and management's concerns that lack of job security leads to an overemphasis on short-term focus and the potential for instability from changes in management. Obviously, the market has to work here and I'm not an expert in just what particular provisions of law and waiting periods and all the rest are most appropriate. So I can't really comment on that part.

But I have repeatedly expressed concern not only in this connection but more broadly about the fashion toward more leveraging, and that is partly what is driving this situation. You have the feeling now if an underwriter finds a company that still has a AAA credit rating—and there aren't very many—he tells them he's not doing right for his stockholders and he'd better go around and leverage that and introduce a little more risk into the equation, and he's got a whole kit bag of techniques by which the company can increase their leverage and reduce their ratings. There is a set of incentives in the economy that seems to push in that direction that I think are unfortunate.

Now one of those incentives is very basic. It's the tax treatment of equity. It's treated more harshly than debt and that's been in the law for almost since the income tax started—the corporate income tax. Why it is so much more important now, I don't know. But people focus on it and that is part of the reason I think for this tendency toward more leverage and it's something obviously within the scope of Congress to look at in a pretty fundamental way.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Dixon.

Senator DIXON. Chairman Volcker, first of all, I want to ask consent of the committee to place in the record a highly complimentary statement regarding your public service.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I come to this morning's hearing with decidedly mixed feelings. On the one hand, I always enjoy the opportunity to discuss monetary and economic policy issues with the distinguished Chairman of the Federal Reserve Board, Paul Volcker. While we are in the fifth year of the current recovery, we continue to face very serious economic problems, and the Fed plays a key role in formulating our responses to these problems. On the other hand, I deeply regret that this will be his last appearance before this committee as the Fed Chairman.

I think the Nation has been very fortunate to have Paul Volcker serve as our central banker over the past several years. He is a tall man, but his reputation stands much taller—and it is a reputation that is richly deserved. His understanding of our domestic and international financial systems is unsurpassed, and he has demonstrated over and over again his ability to handle the numerous problems that have arisen during his tenure.

I think Alan Greenspan will make a very able successor. I want to say to the current Chairman, though, that the United States deeply appreciates the job you have done.

Although this is your last appearance before the committee as Chairman, Paul, I hope we will continue to be able to call on you for advice and counsel in the future.

Mr. VOLCKER. Thank you very much. I will read it with interest later.

Senator DIXON. I want to say, beyond the fact that I'm placing this statement in the record, that you're not only a tall man but I think you are a towering public servant. Not only have you been a great stabilizing influence on our Government, but I'd like to say publicly something that I've never said before about your responsiveness as a public man.

When we had a real financial crisis in my State in connection with the Continental Bank, you called my office and discussed with me every day the things that were being done to address that problem and it's significant, in my memory, that you called me on Christmas Day when you were at dinner at your daughter's house concerning some of those problems. And I'm just very impressed about that.

Mr. VOLCKER. I have absolutely no memory of that.

Senator DIXON. Well, you did. I have a great memory of it.

Mr. VOLCKER. The only way I can account for it is the turkey was overdone or something, Senator.

Senator DIXON. Well, I just wanted to share with you the feeling that everyone on both sides of the aisle has about your extraordinary public service and I want to very briefly discuss with you S. 790. My friend from Missouri touched upon it briefly.

No one here would suggest that it's a perfect bill. There aren't very many of those passed around here I expect. But there is some concern now that the President may be receiving recommendations from some quarters to veto that legislation and I would like to stress that those of us on the committee who achieved a consensus on this bill hope that in what we've done on the moratorium on nonbank banks and what we've done about the powers for banks we will move forward expeditiously over the next few months to do some significant things if this bill is signed.

And while there's some possibility that there's reasonable argument that the $8.5 billion for FSLIC ought to be higher, I expect the administration could come back later if it needed to about that.

But I would like to ask you whether it is correct that you have indicated that, on balance, you believe that to be decent legislation?

Mr. VOLCKER. Yes, sir. There's no question about it. I do think it is, on balance, constructive legislation, even though there are provisions that I either don't like or I think could be greatly improved.

And I have convinced myself anyway that the prospects for a follow-on, which are so clearly necessary in terms of dealing with comprehensive banking legislation, will be advanced by passing this bill rather than the reverse. So the President is certainly not getting any veto recommendation from me.

Senator DIXON. I presume you are aware of the fact that most of us have signed a statement indicating that we mean what we say about the moratorium, that we will move forward, and we expect to address the powers questions and the whole nonbank bank question in a significant way in subsequent hearings.

Mr. VOLCKER. I am aware of that and that is one of the reasons I reached the judgment I reached.

Senator DIXON. And if the President asked you your opinion, would you recommend that he sign the bill?

Mr. VOLCKER. I certainly would.

Senator DIXON. In the event that the President does not sign the bill, would you recommend to the Congress that we enact the bill, his veto to the contrary notwithstanding?

Mr. VOLCKER. Well, I suppose that's implicit in what I said.

Senator DIXON. Thank you. You need not say more. I thank the chair.

Mr. VOLCKER. That doesn't mean the bill couldn't be improved.

The CHAIRMAN. Senator Heinz.

OPENING REMARKS OF SENATOR HEINZ

Senator HEINZ. Thank you, Mr. Chairman.

Chairman Volcker, I think I speak for every member of the committee when I say we are going to miss you as the Chairman of the Fed and your appearances before this committee. We have always learned a great deal. You have always been as candid as you can be consistent with avoiding turmoil in the markets. You've been discreet, but you've been honest and you've been remarkable in the excellence of your dedication to public service over these many years. We are all grateful to you that there are such public servants from time to time as Paul Volcker and I hope you now don't catch all the fish at Spruce Creek. You're certainly going to have more time up there than I will.

Mr. VOLCKER. There is no danger of that.

Senator HEINZ. As you know, the man who is nominated to succeed you was before the committee a short time ago. Maybe he's asked you this question, but whether he has or not, let me ask you. What is the most difficult problem he faces?

Mr. VOLCKER. I don't think he's asked me the question quite that way. We have had quite a few conversations. In the midst of one of them he said, "Why did I agree to take this job?" There's more than one.

But obviously the Federal Reserve has a core of responsibility of dealing with the basic question of money creation and credit creation in a way that ensures a reasonable degree of stability and I think he and I—I shouldn't speak for him—but I certainly feel that that is fundamental to the growth equation and I observe from what he's been saying to the committee——

BIGGEST THREAT TO THE FED

Senator HEINZ. What's the biggest threat that he faces in terms of maintaining that stability? The stability you described you have often described on previous occasions as sustainable economic growth——

Mr. VOLCKER. Exactly.

Senator HEINZ. Which implies keeping inflation under control and all those good things that we all love.

Mr. VOLCKER. Well, in a technical sense right now we are having a bulge in prices. I hope we are getting through it. That was more or less inevitable—let me take out the more or less right at the moment, given the rebound in oil prices and given the sharpness of the decline in the dollar and the rise in import prices that that implies.

So I think the immediate analytic challenge and policy challenge is, given that bulge, can we deal with the economy, deal with the monetary equation in such a way so that indeed it turns out to be a bulge and is temporary and doesn't get built in as a kind of platform for continuing or even increasing price increases?

On the favorable side of that, I don't think it has been built in yet. The wage-cost dimension remains very satisfactory in terms of the rate of wage increase and compensation increase being reasonably congruent or as congruent as we've had it in a long time with the basic rate of productivity growth. And two-thirds of cost in the economy over a period of time are tied up in wage costs. So long as we can maintain stability there, I think we should come back—make a few other assumptions—to a situation where these price pressures we're seeing at the moment indeed turn out to be a bulge rather than a new trend.

