FEDERAL RESERVE'S SECOND MONETARY
CY REPORT FOR 1981

HEARINGS

BEFORE THE

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

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

OVERSIGHT ON THE MIDYEAR MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 22 AND 29, 1981

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

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1981

WEDNESDAY, JULY 22, 1981

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

The committee met at 9:30 a.m. in room 5302, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Cranston, Proxmire, Riegle, Sarbanes, and Dixon.

The CHAIRMAN. The committee will come to order.

You just barely made it, Mr. Chairman. This may be the only ontime committee in Congress, but it is. We appreciate your being here. I do have an opening statement but I will simply insert it in the record and ask my colleague from Michigan if he has any opening remarks before we get to your testimony.

[Opening statement by Chairman Garn follows:]

OPENING STATEMENT OF CHAIRMAN GARN

In accordance with the provisions of the Full Employment and Balanced Growth Act of 1978, the Senate Committee on Banking, Housing, and Urban Affairs today begins its second set of 1981 hearings on the conduct of monetary policy.

So far this year, while there has been considerable variation in the monetary aggregates' realized growth rates relative to the target ranges for those growth rates, the Federal Open Market Committee has done a creditable job in achieving its objectives for monetary growth.

So far this year, our Nation also has benefited from a marked slowing in the reported rate of inflation.

But while the reported rate of inflation has declined in recent months, interest rates—as we are all painfully aware—have not.

Chairman Volcker, from experience I know that you and the other members of the Federal Open Market Committee are deeply concerned about the heavy burden high interest rates are imposing on the homebuilding industry; the automobile industry, its dealers and customers; small business in general; and all other sectors of our economy.

Those individuals who rail against you and the other members of the FOMC for being insensitive to the impact of high interest rates are doing you a great disservice.

Even more serious,.though, is the effect on interest rates when individuals in responsible positions imply that they expect the

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Federal Reserve to implement a "quick fix" which will bring interest rates down overnight.

Experience also teaches me that the financial markets interpret such calls for a "quick fix" as a subterfuge for faster growth in the money supply.

And it is a lack of confidence in the Federal Reserve's ability to resist such pressure to relax the monetary reins that largely explains why inflationary expectations remain high—and also explains why the inflation premium in nominal interest rates remains high—even as reported rates of actual inflation decline.

Quite simply, demagoguery that calls for lower interest rates without specifying how those lower rates can be achieved has the perverse impact of holding rates up by raising fears of attempts to lower rates through faster monetary expansion.

The role of Congress should not be to engage in such demagoguery. Rather, Congress has a responsibility to help convince the financial markets that the will now exists in Washington to persevere with the responsible policies which we all know are essential to bringing inflation down and holding it down.

Such a show of resolve in Washington also is needed to convince labor markets that recent declines in reported inflation will not turn out to be a short-term phenomenon. Only when labor markets are convinced that Washington has the resolve to hold fast in the fight against inflation will the rate of increase in unit labor costs slow—an essential ingredient in the fight against inflation.

Again, I emphasize that demagogues calling for a "quick fix" to lower interest rates are having a perverse impact. Not only are they undermining confidence in financial markets, they also are serving to undermine confidence in labor markets and, thereby, serving to put upward pressure on unit labor costs.

All this is not to say that Congress has no role in its oversight of monetary policy beyond urging the Federal Reserve to "stick to its guns" in seeking to slow growth in the monetary aggregates.

Congress also has a responsibility to work with the Federal Reserve to improve the techniques for implementing monetary policy.

Congress has a responsibility to make sure that the available credit is not denied to those who need it most.

Congress has a responsibility to make sure that our Nation's financial institutions—through which monetary policy operates—are properly structured to serve the needs of the Nation.

Today, all of these areas are touched by questions about loans for corporate takeovers, by questions about the health of some of our financial institutions, and by questions about new financial market instruments designed to help selected sectors of our economy.

As we address these questions, I hope we can do so in a constructive manner and avoid any semblance of demagoguery that can only serve to aggravate the problems we face.

OPENING STATEMENT OF SENATOR REIGLE

Senator RIEGLE. I'll be very brief, Mr. Chairman. I don't have an opening statement as such, but I do have a couple of thoughts to share with the chairman at the outset.

I think it's fair to say in my home State of Michigan we feel we have a genuine crisis with high interest rates. We see it in the auto

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industry, construction, real estate, home purchases, small business and in agriculture. I think perhaps in our region of the country, the duration of economic problems we have been facing now stretches out over a long period of time. The effect of the record high interest rates today is doing severe damage to us, possibly even more so than in other places in the country. I do realize however, the sectors of the economy that are most affected are in serious trouble across the whole United States.

The situation I find that business people and others in my State can't understand is, the seeming contradiction between these $3 to $5 billion lines of credit that major corporations are lining up for, and apparently almost overnight financing takeover bids of other companies. We have this odd skew with the availability of credit and the price of money so that people in poorer positions seem to be having a terrible time getting access to credit sources, except at rates that are really beyond reach. Mr. Chairman, there are three things that I would like to find out from you today.

First, what would be required over the next 90 days to bring interest rates down? In other words, what combinations of possible actions could be taken in the Congress, by the Fed, the administration, or by others which are practical steps that can be achieved in the next 90 days to top off the interest rates and bring them down?

Second, I would be interested in knowing if you're conferring on a regular basis with the Reagan administration on macroeconomic policy and what role that monetary policy plays and if the administration is supporting the tight money policy. In other words, is the approach the Fed is taking to keep the money supply restricted and therefore keep interest rates high a course of action that the administration supports? If not, have you gotten any signals from them asking that there be any modification in your policy to try to bring these rates down?

Third, are we starting to approach a point, or have we reached a point where we have to start thinking about some means of credit allocation to severely depressed sectors of the economy? Have we, or are we approaching the point where the construction industry, the real estate industry, the automobile industry, the farm sector, small business, and others who are in many cases dependent on the availability of credit and more moderate interest rates for their survival need to find some way to remedy that problem, even if it means some policy change that would make available resources in sufficient amounts go into those sectors to keep them going so we don't end up with just an avalanche of bankruptcies and unintended damage to the country as a whole?

If I may, let me add a fourth. I had hoped that you would comment on the problems facing the S. & L.'s and the thrift institutions. I know that disintermediation has been the pattern over the last 2 years and seems to be continuing. The number of S. & L.'s that are on the endangered list seems to grow daily. People, as highly respected as Alan Greenspan, feel we may face an impending cascade of failures in the S. & L. business and with the potential outside liability of possibly $50 billion to the Federal Government. If this began to happen it would gain momentum as it did.

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So, I would hope that you would also address the practical side of that problem and if you view it as serious, discuss what steps, and to what degree the Fed can try to help deal with it. If you want to address money market funds, that need the reserves when those funds are used in checking account type purposes, then it would be useful for us to hear that, but I would like to hear what your thoughts are on that and I will save the rest until later.

The CHAIRMAN. Senator Dixon.

Senator DIXON. I have no statement at this time, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, we are happy to have you with us today. Just one brief comment, not to get back into an opening statement, but I feel very strongly in this whole matter that we're experiencing a tremendous amount of demagoguery in both this body and in the House of Representatives, as evidenced yesterday in the hearing of the House Banking Committee. As you know, I have been sharply critical of the Fed at times and we have had many discussions, but the Fed simply is not the cause of inflation or high interest rates. It is the Congress of the United States for its 30 years of excessive, irresponsible deficit spending. Some Members of Congress love to find scapegoats, and you and the Federal Reserve Board happen to be that scapegoat. Day after day after day on the floor of both houses we hear such comments.

Again, I don't agree with the way you have handled the discount window at times or the borrowed and nonborrowed reserves or the weekly reporting of monetary aggregates and all of that. You know that very well. You have had the letters. But I think it's time people started realizing where the real problem is. It lies here in the fiscal policy of this country and until we get that under control, I don't care who the Chairman of the Federal Reserve Board is. It makes no difference whether it's you, whether we resurrect Chairman Echols who was considered to be a great Chairman and bring him back. As long as this body continues to deficit spend to the tune of $50 or $60 billion a year, you or your Board have no choice but to monetize that debt. That's a plain, simple economic fact.

So I will continue to criticize when I feel it is warranted, but I certainly do not intend to try to make the Federal Reserve into the scapegoat for problems that have been created over a long number of years by both Republicans and Democrats who have bought their reelections by excessive spending in this body and the House of Representatives.

Would you like to give your opening statement now, please?

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

Chairman VOLCKER. Mr. Chairman, perhaps instead of reading my opening statement, which is the same as I gave in the House yesterday, I can summarize some of the points informally and then get to some of the more specific questions that Senator Riegle and others have raised or seem likely to raise.

The first point I would make and acknowledge is that there are clearly many unsatisfactory aspects of the present economic situation. Preliminary figures for the gross national product released this morning show a small decline in real GNP which reflects that, in an overall way, there are areas of the economy that have been

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doing quite well, but there are clearly areas that are under very considerable pressure. I think a lot of those pressures do converge most particularly in the State of Michigan. That is probably the State that has felt this the most; like other States, it feels the pressure on housing construction, but it has the special problem of the automobile industry, which is in a particularly unsatisfactory state at this time.

BRIGHTER ECONOMIC PICTURE

Having said that, I do think there is brighter news in the economic picture. There are some glimmerings—or hopefully more—of a leveling off or decline in the inflation rate. Because inflation has built up over so many years and has been so deeply entrenched and, in my judgment, lies behind so many of our other problems, signs of progress in that area are important. There are reasons to believe that some of that progress you can see in the price indexes is not of the kind that, in itself, you can expect to be lasting. We have seen some of the more immediate results of credit restraint on some sensitive prices. We have obviously had a more favorable oil-supply situation. We had better weather than was predicted in the agricultural area, which has helped the agricultural crisis. We can't count on all of those things lasting, but I do think that we have a platform, so to speak, for capitalizing now on the progress we have begun to see on inflation and for carrying through. If we conduct ourselves appropriately, we can see that first glimmering of inflation control converted into more permanent progress.

We are at the crucial point in many respects with respect to our policy and it seems to me terribly important that we do turn around that inflation situation. As we turn it around, and have more confidence to bring against the existing skepticism in the outlook for inflation, then I think our job becomes easier, and we are going to have more room for real growth, and the progress will feed upon itself. But we are not at that stage yet. We are at the stage of turning around this enormous momentum that has built up. That is the context in which the Open Market Committee reviewed the monetary targets as we must and are reporting to the Congress.

As to a more technical analysis of those targets and what's been going on in the first half of the year, we find divergent trends. The M–1 moneys, the transaction balances, are running rather low compared to the targets. In contrast, the broader aggregates, M–2 and M–3, are running at the high end or a little above their ranges, so we are faced with quite contrasting performances.

Although it's very hard to judge the quantitative impact, part of that is unquestionably due to technological change. We have had very rapid changes going on in the money market. We had, of course, the introduction of NOW accounts, a legislative change which impacts upon these figures and which we knew about. If anything, they went faster than was expected through a big nationwide marketing effort by banks and thrift institutions. And, we have had very rapid growth of money market funds, which substitute for transactional balances to some extent and probably in that sense were an artificially depressing influence on M–1, because we don't include them in M–1, although they have some of the charac-

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teristics of that figure. That helps explain why M-1 was low relative to those other aggregates.

Conversely, the other aggregates were high, and partly this was the flip side of the coin. Money market funds and other factors draw money out of the open market, which isn't reflected in these figures.

After looking at these divergent trends and making a judgment that some of the sharpest impact of the institutional change and shifts of money may be behind us—that's just a judgment—it did not seem necessary or desirable to try to fine tune the targets, but rather to leave them where they were for this year. But, to repeat, the judgment we made 6 months ago was that, in the broader aggregates, we probably would be running around the higher end of the range, but in the case of M-1—given where we are now, given the technological impact to which I referred, given the desire to maintain moderate increases, we would find it acceptable and desirable to end up near the bottom part of the range, particularly if the broader aggregates remain high.

For next year, I might mention as a technical point that we hope to combine the M-1A and M-1B adjusted figures into a single M-1 figure on the presumption that the NOW account shifts will be pretty much over, and reduce the range of that single M-1 figure in line with our long-term policy to work toward lower growth in money. That is reflected in the new target for 1982, which we tentatively set forward at the level specified. We did not, tentatively, change the targets for the broader aggregates on the presumption that although we are running toward the higher end this year we would expect next year—consistent, again, with the declines we are looking for over time—to fall more toward the center of that target range.

This targeting is totally consistent, in our judgment, with the general basic framework of the policy that we have been setting out, namely, that we have to work toward lower growth in money and credit on the basic premise that that is essential for dealing with inflation over a period of time.

MONEY MARKET PRESSURES

I think the markets reflect—and it is apparent in other contexts—that for the time being there is a particularly heavy burden on monetary policy in dealing with the inflationary situation; that is reflected in the pressures on the money market. We are not providing enough money, in general terms, to finance both inflation and growth. The object of policy, of course, is to see the inflation give way so we do have more room for growth, but with the inflationary momentum having run in the other direction so long that policy cannot be achieved without running into money market pressures. Those pressures are there; they are evident; and I think we have to live with them. We have to live with them in the short run in the interest of the longer term objective of creating an economic climate in which those pressures can relax—and not relax just for a few months—and creating the kind of climate in which interest rates can be lower and money market conditions more favorable—or, more importantly, the climate in which growth

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and employment can be more favorable in the long run. That's the whole object of the policy.

Of course, other policies are relevant. Monetary policy can do its job, but by the nature of things, it can only do, part of the job. Fiscal policy, as you have referred to, Mr. Chairman, is crucially important in that respect, and I welcome your comments about the importance of reducing the deficit. Congress and the administration have taken action, which I think is really unparalleled in my experience in Washington to try to turn around that expenditure trend. It is an extremely difficult job, I'm very much aware, to change that built-in momentum, but there are, as you know, very encouraging signs of progress.

All I can say about the tax side is that I have recognized for a long time the importance of reducing taxes in the context of a total economic program. There are important implications for incentives, and I think for costs, but tax reduction has to be fit into a program that is consistent with reducing the deficit over a period of time. The progress that we can make on taxes is refined, in a sense, by that necessity and by what we can do on the expenditure side.

I would also point out that the basic inflationary momentum is very much bound up not only in the attitudes of business, labor, and others, but in the way those attitudes are reflected in behavior—in the kind of insidious spiral we have where wages react to higher prices that are and those higher wages contribute to costs and keep the prices up and the momentum going.

We face a situation in which there are some glimmerings of sign of change in the basic underlying inflation rate. It seems to me much too early to say that that is a convincing change in trend. We are entering a period where it will be extremely important to see whether those perhaps first signs of a change in the underlying rate of inflation can be converted into sustained progress.

We do not have many big wage settlements coming up for the remainder of this year, but there is a crucial round of wage bargaining next year, and with the institutional setting of 3-year wage agreements in this country, what happens in those wage settlements next year is going to have a lot to do with setting the tone for the cost side of inflation for a considerable period of time ahead.

Let me just finally reiterate that when we discuss monetary policy, when we discuss the pressures on the money market, when we discuss all these technicalities of monetary targeting and the necessity for moving the growth in money and credit down, it all seems quite abstract and technical and, indeed, single minded, but it is an essential means to the end of the more prosperous, growing economy that we want. What we are saying fundamentally is that the outlook for the 1980's will not be favorable unless we do come to grips with this inflationary problem, and in that sense we must face up to that priority and be concerned not just with current conditions but with what kind of framework we're setting for a number of years ahead.

For many years, I think it's fair to say, we have not faced up to this problem. We have an opportunity to face up to it now. There are elements in the current situation that suggest a turning point is here. I feel much more confident that we can carry through and

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begin to see real and convincing progress on inflation. That is the fundamental remedy for the ills of the credit market and a major part of the fundamental remedy for setting out economic conditions in which the State of Michigan and the rest of the country can be in a much more prosperous and satisfactory position.

There are risks in the present situation, without question, in terms of the pressures on the money markets. A much greater risk, in my mind, would be in failing to carry through on the effective anti-inflationary policies because we would just be prolonging this agony and see inflation recur again and again over the years ahead with a decreasingly satisfactory economic performance.

I would urge us to face up to the problem now, as I think we are doing, and to carry through on that effort.