But that depends upon not only whether we avoid some external shocks like further increases in oil prices or a precipitous decline in the dollar, neither of which are independent, particularly the latter, of Federal Reserve policy, but continued careful and cautious management of monetary policy over a period of time in terms of the general demand pressures in the economy.

That is a kind of central, continuing challenge that's at a rather sensitive point right now.

Senator HEINZ. At previous junctures where the dollar has fallen, as it did in the mid-1970s, that fall was accompanied inevitably by inflation.

Mr. VOLCKER. Right.

Senator HEINZ. From the heights of the dollar in 1982 or so, we have had a far more steep relative fall. Why will we not see inevitably the kind of inflation that we experienced in the 1970's?

Mr. VOLCKER. Well, we will see some and we are seeing some at the moment. But when you say the type in the 1970's, that was a situation where this all got built in, not just because of the decline in the dollar but other things were going on, including all those oil price increases; and it got built in in a self-reinforcing kind of way. That's what you have to avoid.

Senator HEINZ. It got built in because the general price level of imports went up.

Mr. VOLCKER. That was one factor.

Senator HEINZ. And with the exception of oil, for the most part, so far there has been very little corresponding increase in the general price level of imports. Are we due for that as well?

Mr. VOLCKER. Well, I think there has been relatively little relative to the decline in the dollar, which has been rather large. We've had a 40-percent decline relative to other major industrialized countries. When looked at in that perspective, the price increase has been reasonably restrained, but there's no doubt that import prices are going up substantially more rapidly than average prices. They are going to continue for a while I think inevitably, but maybe not all that much longer, if the dollar stabilizes and it's containable.

Now the question is, is it also consistent with improving the trade position? There's a lot of debate about that and whether or not it is depends on other things than exchange rate, in my opinion. Are you going to follow through on the budgetary side here and are we going to get adequate growth abroad, which is very much in question, to speed and facilitate this adjustment process without requiring further declines in the dollar which in turn is very important—I think in the outlook for interest rates as well—but very important in terms of the outlook for inflation.

Senator HEINZ. Chairman Volcker, my time has expired. If I had time, the next question I would have asked you would have been about the effect—I'm not going to ask it, I just hope someone else will—about what the effects would be of the restimulation of Japan and West Germany and how that increased demand might also increase inflation and interest rates worldwide. But I will not ask you that.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. I think the Senator from Pennsylvania asked a very good question. If you want to comment on his question, Mr. Chairman, I will—and then when my time is up I'll probably have another question that I'll want to ask. Go ahead.

Mr. VOLCKER. Let me try to be reasonably brief. I already suggested in half a sentence anyway that I think a more expansionary thrust in Europe and Japan would be desirable in terms of that process—external adjustment.

I think one could imagine it carried conceptually to the point where it might be destructive by creating pressures on their financial markets and make it more difficult for us to finance our deficit rather than easier, contribute to kind of a worldwide atmosphere of renewed inflation. But my judgment is we are a long ways from that and that that the basic point is that there is room for and a desirability of expansion in the other main economic areas of the world that happen to have large external surpluses that must diminish if our external deficit is going to diminish.

OUR ECONOMY NOW AND IN THE FUTURE

Senator SHELBY. Dr. Volcker, we've all been asking these questions and you've talked about them many times before this committee and otherwise. I see three problems, big ones, that are fundamental that don't seem to go away that impact on our economy now and into the future. As I see them—and I would appreciate your comments on them—they are fundamental—the continuing deficits of the size that we have, and in the growth of our debt which is now approaching $2.5 trillion, and then compounded by our trade imbalance. And you put those together, as I see them, there are tremendous risks out there for your successor and all of us. Then you look at our low savings rate that you've talked about on many occasions in this country and even today in your testimony you mentioned once again we're supposed to be—and I assume we are and I hope we are—the engine driving a lot of the world and yet we are dependent upon other people's capital.

Mr. VOLCKER. Sure.

Senator SHELBY. If you would comment on that, if you agree with some of those assumptions?

Mr. VOLCKER. I agree entirely with the statement you just made. Those are all big problems. They are all interrelated. They all present very substantial risks.

Senator SHELBY. Are these the three big problems we face, the first three plus the lack of savings, the fourth?

Mr. VOLCKER. They really are all part of the same problem. They are all reflecting the fact that we are spending more at home and consuming more at home than we are really producing and can afford, and that is reflected in over-borrowing by the Government and it's reflected by over-borrowing by private people, and both of those are reflected by the low savings rate and reflected in the borrowing from abroad.

Senator SHELBY. All interrelated very much?

Mr. VOLCKER. They are all interrelated.

Senator SHELBY. Dr. Volcker, I want to ask you to comment if you would on the difference between Brazil that has been mentioned that is a big debtor and that of Turkey which seems to be meeting its obligations, and is that a question of discipline internally in those two countries or what?

Mr. VOLCKER. Well, you go back to Turkey 6, 7 or 8 years, you could say that Turkey was more or less in the position that Brazil is in today.

Senator SHELBY. That's right. And what has happened since then?

Mr. VOLCKER. I don't think that Turkey has the same potential resources and dynamism maybe that the Brazilian economy potentially has, but they were in an over-extended position, to put it politely, 7 or 8 years ago. They have gone through a period of very considerable discipline, combined with a basic opening of markets. They got some external help. They got some help from the World Bank. They got some help from creditor countries.

Senator SHELBY. The Germans also invested there?

Mr. VOLCKER. The Germans took some leadership at one point in coordinating international support for Turkey because their economy has some links with Turkey.

Senator SHELBY. But they've shown what could be done?

Mr. VOLCKER. And I think economic performance in Turkey has greatly improved and they've kind of passed the threshold that Alan Greenspan was mentioning as a test of success. They have access to the markets again.

It didn't get so much attention because it was a more isolated situation—not totally isolated, but it is a good example of the way you can work through this process.

Senator SHELBY. And it's also an example perhaps to some of the countries like Brazil and others that they cannot thrive in isolation?

Mr. VOLCKER. I agree with that, yes.

Senator SHELBY. Dr. Volcker, everyone is asking what could be the real surprise out there for your successor, for all of us and the whole nation?

Mr. VOLCKER. If I told you, it wouldn't be a surprise, would it? [Laughter.]

Senator SHELBY. Could it be a continuous default from time to time in the Third World debt?

Mr. VOLCKER. You kind of listed the major risks which could manifest themselves, the international debt problem, the S&L problem—you've got strains in the banking system elsewhere. You've got the inflation question which is certainly not in any immediate crisis situation but would certainly complicate the domestic credit market situation and interest rates if it wasn't adequately dealt with and respected over a period of time. There is the trade problem. There's the protectionist problem which you are grappling with up here. I suppose that's the clearest and most present danger in many ways. That doesn't take anything new happening or anything unexpected happening. It's right here now and it's very largely in control of the Congress, you and your colleagues, in terms of whether that will become a kind of crisis that really is damaging to the world economy.

Senator SHELBY. Dr. Volcker, my time is up, but instead of a question I will leave you with this. You will soon be in a position as an economic philosopher and all of us will be watching what you say and I hope heeding a lot of things you tell us. You honor us by coming back today.

Mr. VOLCKER. Well, thank you very much.

The CHAIRMAN. Thank you, Senator Shelby.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman. Mr. Chairman, I would like to submit a statement for the record.

The CHAIRMAN. Without objection, it will be printed in full.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

I would like to welcome Chairman Volcker for, barring some calamity, what should be his last appearance before this committee. While Chairman Volcker and I have not always seen eye to eye on the policies the Fed has pursured during his tenure, I want him to know that I and my colleagues are most appreciative of his commitment to public service as the Fed's Chairman. I wish him good luck and good fortune as he tries to determine if there is indeed life after the Fed.