WIDE SPREAD BETWEEN INFLATION AND PRIME RATES

The CHAIRMAN. Mr. Chairman, the question that I'm asked every day stems from the fact that over the years that I have been on this committee we have consistently talked about the fact that you really can't separate interest rates from the inflation rate. When people talk about, well, let's artificially lower interest rates, let's have credit controls or whatever, the explanation over and over again is you really can't separate them very much, that they ride very closely together. I have been making that speech along with everybody else and I'm having a difficult time now answering the question of why is there a 12-percent spread. So that's my first question to you. Was that conventional wisdom wrong that we have talked about all these years with the inflation rate of 8 to 9 percent and a 21-percent prime rate?

Chairman VOLCKER. That conventional wisdom which does reflect an important truth, which is that in a fundamental way, over a period of time what lenders demand for their money and what borrowers is willing to pay are related to what is going on in inflation and what they expect to go on in inflation. When you look at a credit borrower, you're always looking ahead; you're talking about expectations, and not an observed figure for last month, and you can't measure the expectations directly. So I think it's is impossible to identify whether the expectation of all those people out there in the market is for greater or less inflation.

I think this is the first time in history when we have had a combination of two kinds of events. One is this kind of persistent inflation in peacetime over a period of years which has profoundly affected expectations in a way that is hard to compare with the past. Second, this has happened at a time when tax rates, at the margin, are much higher than they have been historically. So it's a little hard to tell how people look at these interest rates after taxes.

Obviously, if you're a corporation or an individual in a 40- to 50-percent bracket, it's not clear what the real interest rate is now. It's not very high if you're in that kind of tax bracket and you're expecting inflation in the 8- to 10-percent area, so you have to qualify this real interest rate discrepancy with some adjustment for taxes.

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The CHAIRMAN. Well, if that's the case, why so much opposition from so many quarters to a tax cut, if high taxes are adding to the interest rate?

Chairman VOLCKER. I think from that standpoint, reducing the marginal tax rate makes the interest rate quite high, because more of it would become real after taxes, and that would be an influence over a period of time.

Let me just say, too, that while I belive there is a relationship between interest rates and inflation and inflationary expectations over a period of time, I think it's too much to expect that that relationship follows month by month or quarter by quarter or even year by year. If you look back at the sweep of history, real interest rates have fluctuated over a very wide range, but I would suggest that there should be some tendency to converge over a period of time. We are in a period now where people are undoubtedly confused and uncertain about where inflation is going and where interest rates are going in the short run. It's never nice to be in that kind of a period, but let me suggest that I'd rather have them confused over where the inflation is going to go than convinced that it's going to go higher, which was probably the case a year or so ago. That confusion is a way station, I hope, to much more conviction that the inflation rate is going to come down.

The CHAIRMAN. Isn't it rather interesting that in talking about the psychological factor of the expectations for inflation, we talk about the confusion. At least there are some who think that inflation will go down and certainly it's at a lower rate on an annualized basis than it's been for a long period of time. On the basis of expectations, then why in the past when we have had unrestrained Government spending, high marginal tax rates, all the evils we've described, and interest rates were relatively stable. Now, even though the proof of the anti-inflation pudding isn't entirely there, you yourself in your testimony said this was the most dramatic spending cut you'd ever seen—so although it isn't finished, the trend is there—then why have we got the almost record interest rates and this spread? At least the expectations should be modified somewhat. At least there should be some more hope.

Chairman VOLCKER. I think expectations are beginning to be modified. How far that's gone so far, I don't know. It's difficult to measure. I have talked to a lot of businessmen and asked whether they have changed their plans or anticipations with respect to inflation. The answer I usually get is, "No, not yet. Maybe we will next year when we see some more progress."

The CHAIRMAN. Why did expectations change last year when interest rates went down to 12 percent just before the election and we certainly had no anticipation of big spending cuts? The expectation should have been for much more inflation.

RESTRAINED MONETARY POLICY

Chairman VOLCKER. There's another side to this coin. In my opinion, you have a very restrained monetary policy now. We are not providing as much money as the economy demands when it's got this kind of inflation combined with what has been until recently a quite strong economic advance right through the first quarter.

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The CHAIRMAN. We had restrained monetary policy last year.

Chairman VOLCKER. I think we had a restrained monetary policy last year. You can argue whether it was restrained enough, but we were not supplying money last year at anywhere near the rate of speed the economy was demanding, which is why, during most of the year, the markets were under pressure.

We had a period last year where for a few months the economy fell very rapidly, you recall, which is certainly relevant to the short-range outlook for interest rates. In the most immediate sense, the strongest influence on interest rates will be what's going on in the economy, what demands for credit are being generated by current economic activities. If the economy falls, interest rates fall; that's what happened for a period last year.

That is not happening now. According to the estimate, there has been some, decline in the economy recently of relatively small proportions, but the basic characteristic of the economy for roughly the past year has been rather strong expansion and inflation—nominal GNP rising in the first quarter at an annual rate of about 19 percent, I guess. When the GNP is rising at 19 percent, it's generating tremendous demands for money usage. We weren't increasing the money supply appreciably in the first quarter. When you get that kind of demand for money against an unwillingness to increase the supply of money, don't be surprised to see pressures on the credit markets; that is what happens during that kind of period.

The CHAIRMAN. Last week we passed on the Senate floor the all-savers certificate modified by certain special interest groups who wanted it targeted just for them, or at least most of it. I opposed that, although you have heard me say many times how strongly I feel we need to reduce tax rates on savings in general and stimulate savings and investment capital in this country. Nobody could be more sympathetic than I with the homebuilders' and the realtors' problems, but to say that of new savings generated 75 percent must go to them is not right. Not when we've got 2,000 automobile dealers who have failed in the last year and 400,000 automobile workers unemployed and a record rate of small business failures and so on. How do you feel about that? Is that a good, efficient way to raise money for mortgages, to say to hell with everybody else that's suffering from high interest rates; we simply want anything generated to go to us or at least the majority of it?

Chairman VOLCKER. I'm troubled by the whole concept of that bill because I don't think it will be effective in stimulating overall savings in the economy, and I think it's the kind of bill that creates even more distortions in the money market. If you create tax-exempt securities and people can go out and buy tax exempts, it is then very hard to stop that. I have trouble with the overall concept, and I also agree, basically, with the reservations you have, about the wrinkles in the bill; I don't think we can solve our problems by that kind of allocation.

There is no question that the thrift institutions are under very strong pressure and have problems, but I don't think this is a very efficient way to go about dealing with that situation.

The CHAIRMAN. My time is up. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

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I want to try to move as rapidly as we can to considering the questions I raised earlier. Are you meeting now with the Reagan administration on a regular basis?

Chairman VOLCKER. Yes. I maintain regular contact with officials of the administration and they with me.

Senator RIEGLE. Is there an attempt here to try to fit administration fiscal policy with monetary policy?

Chairman VOLCKER. The administration's fiscal policy was pretty well set when they came into office, and I think they have been following through on the main outline of the program that they came into office with and feel they were elected on.

Senator RIEGLE. Do you feel that you're developing a pretty good cooperative relationship with the administration as far as discussing and working on macroeconomic strategy?

Chairman VOLCKER. I think we have an open, frank relationship.

Senator RIEGLE. Well, is it one where you're able to basically agree on a set of policies to pursue?

Chairman VOLCKER. I think we have understanding on both sides. As I say, the basic elements in their policy were, I think, set when they came into office.

Senator RIEGLE. Are they indicating to you now that they have any concern about the high interest rate figure?

Chairman VOLCKER. We all have concern about the high interest rate. They can speak for themselves, but I don't have any sense that they have any question about what the general posture of the Federal Reserve is. As you know, they have publicly said, right from the start, that they are very much in accord with the general philosophy of reducing the growth in money and credit over time.

Senator RIEGLE. So they have not made any suggestions, direct or indirect to you that you should either lower or increase the monetary aggregates or do anything beyond what you're doing now which would have the effect of trying to bring down the interest rates more quickly?

Chairman VOLCKER. I obviously don't want to have to report every conversation that I have with the administration, but in general terms, answering the general sense of your question, no.

Senator RIEGLE. Well, maybe to make it easier, have you received any signal from them that they would like to see a change in your policy?

Chairman VOLCKER. As I interpret it, they have been very supportive of the general idea of getting this credit growth down.

Senator RIEGLE. I ask that question because that's the general impression that I think one gets from being even further removed from those conversations, but I think it's important to know whether you're basically moving in a direction that you both agree with and it sounds to me as if you are.

Chairman VOLCKER. I think there's a mutual understanding—I hope it's mutual—on these decisions.

Senator RIEGLE. Well, I would expect that, but I think there's a basic question of whether or not there's general agreement rather than a general disagreement. I take it there's a general agreement.

Chairman VOLCKER. I think it's apparent in their publicly stated strategy.

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CREDIT FOR CORPORATION MERGERS

Senator RIEGLE. Let me turn to the merger question which is very much in the news these days, and I'm sure something you're following closely. There are several summaries that have been printed about the lines of credit that have been lined up by various companies which are either being sought by larger companies, other companies, or themselves, who are trying to pick up another company. I notice here that Conoco, for example, has arranged a $3 billion line of credit through a syndicate of six major companies that have arranged lines of credit ranging from $5.5 billion, in the case of Texaco, down to $1.9 billion raised by another company here.

The total, however, is in the range of about $20 billion which has been lined up to finance these takeover bids.

Chairman VOLCKER. More than that now I think.

Senator RIEGLE. I suspect it is. This is a conservative number and it's probably $50 billion or more than that. I'm troubled about that myself, in a situation where credit is scarce by definition and your testimony today has been addressed to the fact that it is, and why it is. I have a very hard time understanding why it is that these folks seem to have such an easy time with securing multibillion dollar commitments literally overnight whereas the rest in the economy are standing in line—it's like the scenes you see outside of the meat markets in Poland. People trying to get credit and can't and here there's such an incredible disparity.

I have two questions for you. One, Is that bothersome to you and are you concerned about that? Second, Are you completely helpless and powerless to do anything about it or is there something that might be done to put a little more equity into the question of who is going to get availability if the credit is there?

Chairman VOLCKER. There are aspects of these takeover loans that cause me concern and are troublesome to me. I recognize the impression they convey which you have alluded to. I don't think, in the broadest sense, it is right to suggest that credit is not available to a lot of other people if it is available to these people. It's obviously available to these people and it's been available quite readily; you almost have the impression that it's available overnight, as you suggest, in very large amounts.

I think the fact is that most people can borrow money in today's market, but they have to pay the interest rate, and these companies are more willing to pay the interest rate than other people. That raises maybe the question you may have in mind as to who can afford to pay the interest rate, but I don't think there's a question of people lined up unable to get credit. The question is whether they are willing to pay the rate; everybody has got to pay more or less the same rate. These companies are apparently willing to pay the rate for these takeovers. It appears almost as if there is kind of a contagious mania, where one company does it and then another comes in and does it in a competitive way. It raises questions in people's minds beyond those of the credit markets—and I suppose in my mind, too—about merger policy, industrial policy, the speed with which these commitments are being made, whether they are thought out appropriately in all cases.

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There are a lot of questions that arise here and may be an appropriate area for investigation more generally. When you come to our particular role in it, I don't think we are the appropriate agency to decide which merger is a good one and which merger is a bad one or whether this one is justified and that one is not justified. In fact, it's a situation which we couldn't control equitably anyway, because there are many ways to finance this kind of activity.

CREDIT MISALLOCATION

Senator RIEGLE. I hear what you're saying, but I'd like to suggest to you that I think you're doing the same thing in another form. I think when you restrict credit as tightly as you are doing now there's much less of it available to finance all the credit needs in the country. Obviously that bids up the price so people who can afford to pay the high rates can commandeer the capital. So take the big shooters, in this case Conoco and DuPont and others, and they are able to go out and commandeer the capital, simply by being able to afford the higher price which takes it away from other sectors.

What I'm saying is that unwittingly you can say, look this isn't my problem; I'm not causing this to happen; but as a matter of fact, you are causing it to happen if you squeeze things so tightly that only the people who are very richly endowed can afford to stay in the game. I think you are, in effect, creating a kind of credit allocation. You can say you're not; you can say that's not your intent. It may well not be your intent, but I'm saying from all the evidence that one can see that's the effect. If that is the effect, if you're having the effect of creating a kind of credit allocation—I might even call it a credit misallocation—isn't there a point at which you've got to look at your policy decision if that's what's taking place?

Chairman VOLCKER. Let me say, first of all, in terms of how much credit this exhausts or diverts, you have to recognize that in some sense this credit doesn't disappear from the market in this kind of a deal. They pay off the existing stockholders, let's say. What do they do with the money? They put it back into the credit market. The allocation of the credit may be affected to some extent, but the money doesn't disappear. Savings are not directly absorbed in this process, so there's some question as to how much pressure is put on the market in the aggregate, although I think inevitably there are some effects. It's very hard to quantify those effects; they are not measured by the total amount of these commitments. Apparently in many cases, these commitments, are targeted on the same company, or they are commitments to fend off the potential bids, so there's a lot of duplication in the commitments. So far, very few of these commitments have been taken down.

But one of the questions that arises when one observes this phenomenon is why does it take place at all? Why do people go out there and bid twice the value of stock as valued in the stock market? This raises the question that's been around for a long time what's the matter with the stock market and with tax treatment of equity; there's a real scarcity of capital in this country and there

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are pressures on the total supply of savings that are probably most acute with respect to equity. Capital rates have been declining; the stock market in the broad scheme of things has been rather depressed for many years relative to other prices. I think this kind of phenomenon raises questions about why the stock market is relatively as depressed as it has been over a good many years, why is it not directly reflecting the valuations that these people seem to think are accurate, and what is the matter with our approach toward equity investment?

SMALL BUSINESSES BEING SQUEEZED OUT

Senator RIEGLE. Well, my time has expired. I just want to make one comment. I'm deeply disturbed about this problem and I think there's a tendency to assume that we have a free market system when it comes to the movement of available credit resources. I don't think in the full sense that it is a true free market because obviously the stronger players and those that can command more ready access to large sums of money can just shoulder their position and squeeze out others. What is happening is you have an incredible squeeze in certain sectors that are very credit sensitive, and are in an absolute emergency condition. Brokers and small business are failing all over the country and cries are increasingly coming in from the major agricultural areas that are feeling squeezed. Yet there seems to be plenty of money at the high end for those that can afford to go to the high rates. I'm disturbed because without necessarily planning to we are into a credit allocation system simply because credit has been limited and the people who can afford to pay the high rates get it and those that can't afford to do it get squeezed out. I question whether that's good national policy, whether it's sound, and whether the Fed should be passive in that and simply say, look, we are washing our hands of that, that's not our problem; we didn't intend for that to happen and therefore don't hold us accountable I think beyond a point there is a kind of accountability that comes back in the picture that somebody has to get hold of it. I think partly that is a responsibility of the Fed.

Perhaps it's partly the responsibility of the Congress as well as the administration, but I don't think it's enough to simply say, gee, this is a shame. We're watching this big intersection and all these collisions keep happening, people keep getting wiped out and there's really nothing we can do about that. I would hope we are not really that helpless.

Chairman VOLCKER. I would hope we're not that helpless either, but I think the real answer has to be to deal with the underlying situation. In the first place, there's no question that if this much pressure is put on the money market those who are the most vulnerable—who are in the weakest position, in your terms—get hit the hardest, but I don't think we are going to deal with that satisfactorily through some kind of credit allocation system. We tried that a little last spring, as you well recall, and I don't think that's any kind of a permanent—or even a temporary—answer that can replace dealing with the conditions that gave rise to this kind of extraordinary money market pressure. To the extent we take our eye off that ball, we are not doing anybody a service. That's got

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to be the ultimate answer for the automobile industry, the housing industry, and everything else. I wouldn't be very optimistic about the future if we backed off from the fundamental solutions as I see them and hoped that we could somehow, by fiat, move around the available supply of credit a little differently to somewhat different areas. It's almost impossible to do that anyway.

Senator RIEGLE. If the cure ends up killing half the patients—and there's a real danger here that that has happened—then I think you may have to start looking at other cures that might get the job done with less long-term damage.

Chairman VOLCKER. The whole object of the exercise is to improve our conditions in the long run. I guess it's something like having an operation; it's not much fun and puts you in the hospital a while, but in terms of your longrun health if you've got something the matter you'd better have an operation. I think that's the kind of situation we're in.