A review of Chairman Volcker's testimony once again demonstrates that although the economic expansion is creeping into its fifth year, the short term outlook is imperiled by domestic and international concern about the depreciation of the dollar, higher inflation and the looming spectre of a Third World debt crisis. Is spite of the somewhat encouraging news contained in Chairman Volcker's statement, I think the 2 keys to maintaining even minimal economic expansion in the near future are: (1) pursuing a policy at the Fed that maintains low interest rates and (2) reducing the size of the Federal budget deficit. At this point in time I believe that progress is being made in both areas.

I am concerned a shift to a more tightened monetary policy could have drastic results for the economy. Although monetary policy alone is not a cure-all to the problems confronting our domestic economy, a tightening or slowing down of the growth of the monetary supply could trigger a recession. The drastic results and the budgetary impact of such a policy were articulated in previous hearings. While the potential inflationary impact of an economic increase in the monetary supply poses a threat that must be considered, the certain recession that can be triggered by drastic reductions of the monetary supply presents a peril that must be avoided.

Chairman Volcker's testimony also emphasizes several points that have been made to the committee in the past regarding the stability, or should I say the relative instability of our domestic economy. Today's testimony again substantiates the assertion that economic forecasting is hardly a precise science. However, certain steps must be taken by the Congress, the President, and the Federal Reserve Board to ensure continued and stable economic growth.

If the economy continues to grow at a moderate rate and if we are going to introduce more stability into the domestic and international economies, then Congress must address two problems that no longer loom on the horizon—these problems are at the front door. The first problem is that the budget deficit must be reduced in as rational and least painful manner as possible. The deficit issue has become a political football with the Congress blaming the President and the President blaming a profligate Congress. Such accusations tend to exacerbate rather than resolve the problem.

The second problem confronting our domestic economy is the trade deficit. Frankly, I am tired of hearing the same old arguments about how Americans can't compete; the unions have priced American heavy industry out of the market; and America is losing its technological advantage. I believe these arguments and those advancing draconian protectionist legislation ring hollow when one takes a real look at what's happening to American industry.

American industry is at the forefront of innovation. U.S. companies spend billions on innovation each year and develop new technologies. However, before these new technologies can be put to practical uses, we find that our foreign competitors are using the same technologies, in practical uses, at lower costs. How can they do this? Easy, many of our competitors are stealing us blind. During our last hearing on the Federal Reserve's monetary policy report, I stated that our so-called trading partners:

> Steal our patents, intellectual property rights, systematically are adjudged guilty in the courts, say we're sorry, pay back penalties, continue the same thing, infringe on patents and then send the products here into the United States. Further, those harmed have limited recourse under the current legal system. At present, even though your copyright may have been infringed or your patent stolen you must

then demonstrate that there is substantial danger to the particular industry, before damages can be awarded. Despite the failure of the laws and trade policies pursued to date we hear, oh, yes, we're going to make changes. We've been waiting a long time for negotiations or other bilateral approaches to work. We wait in vain. It seems to me, absent any legislative action or some very real enforcement of present trade practices, the policies of the Japanese and others will not change because they lack any incentive to change.

I have not changed my point of view on this subject. I should also note that Chairman Volcker supported my motion of the cause of such competitive trade imbalances and urged us to act. I am sorry to state that in the drive to make America more competitive, we and the administration have yet to consider the steps needed to make technological piracy more punitive.

Again I would recomment Paul Volcker for the job he has done at the Fed. When historians review your tenure at the Fed, I believe they will find that you served in a very difficult period where fiscal policy was often misdirected and you had to implement a monetary policy designed to make compensations and adjustments to pick up the balance. As always, I look forward to your testimony.

Mr. VOLCKER. Thank you very much.

Senator D'AMATO. Let me say, Paul Volcker, we commend you for the job that you have done. You and I have not always agreed on some of the issues, but I join with my colleagues as it relates to your stewardship, your dedication, your hard work, the fact that you have I think sensitized certainly this committee and others in the Congress as to the impending fiscal disaster are we not to heed many of the warnings that you have put forth. And I think you have made your point and I think that, notwithstanding our grappling today—the leadership—with the question of the debt and with the question of where do we go, we are much more sensitized and we have our job to do as it relates to dealing with reducing that debt so that we can send out the right kind of signal that we are serious, that we are going to control our deficits, and hopefully some day eliminate them, but at least get on that glide path that you have suggested if we were to begin to demonstrate to others more than just rhetoric that some confidence would return worldwide.

I commend you for that leadership, for your constancy in that area, and, Mr. Chairman, I have no questions. I think that my colleagues have touched on some of the key points and Mr. Volcker has once again reaffirmed the general outlines that we should be concerned with. I, too, join my colleagues in wishing you well and know that we will be calling upon you in the future and looking forward to your counsel.

Mr. VOLCKER. Thank you, Senator. If I may just respond in one sentence perhaps in talking about all these risks and problems, and you alluded to them again, Senator, I want to emphasize what I emphasized in my statement, that we have an awful lot upon which to build that's moving in a constructive direction. I think those risks and problems are very real, but we also have an enormous opportunity here. We've come a long ways toward restoring stability and we've just begun restoring I think the balance in the economy that we have to restore, but we have begun and you can see signs of it.

The CHAIRMAN. Senator Riegle.
Senator RIEGLE. Thank you, Mr. Chairman.

STATEMENT OF SENATOR RIEGLE

Chairman Volcker, I think we all feel a little wistful today about the fact that this is your last appearance before us in this capacity and I want to join with what others have said and thank you for all the years of service that you've given the country. I don't know anybody who's worked any harder or been more of a straight shooter in terms of saying what you feel, doing what you thought had to be done, and setting a model for public service that I think is a very tough one to match. And I just thank you very much for that length of service and that kind of service.

I also want to extend a thank you to your family. I don't know that anybody appreciates the real demands that go with your job, but there's a lot of requirement to attend international meetings and to undergo a certain amount of travel, and there is a family sacrifice involved here. And while we thank you, I think sometimes we don't really thank those that are associated with the people who give outstanding service, so I just want to take this occasion to say to your family members who have supported your efforts to serve in a public capacity that we appreciate that investment by them.

POSSIBLE LOSS OF CONTROL OVER FINANCIAL AND ECONOMIC PROBLEMS

You gave a commencement address a while ago and the reports that I read about it were to the effect that, among other things in that commencement address, you sounded a warning about the possibility that the United States could start to lose control over its own financial and economic destiny unless it really paid attention to certain critical problems. And you made a reference, I gather, to the deficit problems, the Federal budget deficits, which you've talked about a lot, the trade deficits, and the tone of what was reported was to the effect that if we don't discipline ourselves now appropriately, we could find ourselves in the future turning over some degree of our own future consequence and ability to decide things to others, to international forces or others who we owe a lot of money to or who have a new kind of leverage in the equation that hasn't been true in the past.

I've had that concern. We've talked some about that. But I'm wondering if you can give us a sense for your concern of how the United States sits these days in the broader sense in terms of making sure that we keep as much control as we can over our own economic and financial destiny.

Mr. VOLCKER. Well, the concerns I was expressing then—I'm sure they were pretty summary—were probably expressed more eloquently by Senator Shelby just a little while ago. That was the complex of issues that I was talking about and I think what you have to do about that is pretty plain. It's simple to state and hard to carry out.

What do you do about the budget deficit? What do you do about maintaining a continuing sense of discipline in money and in credit creation? What do you do about financial practices and the prudence and stability of bankers and the banking system? All those things that are the meat and potatoes of what we talk about over the years I think are part and parcel of that range of issues, and I haven't got any bright new insights to give you beyond what we've been talking about over these years.