[Complete statement of Chairman Volcker follows:]

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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to be here this morning to review the conduct of monetary policy and to report on the Federal Reserve's objectives for the growth of money and credit for this year as well as tentative targets for 1982. You have already received our formal report, but I would like to briefly summarize some points and amplify others.

I do not need to belabor the point that the current economic situation is far from satisfactory. But we see some encouraging signs that we are beginning to make progress against inflation. I realize the evidence in the recent price data is not, by itself, conclusive. However, I strongly believe that we now have the clear opportunity and responsibility to achieve and sustain further progress on the price front. That progress, in turn, will be an essential ingredient in laying the base for a much healthier economy in the years ahead.

The process inevitably requires time and patience. It would obviously be much more pleasant for me to appear before you today were both unemployment and interest rates lower. High interest rates undeniably place a heavy burden on housing, the auto industry, small business, and other sectors especially dependent upon credit. The thrift industry, in particular, has come under heavy stress as its costs of funds exceed returns on fixed rate assets acquired when interest rates were much lower. The high level of U.S. interest rates also has repercussions internationally, complicating already difficult economic policy decisions of some of our major economic partners. The surprisingly

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strong growth in national output last winter has given way to a much more sluggish picture. With continuing sizable increases in the labor force, unemployment has not declined from higher levels reached last year. The trend of both productivity and savings remains low.

Amidst these difficulties, we must not lose sight of the fundamental point that so many of the accumulated distortions and pressures in the economy can be traced to our high and stubborn inflation. Moreover, turning back the inflationary tide, as we can see, is not a simple, painless process, free from risks and strains of its own. All that I would claim is that the risks of not carrying through on the effort to restore price stability would be much greater. Dealing with inflation is essential to our future well-being as a nation, and the Federal Reserve means to do its part.

As I noted, we have begun to see some tentative signs of a relaxation of price pressures. To be sure, much of the recent improvement in various price indicators is accounted for by some reversal of "special" factors that drove the inflation rate higher in 1979 and part of 1980. Instead of the huge increases of the last two years, energy prices have stabilized and some oil prices have even declined in the face of the recent production surpluses. Retail food prices have risen at rates of less than 1 percent this year, partly reflecting improved crop conditions, in contrast to the 10½ percent pace in 1980. Commodity prices generally have been weak, as speculative forces have subsided

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under the pressure of the high cost of finance and more restrained price expectations. Despite sharply rising mortgage costs, the recorded overall cost of homeownership has been rising less rapidly.

Some of these developments could prove temporary. Special factors and short-term improvements in the prices most sensitive to credit restraint alone cannot be counted upon to sustain progress indefinitely. The deeply entrenched underlying rate of inflation is sustained by the interaction of labor costs, productivity, and prices. So far, there are only small and inconclusive signs of a moderation in wage pressures. Understandably, wages respond to higher prices. But in the economy as a whole, labor accounts for the bulk of all costs, and those rising costs in turn maintain the momentum of the inflationary process. Low productivity gains, high taxes, and unnecessary regulatory burdens aggravate the situation. Moreover, to the extent firms and their workers are shielded from the competitive consequences of poor productivity and aggressive price and wage policies, those attitudes are encouraged.

These considerations help point to the wide range of policies necessary to support a sustained and effective effort against inflation. Fortunately, recognition of the need is widespread, and progress is being made in a number of directions. But there can be no escaping the fact that monetary policy has a particularly crucial role to play and, in current circumstances, has a particularly heavy burden.

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An effective program to restore price stability requires reducing growth in money and credit over time to rates consistent with the growth of output and employment at stable prices. That is the basic premise of our policies, and I believe consistent with the philosophy of the Humphrey-Hawkins Act mandating our report to you today on our monetary growth ranges. The periodic decisions we in the Federal Reserve reach about those monetary "targets," and the implementation of policy, are entirely within that broad policy context; essentially, they are matters of how much, how fast, not basic direction.

In approaching its mid-year review of the monetary and credit targets within this framework, the Federal Open Market Committee was faced with rather sharply divergent trends in the several aggregates during the first half of the year.

These trends were significantly influenced by the rapidity of market responses to regulatory or structural changes, including the exceptionally rapid growth of NOW accounts nationwide and of money market mutual funds.

The basic measures of transaction balances -- "narrow money" or M1 -- have risen relatively slowly after adjusting for the effects of the one-time shifts of funds into interest-bearing NOW accounts; those accounts were available for the first time nationwide, and have been aggressively marketed by

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banks and thrift institutions.* To a degree that cannot be precisely measured, individuals and businesses, spurred by high interest rates, appear to have intensified cash management practices designed to minimize the use of traditional transaction balances, tending to speed up the "velocity" relationship between M1 and GNP during early 1981. For example, to some limited degree, needs for "M1" transaction accounts may have been reduced by the growing popularity of money market funds -- not included in the definition of M1 -- which can be used as a substitute for demand deposits or NOW accounts.

At the same time, as shown on Table I, the broader aggregates, M2 and M3 (which do include money market funds and some other close money substitutes) have been rising at or above the upper end of the target ranges. You may recall I suggested to the Committee in presenting the targets for 1981, that these broader aggregates might well be expected to rise toward the upper part of their ranges. This expectation is reinforced by the further liberalization of interest ceilings of depository institutions by the Depository Institutions Deregulation Committee, a continued growth of money market funds, and potentially the availability of tax-exempt so-called "All Savers Certificates" at depository institutions, all of which could continue to result in some diversion of funds from market outlets into M2 and M3.

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*These shifts sharply depressed recorded (i.e., before "shift adjustment") M1A early in the year because the bulk of the NOW accounts reflected transfers from demand deposits which are included in M1A. Recorded M1B, which includes NOW accounts, was "artificially" increased to the extent funds were shifted into NOW accounts from savings accounts or other assets not counted as transaction accounts, but continue in part to serve the economic function of savings. The Federal Reserve publishes estimates monthly of "shift-adjusted" data based on a variety of sources. As the transfers diminish, as appears to be happening, the "adjusted" and "unadjusted" data will more closely coincide.

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In the light of this situation, the Committee considered the possibility of making small adjustments in the 1981 ranges to account for the impact of institutional change. However, it seems probable that the strongest impact of the introduction of NOW accounts and of adjustments of cash management practices to high interest rates may be behind us. Therefore, the Committee did not feel that changes in the growth ranges for 1981 were justified. (All targets for 1981 and 1982 are shown in Table II.)

However, given developments during the first half of the year and the need to avoid excessive growth in coming months, the Committee agreed that growth in M1B near the lower end of its range for the year as a whole (3½-6 percent, after adjusting for NOW account shifts) would be acceptable and desirable, particularly should relatively strong growth in the other aggregates continue. As indicated at the start of the year, the Committee does feel it acceptable that growth in M2 and M3 be toward the upper part of their ranges (6-9 percent and 6½-9½ percent, respectively). Growth of bank credit, while often fluctuating considerably from month to month, is expected to remain within its specified range of 6-9 percent.

In its tentative consideration of the targets for 1982, the Committee decided to plan for targeting and publishing a single M1 figure, equivalent in coverage to the present M1B. Assuming that further "structural" shifts into NOW accounts from non-transaction accounts are by that time minimal, "shift adjusted" targets and data should not be necessary. The tentative range for

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M1 in 1982 was set at 2½-5½ percent, the midpoint of 4 percent is three-quarters percent below the midpoint of the closely comparable current range for M1B "shift adjusted."*

The tentative ranges for the broader aggregates in 1982 were left unchanged at 6-9 percent and 6½-9½ percent for M2 and M3, respectively. However, we would anticipate actual growth closer to the midpoint in 1982, consistent with the desired reduction over time.

Setting precise targets has inevitably involved us in consideration of the effects of technological and regulatory change on monetary measures. Those technical considerations should not obscure the basic thrust of our intentions -- that is, to lower progressively effective money and credit growth to amounts consistent with price stability. We believe the targets for both 1981 and 1982, and our operations, are fully consistent with that objective.

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*The tentative range for M1 in 1982 is substantially below the range of 6-8½ percent specified for <u>recorded</u> M1B growth for 1981. Recorded M1B data for 1981 have been strongly affected, particularly during the early months of the year, by the "one-time" shifts into NOW accounts of savings and other funds not included in the M1 series. These shifts are diminishing, and the new tentative target for 1982 assumes they will be essentially completed by the end of this year. The slightly wider range specified allows for the possibility of some residual shifting. That assumption will, of course, be reviewed at year end.

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I have often emphasized that money supply data -- like many other financial and economic data -- have some inherent instability in the short run. The trend over time is what counts, both as a measure of monetary policy and in terms of economic effect. For some months in the latter part of 1980, as you will recall, the rise in M1 was relatively rapid. Against that background, the sluggish growth during most of the first half of 1981 was welcomed as a desirable offset by the FOMC, confirming the trend toward a lower rate of growth over time. At the same time, we have been conscious of the relative strength of M2 and M3. Those measures include money market funds, short-term repurchase agreements, and certain U.S.-held Eurodollars, that to a greater or lesser degree can serve as substitutes for M1 balances. With those components growing relatively rapidly, our experience this year, to my mind, reinforces the need to take account of all available information in assessing the significance of short-term movements in the monetary aggregates and judging our policy posture.

More fundamentally, what recent experience also confirms is that demands for money and credit growing out of an expanding and inflating economy, pressing against a restrained supply, will be reflected in strong pressures on interest rates and credit markets -- pressures that in turn restrain the growth in business activity. Some important sectors of the economy are relatively impervious for one reason or another to direct financial restraint --

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energy, high technology, many services, and defense. Those sectors have been strong sustaining forces in the economy generally, and particularly in some geographic areas. The brunt of the restraint falls on other credit-dependent sectors, and, as the dollar has sharply appreciated, increasingly on exporters faced with a less favorable competitive position. Should interest rates decline in response to weakness in the economy, many of those sectors would likely, and rather promptly, rebound.

In a longer time frame, the outlook for interest rates will depend importantly on confidence that inflation will be controlled, and on actual progress toward greater price stability, as well as such factors as the Federal deficit. Differences of opinion about these matters help to account for the relatively wide range of forecasts now characteristic for the period ahead, including those set forth by members of the FOMC. (Table III sets forth the range of those projections.)

I cannot fully resolve all those uncertainties in the outlook for you this morning. What does seem clear to me is that progress on inflation is a prerequisite for lasting improvement in financial markets, and for sustained, balanced growth. I can also emphasize the policies that seem to me necessary to speed the transition to more equable financial markets and to a more prosperous, productive economy generally.

First, as I have already indicated, curbing inflation will require persistent restraint on the growth of money and credit. An attempt to escape from high interest rates and

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strains on financial markets and institutions by abandoning that restraint would be self-defeating. By encouraging expectations of more inflation, that approach would soon stimulate even more borrowing, further reduce incentives to save, and ultimately result in still higher interest rates and more economic difficulty. You and I know that, after a decade and more of disappointment, there is persisting skepticism and doubt about the ability of the nation to persevere in an anti-inflation program. I believe that skepticism is unwarranted, but we must make that claim good by our actions. Indeed, sustained monetary restraint, by encouraging greater confidence in the price outlook, will in time help bring interest rates lower.

Pressures on financial markets can also be relieved by actions from other directions, entirely consistent with the anti-inflation effort and the longer-run needs of the economy. Specifically, government deficits and credit programs absorb a large fraction of our available limited savings. You are well aware that the Administration and the Congress are hard at work on both sides of that question. It requires a difficult balancing of priorities. Some forms of tax reduction are justified by the need to improve incentives and to reduce costs. But if we are to be convincing in our efforts to reduce the deficit at the same time, Congress will need to maintain and even intensify the courageous effort to reduce the upward trend in spending.

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Monetary restraint implies that the growth in the current value of our output -- the nominal GNP -- will also be restrained. To the extent that restraint falls on prices, the more room there will be for the growth in real output we want. I have already suggested that the recent improvement in the price performance has some elements that we cannot count on continuing. But, along with the present slack in many labor and product markets, the more encouraging price data certainly helps create a more favorable setting for changing the fundamentals of pricing policy and wage behavior in ways that can be sustained.

A bulge in labor compensation early this year, and continuing large increases in unit labor costs, have reflected in substantial part a "catch up" in wages after last year's large rise in the consumer price index, as well as sizable increases in the minimum wage and social security taxes. These sources of pressure should be much diminished or absent in the period ahead. Intensified by the appreciation of the dollar, there are also strong competitive incentives domestically and internationally, on important industries to control costs.

In these circumstances, there is a compelling logic, from an overall economic view, in looking toward a sense of greater caution and restraint in both wage and pricing behavior. What is at issue is the extent to which that need will seem equally compelling, viewed from the specific shop floor or the individual executive suite. These decisions are, of course, made continuously

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in the non-union sector of the economy, but a crucially important round of union wage bargaining begins next January, potentially setting a pattern for several years ahead.

That is one reason why we need to be clear and convincing in specifying our monetary and fiscal policy intentions, and their implications for the economic and inflation environment. Without room for financing both high levels of inflation and strong growth, inflationary behavior by individual firms can jeopardize markets, jobs, and profits.

The lesson already seems apparent in some key industries. Government can and should help directly by removing unnecessary regulatory burdens, and by reviewing laws and practices that actually inhibit competitive pricing and add to costs. I believe it can also help indirectly by making clear that industries suffering from problems of their own making are not entitled to new governmental protection.

What this all adds up to is that we are at a critical point in the fight on inflation.

We see the first stirrings of progress in the recent data.

With enormous effort, the Administration and the Congress are moving together to attain control of spending. We all know much remains to be done for future years, but the unparalleled effort bodes well for the future. With a full measure of success, the most urgently needed tax reduction can be responsibly reconciled with reduced deficits.

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We in the Federal Reserve are committed to reducing growth in money and credit.

There is, I believe, a genuine urge to let the competitive marketplace work, and to review government practices that unnecessarily add to costs or limit competition.

These policies can and will be effective. But if they are to work, they must be sustained with conviction. Then, the apparent reluctance of many to bet on reduced inflation -- in financial markets, in wage bargaining, in pricing, and in other economic decisions -- will change. As they do, the unwinding of the inflationary process should be much easier.

In a real sense, the hardest part of the job faces us now and in the months immediately ahead. We must demonstrate our ability to carry through on our good intentions -- not just in monetary policy, but in the fiscal and other areas as well.

I have talked at some length this morning about the technical aspects of monetary policy and our numerical targets for the various monetary aggregates. I have reemphasized why the Federal Reserve must be and is determined to avoid excessive growth in money and credit. I have stressed the key role other policies, including budgetary restraint, must play if we are to make real progress toward price stability and relieve pressures on financial markets.

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That may all seem abstract and even singleminded, given the pressing problems of the real world.

For far too long, we have not had acceptable economic performance. The average worker has found his or her real income growing slowly if at all. The overall unemployment rate, high as it is, does not reflect the intensity of the problem for some groups and areas, and the burden too often falls on those least able to bear it. Interest rates are at extraordinary levels.

We in the Federal Reserve are acutely aware of these problems. We do not restrain money and credit for its own sake, or simply because inflation is an evil in itself.

Financial discipline is a means to an end. It is an essential part -- if only a part -- of strengthening our economy so that productivity and living standards can rise and worthwhile jobs can be found, not just for a few months, but for the longer period ahead.

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Table 1

GROWTH RANGES AND ACTUAL GROWTH IN MONEY AND CREDIT
(All data percent at annual rates)

	Growth Ranges	Actual	
	1980_{Q4} - 1981_{Q4}	1980_{Q4} - 1981_{Q2}	1980_{Q4} - Latest Data
M1-B*	3-1/2 to 6	2.2	2.6 (July 8)
M2	6 to 9	9.5	8.7 (June)
M3	6-1/2 to 9-1/2	11.5	11.1 (June)
Bank Credit	6 to 9	8.9	8.7 (June)

*Adjusted for shifts into NOW accounts. The range for recorded M1B associated with the "shift-adjusted" M1B range at the start of the year was 6 to 8-1/2 percent. Actual growth in that measure from 1980_{Q4} to 1981_{Q2} was 6.8 percent at an annual rate. With NOW account growth larger than anticipated at the beginning of the year, the divergence between the recorded and shift-adjusted data should be slightly greater than anticipated at the start of the year.