Senator RIEGLE. Let me quote from that commencement address where you said that "We have mortgaged our future and we are obviously in danger of losing control over our own economic destiny." Those were your words.

Mr. VOLCKER. The most obvious reflection of that is when we have to borrow $150 billion a year, a lot depends upon the willingness of the creditors to lend the money. And it is a dimension that puts you under more scrutiny and more potential difficulties than you otherwise would be.

Senator RIEGLE. Let me ask you a specific question with respect to that. We saw interest rates kick up a couple months ago and as a result the prime rate went up, adjustable rate mortgages went up, and so forth. So it was a question as to how that was related to a Treasury refinancing that was coming at that time.

The yen is at about 152. It's been lower than that. I'm wondering if we were to see levels in the 140 or 130 range in the yen-dollar relationship, would we likely find ourselves in a situation where interest rate pressures would really start to build again and we would find ourselves maybe with the Japanese particularly backing away from picking up and continuing to lend us that billion dollars every 2½ days that we're borrowing from the rest of the world?

Mr. VOLCKER. Well, 130 would be quite a change from where it is now in percentage terms. The answer to your question is, while a lot depends on how you get there and what the surrounding circumstances are and all the rest, sure, there is a lack of confidence in the dollar—forget about particular levels—a lack of confidence in the dollar in the sense that it was kind of a one-way risk to go down is clearly deleterious to the stability of our internal financial markets.

And you saw that quite evidently during the spring when there was a kind of a sudden chill that went through the markets for partly that reason, partly fears on that side, partly because of domestic inflation. And that would be an unholy alliance—if you get one, you get the other—and you're likely to get the other because there is a relationship between the two in fact, and certainly that relationship is made psychological by the market.

So that would be, depending upon a lot of other things, the worst possible combination for domestic financial markets stability.

Senator RIEGLE. It sounds like anybody that thinks that just driving down the dollar indefinitely to solve the trade deficit is going to run into a wall of other problems.

Mr. VOLCKER. I think that is right. He's going to run into the kind of problem I'm talking about. The tendency has been in these situations for exchange rates to overshoot and it's one thing for a smaller country and a less central country, it would be another thing for the United States, and we've had some experience with it.

The other difficulty with that is the more people have the impression you can solve all these problems by currency depreciation we fail to do these other things. We fail to deal with the budget problem. We fail to maintain the discipline on costs and prices that is necessary. We fail to do the things that are necessary to increase productivity. That is a real part of the danger of just saying we'll solve all of this problem by exchange depreciation. I don't think that's ever worked.

Senator RIEGLE. Thank you.

The CHAIRMAN. Thank you, Senator Riegle.

Senator Karnes.

OPENING REMARKS OF SENATOR KARNES

Senator KARNES. Thank you, Mr. Chairman.

As the "new kid on the block," I've not had the pleasure to have your counsel and hear your numerous testimonies before this committee and as just 5 months ago being a businessman in Nebraska I want to thank you from that segment of the world for your leadership and stewardship and I know even in the commodity markets where I spent a great deal of my time we look to you and your leadership, even though that wasn't your particular area of expertise, as being a steadfast bulwark in that area as far as sending a strong signal for us in the international marketplace, and I take this opportunity, even though we have not had a chance to work together, to applaud you for your public service.

Mr. VOLCKER. Thank you very much.

Senator KARNES. Also during that period of time, the last 4 years, I had the opportunity to serve as Chairman of the Federal Home Loan Bank in Topeka and I had a chance to see the good, bad and the ugly from the thrift side, having in our jurisdiction States of Oklahoma, Nebraska, Kansas and Colorado.

SAVINGS RATE

One of the things that we were very concerned about and you noted in your testimony has been the low savings rate. I am curious to see what type of savings rate you believe would be appropriate in our dynamic financial environment as a percentage of some other figure, and indeed, is this something that we are going to see in the future continue to be too low a savings rate and is this something we should encourage, those of us that may have an opportunity to, to craft legislation to encourage additional savings on the part of the American consumer?

Mr. VOLCKER. I'm not going to get very far off on the limb in suggesting just what the right savings rate is. I will state with all the force I can state and all the conviction I can state, whatever the right rate is, we are below it—and below it by a significant margin.

Now just where it should be is rather a technical question we really couldn't answer unless you tell me also where the budget deficit is and where some other things are because those are all users of savings. The smaller the budget deficit, the more we can get by with less private savings. If the Government would ever reach that happy day when the Government was running a surplus, then the Government would be providing savings.

Having said that, I don't want to suggest to you that raising the savings rate is very easy in terms of what you can do in the Congress.

My observation in the United States and elsewhere is that the savings rate reflects obviously a lot of habits, a lot of culture, a lot of rather basic economic forces, and social forces that are hard to change. And fooling around with the tax system around the edges, which we've done a lot of, we can't see the effects of in the savings rate because more powerful forces are at work.

I think it comes down in the end—when you get beyond general social trends in the economy—importantly to a matter of whether you can count on stability in the future, whether you have outlets for savings that people trust that really will provide a rate of return over a long period of time. And that is a matter that has to be built up over a period of time and certainly fear of inflation or confidence in price stability is one of the major factors, I suspect, over a period of time in affecting savings rates. But you only see that over a long period of time.

Senator KARNES. Of course, on the opposite side of savings is consumption and spending and I've been frankly disappointed that as we've established some stability with interest rates over the last year or 18 months or so that we have not seen a corresponding increase in savings. If you follow that premise and say that people feel that their investments in a savings instrument of some sort will keep track with inflation, we have not seen that happen.

Mr. VOLCKER. I agree with that and it's disappointing, and I think it probably reinforces my skepticism, if that's the right word, about our ability to either forecast or affect the rate of savings in the short run.

The one area of savings, if you call it that, that you can affect without any doubt, directly and decisively, is the Government deficit, and I think that's the variable you have to work on.

Senator KARNES. Mr. Chairman, my time is over. Again, I regret I did not have a chance to work with you more, but I got here as soon as I could. Thank you.

The CHAIRMAN. Thank you, Senator Karnes.

Mr. Chairman, when Senator Heinz was questioning you, he asked you about the greater threat to stability in our economy and you mentioned wages, the price of oil, the drop in the value of the dollar obviously would reduce the competition from imports and tend to be somewhat inflationary.

You didn't say anything—maybe I'm wrong and maybe I missed it—about the deficit in this particular connection. We talked about it this morning.

But how inflationary is it, in your judgment, is the enormous deficit we have and the deficit we are likely to have in the next few years?

Mr. VOLCKER. Well, one answer to that question, and I guess the right academic answer in a way, is that the deficit itself need not be inflationary if we adhere to very disciplined monetary policy and all the rest.

The question is, whether in the real world that's really possible and feasible, given the distortions that the deficit injects into the situation. And I don't think you can do it by monetary policy alone.

So I think the deficit contributes to a structural situation as it persists over a period of time that increases the risk of inflation, and I can't quantify that, but I think it creates a basic financial market structure and situation and economic structure that makes us more vulnerable to accident, makes us more dependent on external capital, more vulnerable to excessive declines in the dollar, and an environment in which it is more difficult to run a restrained monetary policy, all of which increase inflationary risks.

The CHAIRMAN. Now you devoted most of your career to public service at a considerable financial sacrifice to you and your family. As Senator Riegle pointed out, your family has certainly had to share the sacrifice that you made. We now live in an era where public service seems less attractive to our young people. Doing deals and making a million dollars before age 30 seems to be the name of the game. It's very tempting for our most gifted young people to get into that area.

ENCOURAGE YOUNG PEOPLE TO CONSIDER PUBLIC SERVICE

Are there any steps we can take to encourage more of our young people to consider public service as a noble and honorable profession under the circumstances?