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Table 2

GROWTH RANGES AND ACTUAL GROWTH OF MONETARY AND CREDIT AGGREGATES
(Percent changes, fourth quarter to fourth quarter)

	M1-A	M1-B	M2	M3	Bank Credit
Growth Range for 1980	3-1/2 to 6	4 to 6-1/2	6 to 9	6-1/2 to 9-1/2	6 to 9
Actual 1980	6-1/4 [1]	6-3/4 [1]	9.6	10.2	8.0
Growth Range for 1981	3 to 5-1/2 [2]	3-1/2 to 6 [2]	6 to 9	6-1/2 to 9-1/2	6 to 9
Growth Range for 1982	n.a.	2-1/2 to 5-1/2 [3]	6 to 9	6-1/2 to 9-1/2	6 to 9

1. Adjusted for unanticipated transfers into ATS and other similar accounts from other assets.
2. Adjusted for shifts into NOW accounts.
3. Assumes negligible impact of shifting into NOW accounts.

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Table 3

FOMC MEMBERS' ECONOMIC FORECASTS

	Actual	Projected	
	1980	1981	1982
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.4	10 to 11-1/2	9-1/2 to 12-1/4
Real GNP	-.3	1 to 3-1/2	1 to 4
Implicit GNP deflator	9.8	7-1/2 to 9	6-1/2 to 8-1/2
Average level in fourth quarter			
Unemployment rate (percent)	7.5	7-1/2 to 8-1/4	7 to 8-1/2

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For use at 10 a.m., E. D. T.
July 21, 1981

Board of Governors of the Federal Reserve System

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

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 20, 1981

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

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

Sincerely,
Paul A. Volcker, Chairman

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CHAPTER 1

FEDERAL RESERVE POLICY AND THE OUTLOOK FOR 1981 AND 1982

Section 1: The Objectives of Monetary Policy

The Federal Reserve reported to the Congress in February that the principal objective for monetary policy in 1981 would be to exert continuing resistance to inflationary forces. This goal requires gradual reductions over time in the expansion of money and credit to rates consistent with sustainable growth in output at reasonably stable prices. Signs of a deceleration in broad price measures this year are encouraging. Nonetheless, inflationary forces are still well entrenched, and the Federal Reserve must remain firmly committed to a policy of monetary restraint.

The persistence of inflation and the extraordinary costs it imposes on the economy have been widely demonstrated in recent years. Deeply embedded expectations of inflation have created serious imbalances in financial markets, distorted spending patterns throughout the economy, and imparted a strong upward momentum to wages and prices. At the same time, productivity growth has slowed markedly and the unemployment rate has remained consistently high by historical standards. Dealing with the inflation problem, with all its difficulties, is essential if we are to provide a solid base for sustained growth, lower unemployment, and higher productivity, goals central to the Humphrey-Hawkins Act.

The reduced rate of price increase this year has reflected, in substantial part, developments in the food and energy sectors. Sensitive commodity prices, more broadly, have been restrained by the high cost of credit and reduced speculative interest. In short time periods, however, prices in these sectors can be greatly influenced by developments only tangentially related to broader trends in the economy and can be quite volatile. The underlying inflationary tendencies in the economy generally are better captured by

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trends in labor costs--the largest element in production costs for both goods and services. While there are scattered and tentative indications of some moderation of the rise in unit labor costs, their advance remains rapid.

One key element in slowing the rise in costs is avoiding excessive pressures on productive capacity. Restraint on growth of money and credit helps to prevent such pressures. But the process of slowing inflation through monetary restraint can entail strains on particular markets and sectors of the economy, especially when so much of the task of dealing with inflation rests on monetary policy. As long as strong demands for money and credit persist, and inflationary expectations remain intense, restrained monetary growth may be accompanied by high interest rates and considerable financial stress. These financial strains impose particular hardships on industries that depend heavily on credit markets such as construction, consumer durables, and business equipment. Most obviously, the thrift institutions are experiencing severe pressures on earnings and reduced inflows of deposits. More generally, the recent inflation, combined with a long period of relatively slow growth in activity, has distorted the balance sheets of many businesses and individuals, leaving them more vulnerable to adverse financial and economic developments.

Lasting relief from these financial pressures will be dependent on success in dealing with the inflation that lies at the root of the problem. Monetary stimulus can encourage, at best, only short-lived declines in interest rates and would without question sustain or aggravate underlying inflationary forces. The only effective way to bring down interest rates and restore financial stability is through the sustained pursuit of anti-inflation policies. The more quickly inflationary forces are defused, the greater the

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potential for a sustained easing in credit market conditions and a return to more satisfactory production and employment growth.

Disciplined money policy is an essential element in the effort to damp inflationary forces. Progress in this direction will be speeded and the near-term hardships minimized if other governmental policies complement the efforts of the monetary authority. As businesses and wage earners become convinced that the government is committed to slowing the rise in prices, expectations of inflation will have a lessening impact on the determination of wages, interest rates, and prices. In this regard, the stance of fiscal policy is of particular importance. Assurance that growth in Federal expenditures will be limited and that the budget will move toward balance will reinforce the effectiveness of monetary restraint and help relieve pressures on financial markets.

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Section 2: The Growth of Money and Credit

The targeted ranges of growth for the monetary aggregates announced in February anticipated a deceleration in monetary growth. Measured from the fourth quarter of 1980 to the fourth quarter of 1981, and abstracting from the effects of the authorization of NOW accounts nationwide, the ranges adopted were as follows: for M1-A, 3 to 5-1/2 percent; for M1-B, 3-1/2 to 6 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The corresponding range for commercial bank credit was 6 to 9 percent.

The monetary aggregates have shown disparate patterns of growth so far this year. The narrow aggregates, after adjusting for the newly authorized NOW accounts, have fallen short of their ranges. At the same time, M2 growth has been at the upper limit of its range, while M3 has exceeded the upper end of its range. The divergent behavior of the aggregates is symptomatic of the rapid structural changes that are underway in financial markets in response to high and volatile interest rates and to an evolving regulatory environment.

Recently, the most prominent structural development affecting the measured aggregates has been the introduction at the end of 1980 of NOW accounts nationwide. As expected, there have been major shifts of funds into NOW accounts from conventional checking accounts included in M1-A and from interest-earning assets included in M2. Consequently, the Federal Reserve is publishing estimates of M1-A and M1-B that are adjusted for these shifts in order to facilitate comparisons with earlier years. Through June, these adjustments have had the effect of raising M1-A by $28 billion and lowering M1-B by $10 billion. Shifts into NOW accounts were particularly large early in the year, reflecting the rapid response by individuals with

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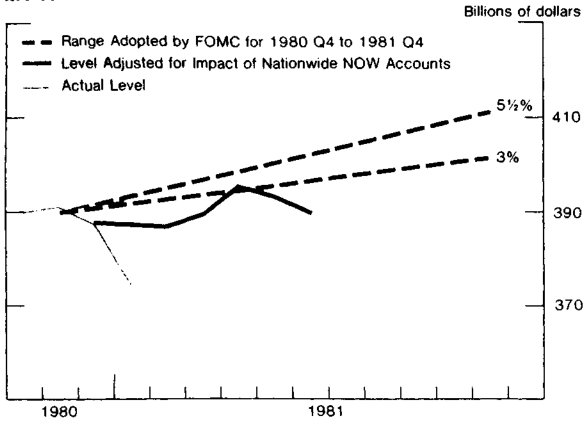
Growth Ranges and Actual Monetary Growth

M1-A

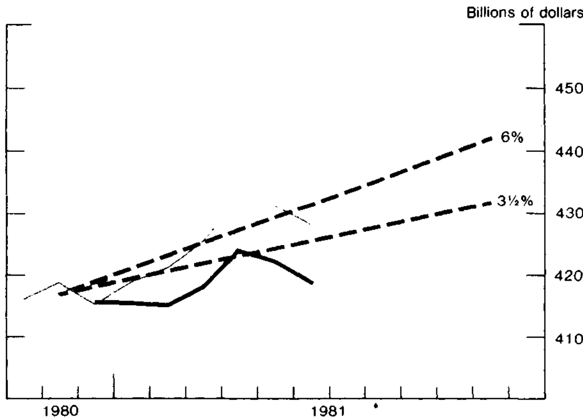


Annual Rates of Growth
Adjusted

1980 Q4 to 1981 Q2
1.6 Percent

1980 Q4 to 1981 June
0.0 Percent

M1-B



Annual Rates of Growth
Adjusted

1980 Q4 to 1981 Q2
2.2 Percent

1980 Q4 to 1981 June
0.7 Percent

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large demand deposit balances. Over the past two months, in contrast, the shift adjustments have been negligible, as there have been small outflows from NOW accounts. These outflows probably do not signal the end of the NOW account buildup. The record in New England, where NOW accounts were introduced some time ago, suggests that the process of adjustment has further to go. Also, a recent survey indicates that individuals are continuing to open NOW accounts, though at a much reduced pace from earlier in the year. Even so, the adjusted and unadjusted data are likely to continue to move much more closely together than in the early months of the year.