Mr. VOLCKER. Well, if I can impose upon the committee a moment to discuss that issue, Senator, a lot of nice things have been said about my public service and, of course, I'm in a very prominent position and there's a lot of rewards in another direction, but the Government isn't going to depend just on me in any important way. There are millions of people out there that run the Government.

I have had some concern, and I'm not alone, along the lines you suggest, that the quality of the public service, the quality of the career service, the quality of the semicareer service, if I may call it that—maybe it's just a man who's getting older, but I don't think the quality is going up; it's going down. And the attractiveness of Government to young people, as you say, is diminishing or has diminished; it has not increased. It's harder to get them to come and it's harder to get them to stay and that is all bad in a very fundamental way for the operation of the U.S. Government and for the United States.

In fact, there have been studies of this. Brookings and AEI corroborated on a study recently and came to the conclusion that there is what they call a quiet crisis in this area and a lot of distinguished Americans have been concerned about it.

I'm going to put in a little plug here that some of them have gotten together to make a commission on public service to arrive at just the kind of recommendations, among other things, that you're talking about, recommendations that I hope we can be back talking about in a congressional forum, but concerns about what you can do to interest young people, what should be done in the universities or whatever.

Elmer Staats, Bob Schaetzel, Elliot Richardson, Senator Muskie, Senator Mathias have all been active in this effort, and I'm somewhat familiar with it because they asked me to become the Chairman, so I agreed to take this on—I got my priorities backward, taking on my extracurricular activities before my real activities—but nonetheless, this question is on my mind and I'm not going to attempt to give you a complete answer. I have my own feelings about it.

You mentioned pay earlier for Federal Reserve Governors. It's a relevant question for more than Federal Reserve Governors, but I don't think that's the whole question or answer at all. There are many other things that enter into this equation and the whole object of this commission is to give you a more complete answer, I hope in 18 months or so, and I hope we will have a sensible report that attracts some attention in the Congress and elsewhere.

The CHAIRMAN. Unfortunately, my time is up. I'm going to sneak in this question anyway because it won't take you long to answer it.

Have you really stopped smoking cigars?

Mr. VOLCKER. I have a number of surplus boxes of cigars that people were kind enough to send me back in the old days several months ago when I smoked them and I'm going to send them up to Senator Bond to take temptation away. [Laughter.]

The CHAIRMAN. I was just going to say the Banking Committee room smells a lot better since you gave that up, and if Bond starts smoking we're going to go back to the old smokey syndrome, but I take it it's not El Ropo that you have.

Mr. VOLCKER. No, these are the good cigars that I didn't smoke. That's why I still have them.

The CHAIRMAN. I wondered why Senator Bond asked that question and he got paid off. [Laughter.]

Senator Heinz.

Senator HEINZ. No further questions, Mr. Chairman.

The CHAIRMAN. All right. Senator Graham.

Senator GRAHAM. Well, I can't resist my suggesting that most of those cigars that he has left are the ones that were made in Tampa since those are the best ones that he's saving.

The CHAIRMAN. Not in Cuba.

Senator GRAHAM. No comment.

NEGOTIATING AN INTERNATIONAL DEBT FACILITY

Mr. Chairman, I concluded with some questions on the Third World debt and my final question was, in the bill that passed the Senate recently on trade there was a provision for an encouragement to the Secretary of the Treasury to consider negotiating an international debt facility.

Do you have any comments as to whether that would be constructive?

Mr. VOLCKER. Well, in talking with the Secretary this morning, he seemed to feel it has been watered down to the point that it was livable. I very much see eye-to-eye with him on this issue, that I did not think it was constructive to put in a directive in that bill that would lead to false expectations and would lead people perhaps to relax in doing the things it seems to me they have to be doing in the hopes that there was going to be some grand solution arising out of some international negotiation that as near as I can see other countries aren't particularly interested in and don't see much promise in.

So I was concerned, as he was concerned, that it may lead to unwarranted expectations and I understand, although I haven't looked at it closely myself, that the language now included should be sufficient to avoid that particular danger.

Senator GRAHAM. Are there any systemic recommendations that you would have in terms of institutional change or creation relative to Third World debt?

Mr. VOLCKER. Well, it's clear that that problem, when you go back and look at it over the past 15 years, not just the past 5 years or so, you are forced to ask yourself, why did we get into it in the first place in terms of this as well as other problems; and it does raise questions about supervisory policies, about policies toward banks and banking supervision in general that are difficult to answer.

But I think we learned one lesson and that is—even in fair weather days, which we thought we had in the 1960's and 1970's—we've got to pay attention to such basic matters as bank capital perhaps a little more than we did at those times when we let them slip. A lot of this lending took place in an environment of much more leverage and it wouldn't have been so easy to do lending if we had been more insistent upon appropriate standards by the banks at that time. It was never popular then when there was no problem—but that's what we're here for.

The other thing that concerns me greatly from this dimension as from others, as you grope with trade problems, as you grope with budgetary problems, what seems to get the short end of the stick much of the time is our participation in certain international activities that seem to me absolutely critical to a cooperative developing world economy—the World Bank, the IMF, the regional development banks.

If the United States can't support these institutions halfway adequately, we can't expect that other countries will. We are the leader and it seems to me that it is pretty cheap what we get at the price. But it's both a question of budgetary money which has been extremely difficult to get even at levels of funding that seem to me absolutely minimal in terms of the problem—the debt problem and otherwise—and beyond the funding, unrealistic restrictions that are put upon the activities of these institutions that threaten to potentially render them fairly impotent in dealing, for instance, with the debt problem, and they have a large role to play in the debt problem.

So I would leave you with a plea that in developing priorities that go around budgetary restraints—I understand there are no votes in this particular area and there are very few constituents that are directly affected—it seems to me it is part and parcel of American economic leadership that's essential to resolving the debt problem and the international economic problem in general that's getting too short shrift from the Congress, quite frankly, in terms of the budgetary decisions and some other decisions.

Senator GRAHAM. Mr. Chairman, one final question in a different field.

You have stated your belief in this committee's commitment to looking at long-range restructuring of financial institutions and the importance of that effort.

Mr. Corrigan, of the New York Board, has submitted a proposal. Could you comment on that as the first draft of what might be that ultimate restructuring?

Mr. VOLCKER. Well, it's his proposal and not mine, and there are some particular portions of it that I would question or debate, but in terms of—as you might imagine—the general structure of that, much of the basic argumentation and the basic points of departure I fully share. So I think it is a very constructive element in the debate that you are having and I hope that debate intensifies over the coming months and I know that he has testified before you and that proposal will be one of your important starting points in providing a constructive framework for the debate.

Senator GRAHAM. Thank you.

The CHAIRMAN. Thank you. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

INTERNATIONAL TRADE DEFICIT

Chairman Volcker, in discussing a number of these questions, you have focused on some of the problems that we have in international trade and I would like your views on whether the international trade deficit that we are running is in fact more related to our Government deficits, our inability to save versus what we borrow—would you say that is the major factor in our international trade deficit?

Mr. VOLCKER. I think without a question that is the major factor, combined with what's going on abroad in the complement of those kinds of policies.

If the sense of your question is, is that much more important than specific trade practices, my answer is an unambiguous yes. I mean, our deficit is not primarily an outgrowth of restrictive trade practices abroad, although there are plenty of those, and the evidence for that is this deficit has arisen over the past 3 or 4 years and trade practices abroad have not changed appreciably over those 3 or 4 or 5 years. In some ways they have gotten worse and in other ways have gotten better, but you cannot explain our $150 billion deficit by a change in world trading practices where you have to look to these other general economic sources.

Senator BOND. There are some in Congress who believe that by legislation we can require other countries to lower the trade imbalance they have with the United States.

What would be the economic impact of such a proposal?

Mr. VOLCKER. I think destructive, if it was implemented. It just goes away from the whole idea of an open multilateral trading system when you begin dealing with these balances presumably by administrative means on a bilateral basis or a country-by-country basis. It is the antithesis it seems to me of the kind of trading system that the United States took the leadership in forging during the postwar years.

Senator BOND. Would you favor us with any comments you have on the measure that the Senate just passed this week dealing with international trade? Have we gone too far toward protectionism?

Mr. VOLCKER. Well, I think you almost certainly have, without having looked at the bill in detail. And I am not going to comment on it in detail because I haven't looked at it in detail. But it is my impression, yes, you are going too far.

Let me throw in one—while you're on this subject—again, I'm no great expert, but there is one negotiation going on that seems to me in a constructive direction and that is the free trade negotiation with Canada and there are some important issues left open there, but it's a very important matter in Canada. It tends to get more overlooked in the United States.

But in the midst of this whole trade problem and trade legislation, I would hope that there can be a breakthrough in those negotiations and that it does receive the amount of attention that's necessary in a sympathetic way in the Senate. It's going to have to be approved by the Congress. I hope there's some attention paid to that. Time is short for various procedural reasons that I don't fully understand, but you've only got a couple of months to complete that negotiation and I hope it can be constructively completed.

Senator BOND. One other area, Mr. Chairman. I was visiting with an officer from the central bank of one of our allies who expressed great puzzlement over the large number of financial institution failures and problems during a time of unprecedented economic progress and he asked what would happen if we went into a recession.

Do you have a view? Are these problems sectoral problems? Is there something more at work? How would you answer that?

Mr. VOLCKER. Part of it is sectoral obviously. We have had these enormous pressures in agriculture and energy, both of which I think, to be a little more optimistic, show some signs of bottoming out and it makes people feel better and maybe from the credit standpoint is getting a little better finally. There is some evidence that we have turned the corner.

But if you just look at the sheer number of bank failures let's say, that is an important element in it. But I am afraid something else has been going on, too; that even if you look beyond those sectoral questions, you have some strains, some pressures, some tendencies toward nonperforming loans, toward nonperforming credits of various sorts either in the banking system or the savings and loan system, after 4½ years of economic expansion.

Normally, at this period of time, except for particular sectoral problems, these kinds of indications of strain or credit problems should be diminishing toward the vanishing point. They have not this time. I think that is a reflection of what Senator Shelby and others were talking about during this period where we've been on this great ride of more borrowing, more leveraging in every direction; and it shows up, among other places, in bad credits. And it has sure shown up in a way that is troublesome.

That is another matter I think this committee has to look at. It has to look at it from a number of aspects, but to what extent is this in its extremes, including some of those savings and loans that we were referring to earlier, aided and abetted by the workings of the deposit insurance system now where you can, in effect, bet on the Government's money. That is a very difficult problem to deal with in the midst of all these pressures and strains, but I think you're going to have to look at it.

Senator BOND. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Dr. Volcker, oftentimes, we repair ourselves to Europe where it seems that a lot of the European countries have so many mandated benefits in the work force and compare the job creation ability of the United States economy to Europe and, in a sense, there's no comparison, as you've talked about and written about and others have.

IMPACT OF MANDATED BENEFITS

I want to ask you this question. How inflationary to our economy are mandated benefits such as raising the minimum wage and then indexing it and mandated health benefits, which would probably be followed by other things, to a lot of small businesses, marginal operators in this country; and will measures such as these cost us jobs and cost us some gilt that we have had in our economy?

Mr. VOLCKER. Well, I think the answer to that question is, yes, in general terms, but it's really a question of how much and what you buy for it.

Senator SHELBY. Well, that will have to be measured, but still it will cost, will it not?

Mr. VOLCKER. It will cost. Of course, it's my social preference I suppose, but I would think there might be a difference in that judgment between the minimum wage which I see as not helping very many—I don't know who that's supposed to help, but it has some problems because it prices people out of the market and maybe somebody at the margin is favorably affected but whether that's worth paying the cost or not——

Senator SHELBY. But it also raises the tier for other things, doesn't it?

Mr. VOLCKER. Well, yes, and to that extent you get into inflation. There's no question it works in the direction of an inflationary push on costs and I puzzle as to where the offsetting benefit is, let's say, as opposed to health insurance where it also imposes a cost and may be a problem, but I can understand health insurance is a pretty important problem, if you don't have health insurance, and that's a vital social issue.

So I think all these issues have to be looked at on their merits and I do not think myself the country has suffered from not raising the minimum wage over the past whatever it is—4 or 5 years. I am not saying catastrophe is going to ensue with a modest increase in the minimum wage at this point, but why? What are you accomplishing? Is there a positive result? I know the bad side effects which you allude to.

Senator SHELBY. But in Europe, as I pointed out in prefacing my question to you, they do have so many of these mandated benefits that seems in a sense from studies and writings by the economists and different people to put a drag on their ability to create jobs all at once.

Mr. VOLCKER. Well, they are more worried about the inflationary ramifications than we have been and they have more of these programs, but they also have—I won't pose any great expertise—but the generosity of benefits to those who are unemployed and the permanence of it leads to or reinforces a resistance to moving from the north of England to the south of England or from the north of Germany to the south of Germany where the job creation is more rapid and, therefore, it clearly places a drag on economic growth.

Senator SHELBY. And it's continuance interference with the basic market forces in our economy, isn't it, in a sense, any kind of mandated benefit?

Mr. VOLCKER. That's true, by definition.

Senator SHELBY. With the natural economic forces that we talk about?

Mr. VOLCKER. Yes.

Senator SHELBY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

OPENING REMARKS OF SENATOR SASSER

Senator SASSER. Thank you very much, Mr. Chairman. I want to apologize to you and to Chairman Volcker for being tardy in getting here this morning.

Mr. Chairman, I must say that I think we are on the verge of experiencing a great public loss when Paul Volcker leaves as Chairman of the Federal Reserve Board, and quite frankly, I feel a sense of private loss that he's not going to be there any more.

Chairman Volcker, I think you've served in your position with great distinction at a time when a steady hand was certainly needed at the helm. I think you brought great stature to the position of Chairman of the Federal Reserve Board and have distinguished yourself with your service there.

Now I have not always agreed with your policies and have not agreed with them pretty strongly on occasion, particularly back in 1981 and in 1982. And I'd like to just be retrospective for a moment if I could and get the benefit of your accumulated wisdom as you lay down the burden or anticipate laying down the burden as Chairman of the Fed.

Back in 1981 and 1982, I felt and a number of my colleagues on this committee felt and a number of economists felt that the Fed had simply gone too far in pursuing what we perceived to be an overly restrictive monetary policy.

I want to inquire of you whether you believe today in the summer of 1987 that trying to wring the last iota of inflation out of the economy in 1981 and 1982 was too extreme, gave us the worst recession we had had since the 1930's, or if you had to do it all over again would you do it just the way you did it?

HINDSIGHT

Mr. VOLCKER. Well, hindsight is a wonderful thing.

Senator SASSER. It is, indeed.

Mr. VOLCKER. But I'm not inclined to second guess our performance during 1982, to be perfectly frank about it, although that was the bottom of the recession. You can always sit back and say, well, if they had only eased 3 months earlier or something you might have avoided a few tenths of a percent of the unemployment rate and maybe you wouldn't have lost much on the inflation rate—I don't know.

I am not inclined to think, looking backward from the benefit of this particular point of hindsight and looking at that very difficult situation that has materialized into a 4½ year expansion, one of the longest in peacetime history that has been accompanied so far—setting aside the current bulge—with a continuing decline in the inflation rate, with costs and wages under pretty good control, the outlook for the economy seeming reasonable, I am not inclined to go back there and agonize about 1982.

I'm not saying we never made any mistakes. Obviously, anybody makes mistakes. The obvious mistakes I think we made in the Federal Reserve or Federal Reserve related policies were more in 1980 when we had this experiment with credit controls and a sudden drop in the economy and then kind of overstimulation, all in a relatively small period of time which probably set back the basic effort or delayed the basic effort and the basic agony, as well as the benefits.

I am not inclined to be too introspective about 1982, frankly.

Senator SASSER. Well, maybe we'll have to wait and read your memoirs to really get the full measure of it. But I sometimes wonder—what do you think would have happened if OPEC hadn't collapsed to a certain extent and oil prices hadn't dropped precipitously? What would have happened?

Would we still have been successful, do you think?

Mr. VOLCKER. Well, I don't think that's an independent event. It's partly an independent event, but part of dealing with this perpetual, to some degree self-cumulating, movement in oil prices and the overshooting of oil prices was a reflection of the inflationary environment, and bringing that process to an end was in part at least a reflection of a disinflationary environment.

So I don't think you can set that aside and say, look, the oil price is an entirely independent event and what would have happened to the inflation rate if that had not happened and that wasn't due to monetary policy or fiscal policy or whatever. These were interrelated events and I would suggest if we hadn't had an anti-inflationary policy, the oil price today wouldn't be $20 or wherever it is, it would have continued to go up for a considerable while anyway in the direction it was going before that.

Senator SASSER. Well, they tell me my time is up, Mr. Chairman. I just say this to Chairman Volcker. We are going to miss you around here and it's been a great pleasure for many of us over the years to watch you operate and perform before this committee and I wish you the best of luck in your future endeavors.

Mr. VOLCKER. Well, I permitted the committee attendance to dwindle to just you and the chairman, but I fear I have not emphasized enough what I have said in my written statement—how much I have enjoyed the interplay with the committee and reporting to the committee and I appreciate the many, many courtesies that you have given me in this room and elsewhere.

Senator SASSER. Thank you.

The CHAIRMAN. Thank you, Senator Sasser.

Chairman Volcker, I seldom disagree with my good friend, Jim Sasser. He's a fine Senator and a great member of the committee. But I vigorously disagree with him on the 1981-1982 policies. I think that was, without question, your finest contribution, your toughest, most painful contribution. You got overwhelming criticism from the administration and from the Congress and from business and from virtually everybody else, but you stood the course. You were tough. You maintained the position you did. You held your Governors in line. I thought you did a superb job under the toughest kind of circumstances.

There's no question in my mind, the one reason we were able to get inflation under control was what you did and we all take credit for it but you were the one that did it.

Mr. VOLCKER. It was partly the Governors holding me in line. They go together.

The CHAIRMAN. I doubt that.

BUILD A WALL TO SEPARATE BANKING AND NONBANKING ACTIVITIES

In his nomination hearing, Alan Greenspan said he could see no problem in allowing commercial and industrial firms to own and operate banks as long as a fire wall could be erected to separate the banking and nonbanking activities.

He went on to say he thought it was feasible to erect such a wall.

What's wrong with that argument? Why can't we build an airtight wall between banking and nonbanking activities within a single corporate organization?

Mr. VOLCKER. It's a matter I've thought about, of course, a great deal. I don't know exactly how he would define the fire wall.

My view has been that it is very difficult to take a corporate organization and insulate one part from another fully. When push comes to shove, it gets managed as a whole and there is an enormous effort, if you have laws as we do now between parts of a bank holding company, between the bank and the rest of the holding company—it's almost impossible to write those laws in a way that provides full insulation.

Even if you could—and maybe you could by being absolutely draconian—then I have to ask the question, who's interested in owning the bank? I mean, if it's really operated as an entirely freestanding institution, there are going to be very few industrial companies that are going to want to own a bank. It would just be portfolio diversification.

The CHAIRMAN. And what economic benefit does the system get by having the commercial firm own a bank under those circumstances?

Mr. VOLCKER. Well, I think the dangers obviously exceed any benefits there might be. The only benefit that I know of that is pushed is it's a way of getting capital into the banking system. I think that's a matter of how profitable basically the banking system is, what the future of banking is, and if the future of banking is good and reasonably profitable—and it's tied up in all your questions of banking reform—capital will flow into the industry whether or not you permit combinations of commerce and banking.

I don't think there's any question that capital will flow where the returns are adequate.

So I don't really worry about that aspect and I do see some dangers and I think many of the proponents of nonbank banking or combinations of commerce and banking are quite open in saying they are interested in it because they want to operate the businesses in tandem. They want to have joint marketing. They want to draw upon synergies. I think that's obviously right. That's why they want to get into it. But it is precisely in that area where the dangers lie.

The CHAIRMAN. The July 6 edition of "Bank Letter" contained an article on the subject of whether loan loss reserves would be counted as part of a bank's primary capital. The article noted that bank regulators would prefer to exclude loan loss reserves from primary capital. It quoted one U.S. regulatory official as saying, "The real problem is that banks have got 5 to 6 percent capital but only 2 percent equity. The rest is loan loss reserves."

Do you think loan loss reserves should be counted as part of a bank's primary capital? If so, why?

Mr. VOLCKER. I think it's almost impossible to give a yes or no, black and white answer to that question. I think we clearly do have a problem now in how we define it and how we approach this question.

Traditionally, right or wrong—and I question whether it was the most desirable approach—many years ago it was decided to include general reserves as part of capital. In the American banking system, almost all reserves are considered to be general reserves and you can make that argument and we proceeded on that basis.

And if you set the level adequately, it's all right. You know they are in there and you set the level adequately.

What these recent actions spotlight is you don't have a pure concept of a general reserve which might logically be included along with equity as part of general capital. It has something of the nature of a specific reserve against particular risks and if those risks are real and exceptional, it does raise a question as to whether that portion at least or some portion of the capital provision should be considered on a one-for-one basis alongside equity. And I think the conceptual answer to that has to be no.

How you arrive at an explicit pragmatic decision of how much should be included and what arrangements are made in that connection is something we have to grapple with—it's not going to be we any more—they are going to have to grapple with in coming weeks and months, and we've begun grappling with it. I don't have an answer to report to you now but it is very much on the agenda and I think it will be resolved and some decisions will have to be made in connection with this whole risk-based capital proposal.

The CHAIRMAN. It could be a very, very important issue come another recession.

Mr. VOLCKER. Well, it's an important issue right now and obviously an important issue come another recession. Of course, to the extent some of these risks materialize and the loans are written down, the reserves would be written down too and it would become apparent in the capital position and be taken into account. But we want to take it into account before that.

The whole object of the thing is to have enough capital in preparation for the risks, not after the risks materialize. So it's a very real issue and I might just say, just to bring you up to date, this whole risk-based capital question has been somewhat delayed—we have reached a basic agreement with the Bank of England—I hope constructively delayed because there is the potential clearly, maybe more rapidly than I might have imagined, of reaching agreement more comprehensively internationally with both the Common Market, Japan, and with Canada at the same time. And so we've got a few more rounds of discussion to see whether that can be done by the end of the year.

The CHAIRMAN. That would be good.

Mr. VOLCKER. But central to that discussion is precisely the question you raise because different countries do it differently and we're going to have to resolve that question as part of that international agreement.

The CHAIRMAN. Now that you are departing from the Board it's possible to ask you questions I couldn't ask you otherwise.

COMPARING PRESIDENTS CARTER AND REAGAN

One thing I'm very curious about is your relationship with Presidents Carter and Reagan. How often did you personally meet with these two Presidents and how did they approach issues of monetary policy? How were they similar and how were they different?

Mr. VOLCKER. There's an old saying, there's not such a thing as an indiscreet question, there's only an indiscreet answer. [Laughter.]

And I want to be careful about that. I obviously served under President Carter for 18 months I guess as compared to a much longer period with President Reagan, and I think I would go so far as to say that I met more frequently with President Carter on a greater variety of issues than with President Reagan.

But partly that may be natural. I was initially appointed, of course, by President Carter and I think that may set up the potential anyway for a somewhat different psychological situation and relationship.

And I'm not sure there is any rule as to how this should work. There is an argument I think against any Chairman of the Federal Reserve working too closely with an administration and too closely with a President. I don't know where the line should be and I think it depends a lot upon particular circumstances, particular personalities. But I don't think there is any uniform answer to just what that relationship should be.

The CHAIRMAN. How did they approach the issue of monetary policy, or did they?

Mr. VOLCKER. Pardon me?

The CHAIRMAN. Did you discuss monetary policy with either one?

Mr. VOLCKER. Well, obviously, yes, that came up occasionally.

The CHAIRMAN. On occasion?

Mr. VOLCKER. But at the time I was appointed by President Carter I think he had some reason to understand the direction in which I thought policy had to go and that wasn't really a question.

The CHAIRMAN. And President Reagan?

Mr. VOLCKER. Well, he inherited me, so——

The CHAIRMAN. Did he have ideas as to where monetary policy should go?

Mr. VOLCKER. Yes. I think you saw some of those ideas expressed publicly by the administration from time to time.

The CHAIRMAN. You've made a number of hard decisions as Chairman of the Federal Reserve Board. As you look back over your distinguished service on the Board, which decision gave you the most trouble?

Mr. VOLCKER. If I answer that question now I would probably be sorry because I would think of something else as soon as I go back out the door, so I guess I'm not going to answer—I'll have to save that one for my memoirs. I'd simply have to think about it instead of giving you an offhand answer. Lots of them give me trouble. I don't make decisions all that easily.

The CHAIRMAN. Are there any improvements you would like to suggest in the procedures for formulating monetary policy and explaining the actions of the Board to the public?

NEED FOR CLEARER GUIDELINES FOR POLICY

Mr. VOLCKER. I do have the feeling that—we are often criticized for this and I don't accept the criticism in one sense and I do in another sense—that it is helpful—you have made this point—it is helpful to have some clearer guidelines for policy and something that more approaches a rule.

I don't think we'll ever get to ironclad rules, but the more you have an understanding among yourselves and with the public and with the Congress about what the rule is, in some ways things are much easier. And it's easier to do what would otherwise be maybe politically very tough. We get criticized for making too many ad hoc judgments. Well, I don't think our judgments are totally ad hoc, but I do think we feel forced, and I feel forced, to take account of many shifting circumstances in making particular operational decisions these days. I wish it wasn't so because it's easier to explain with a rule. We have not had extemely tough decisions in the last few years in terms of very large changes in monetary policy. In an operational sense, the changes have been quite small and almost nuances. We go for months without changing anything.

But if you had to make bigger changes and in difficult circumstances, it helps to have kind of clearer rules of the road, simpler rules of the road, but I don't know how you do that right now.

But you asked what you would like to see changed over a period of time, if somebody can come up with those rules of the road—and in different economic circumstances they seem to make sense—I think that's good.

One thing we do now, and obviously we have felt forced to do this, and it is consistent with international policy conclusions, policy conclusions of the administration as well as ourselves—we have paid attention and felt we had to pay attention to the stability of the dollar. Now that's, in a sense, a response to a particular set of developments at the moment.

But one of the questions is, should that not be part of a more organized international and domestic monetary system? And I think that remains an open question and I have some sympathy in thinking of that in a more institutional basis as well in terms of a particular response to a particular situation in 1987.

The CHAIRMAN. Under Secretary Gould has suggested that the United States needs to develop 5 to 10 megabanks in order to maintain competitiveness in the U.S. banking system internationally. Do you agree?

Mr. VOLCKER. Well, I don't know whether he said it, but I don't visualize the United States with 5 or 6 megabanks, no. And I think we are a long ways from that. I don't know what he meant by megabanks. I don't think there are any limitations now on the growth of American banking institutions that make them noncompetitive either nationally or internationally, particularly with the progress which has been made which I, of course, strongly favor toward interstate banking. We've had some differences on that, but I do think that that is a necessary and positive response to the situation as it exists today.

But I don't think we have to deliberately go out and create something called megabanks. I think you will have some bigger banks and some smaller banks and I hope the United States has a big variety of sizes, types, shapes, forms of banks in the future.

The CHAIRMAN. I have two more brief questions. First, we've stressed this on the committee and you have made this a very important matter. That is the independence of the Board is the keystone of our monetary system.

GREATEST THREATS TO THE INDEPENDENCE OF THE FED

What, in your opinion, are the greatest threats to the independence of the Federal Reserve and what steps can we take to preserve the Fed's independence?

Mr. VOLCKER. Well, I think you have the obvious ordinary, recurring foreseen threat that Congress has always seen in making up the Federal Reserve, that you have political questions in responding to all the short-term political considerations that exist to produce easier money than the basic situation warrants and the long-term health of the currency and the economy warrants. That has been perceived historically as the threat. I think it's there, it's continuing and it's always going to be there. And it's the basic justification for the independence of the Federal Reserve.

I do think that it has another dimension which is sometimes overlooked, and that's the regulatory side. And, again, we've discussed this from time to time in the past, but I do think it is a benefit to have banking regulation in this case—the same principle may be applied to other parts of the regulatory process—not be conducted by agencies whose sole responsibility is banking regulation, and that may develop such close ties and allegiance to the industry that they regulate that you don't get effective independent regulation in the public interest as opposed to the perceived industry interest which may sometimes be a very short-run interest.

I think you see some of the results of that, as I said the other day, in the situation we have in the savings and loan industry today. I think the currently and immediately past Federal Home Loan Bank Board have been fighting very hard to restore some regulatory supervisory discipline in that area. But they inherited a situation created over a period of years where I think the approach of the regulatory authorities was lax and incomplete and it's supported in the Congress in that. I don't think it was—you can't just point the finger at the regulatory agencies. They probably would argue that Congress almost directed them to be that way and that was their sole responsibility and I think we are reaping some of the results.

The CHAIRMAN. At the same time, don't we have a competition in laxity with three commercial bank regulators?

Mr. VOLCKER. I think that can be a problem, too. We got into this discussion through the independence of the Federal Reserve and obviously the Federal Reserve is not the most popular banking regulator. That's because we are misunderstood rather than because of anything we do, but for better or worse, we are not always popular and that steams up a lot of the people we regulate, and I think a lot of them would just as soon attack our independence, although they have generally been defenders of the institutional independence of the Federal Reserve. When they get all worked up on regulatory issues, they begin wondering about the Federal Reserve itself, and we understand that, but I think there is that problem. It's just an area that has to be watched a bit.

The CHAIRMAN. A final question. As you are leaving the Board, what words of advice would you impart to your successor, Alan Greenspan?

Mr. VOLCKER. I think any useful word of advice I might impart to him privately, but I don't think that I have any single dramatic piece of advice to give him. He seems to be a man of very solid judgment and solid instincts and he certainly is a well-prepared economist. So I'm not sure he needs much advice.

The CHAIRMAN. Well, thank you, Chairman Volcker. As everybody else has said here, you've done a magnificent job. We are very grateful to you. We are going to miss you very, very much and I do hope that you will come back and give us the benefit of your wisdom often.

Mr. VOLCKER. Thank you very much.

The CHAIRMAN. The committee will stand adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]