The shift adjustments published by the Federal Reserve have attempted to correct for one important distorting influence on the narrow aggregates. After taking account of these adjustments, M1-A and M1-B have been low relative to their past relationships to income and interest rates, so far this year. For example, despite the rapid growth in nominal income over the first half of 1981, shift-adjusted M1-B expanded at an annual rate of only 2-1/4 percent from the fourth quarter of 1980 to the second quarter of 1981. This was less than half the rate at which M1-B grew in 1980 even after allowing for the shift into ATS and related accounts last year. In the first quarter especially, growth in adjusted M1-B was well below that which would be expected on the basis of average historical relationships among money, income, and interest rates. Relatively low growth in transactions balances has occurred on occasion when interest rates have reached new highs, such as happened at the turn of the year. In addition, the introduction of NOW accounts may have stimulated a general reconsideration of alternative deposit and nondeposit instruments and thereby have intensified the response to the peak in rates.

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Indeed, at the same time that the narrow aggregates have been unusually weak, the broader aggregates in the first half of 1981 have been at or above the upper limits of their specified ranges. Instruments that offer market-determined yields have continued to grow rapidly, insulating M2 from the damping effects of rising interest rates by encouraging investors to keep their funds in financial intermediaries rather than shifting into open market securities. The growth of money market mutual funds has been particularly rapid, averaging about 125 percent at an annual rate from December 1980 to June 1981; this growth accounted for 60 percent of the increase in the nontransaction component of M2. While available data do not permit accurate estimates, the exceptionally rapid growth in these funds, which at least in limited part are used as transactions balances, may have lowered growth in recorded M1-B a bit. To the extent that money market mutual funds attracted funds from the open market, the effect was higher M2 and M3.

Thus far this year, M3 growth has averaged 11-1/2 percent at an annual rate--about 1-1/4 percentage points faster than last year and 2 percentage points more than the growth of M2. Large denomination certificates of deposit, which are the main additional instruments included in M3, have been growing strongly, reflecting the need for depository institutions to expand their managed liabilities to offset the weakness in their core deposits. In addition, M3 appears to have been influenced by changing patterns of transactions between U.S. banks and their foreign branches.

Over the first half of 1981, commercial bank credit grew on balance at a rate a bit below the upper limit of its range for 1981. Loan growth was strong early in the year but soon tapered off. With the prime rate lagging

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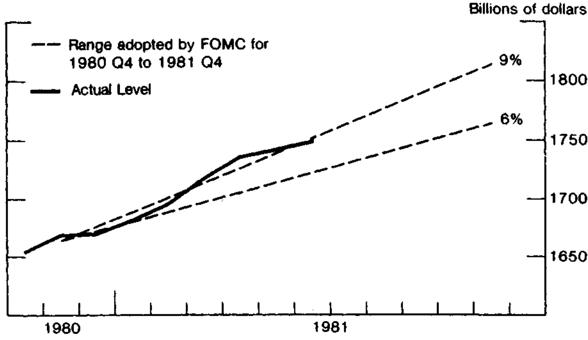
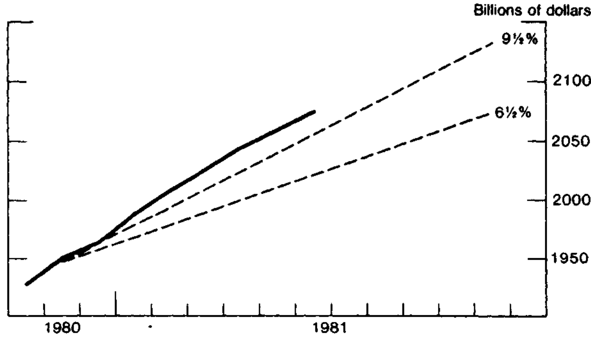
Growth Ranges and Actual Monetary and Bank Credit Growth

M2



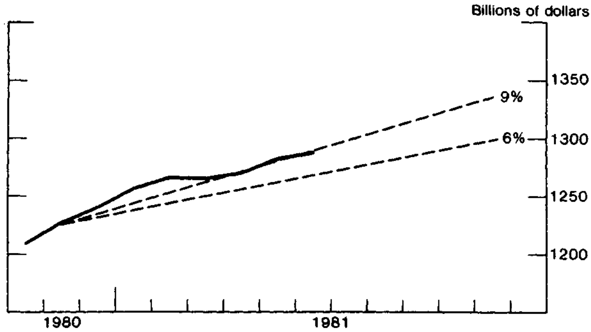
Annual Rates of Growth
1980 Q4 to 1981 Q2 9.5 Percent
1980 Q4 to 1981 June 8.7 Percent

M3



Annual Rates of Growth
1980 Q4 to 1981 Q2 11.5 Percent
1980 Q4 to 1981 June 11.1 Percent

Bank Credit



Annual Rates of Growth
1980 Q4 to 1981 Q2 8.9 Percent
1980 Q4 to 1981 June 8.7 Percent

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behind the drop in market rates, business loan growth showed a particularly sharp deceleration, as corporations switched much of their borrowing to the commercial paper and bond markets. Later in the spring, however, business loan growth picked up again, as bond rates moved to all-time highs. Real estate loans have shown a more even pattern of growth, sustaining their moderate 1980 rate of increase, while consumer loans outstanding have continued to edge down this year. Security holdings at banks have grown somewhat faster than loans over the first half of 1981, with the bulk of the increase accounted for by U.S. government obligations. So far this year, bank credit growth has been almost 3 percentage points slower than M3 growth. This divergence between the increase in bank asset portfolios and the expansion in M3--which includes most bank liabilities--mainly reflects the large increase in money market mutual funds; much of the inflow to money funds was channeled into commercial paper and other nonbank instruments.

At its meeting in July, the Federal Open Market Committee reassessed the ranges it had adopted for money growth in 1981 and formulated preliminary objectives for 1982. In the light of all the circumstances, the FOMC elected to retain the previously established ranges for the monetary aggregates over the remainder of 1981. In doing so, the FOMC recognized that the short-fall in M1-B growth in the first half of the year probably reflected in part some shifting of transactions balances included in M1-B into other highly liquid assets; in light of that pattern and the desire to moderate growth in money, the FOMC contemplates that growth in the narrow aggregates, adjusted for shifting into NOW accounts, over the year as a whole may be near the lower ends of their annual ranges. Growth in the broader aggregates, on the other hand, has been running at the top or somewhat above the upper ends of their

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ranges, and given their behavior in the first half of the year, may be toward the upper part of their ranges for the year as a whole.

As indicated, the nontransactions components of M2 that offer market-determined rates have been growing vigorously, apparently partly at the expense of market instruments not included in the aggregates. Moreover, the attractiveness of the small time deposit component of M2 recently was enhanced by the decision effective August 1 to uncap the ceiling on 2-1/2 year or longer "small saver certificates" and to remove ceilings entirely on small time deposits with initial maturities of 4 years or more.

In the context of sluggish profits growth and an expanding need for external financing, business loan demands seem likely to remain relatively strong, though a surge in long-term financing could reduce business borrowing at banks if bond rates were to fall. Other components of bank credit are expected to continue recent trends, with real estate loans showing moderate growth and consumer lending remaining weak. While total bank credit is subject to considerable short-run fluctuation, the 6 to 9 percent range for its growth in 1981 remains appropriate.

Looking ahead to 1982 and beyond, the FOMC remains committed to reducing money growth to a rate consistent with non-inflationary economic growth. The speed with which monetary expansion can be reduced without large short-run effects on production and employment will depend critically on the forces bearing on inflation and credit market demands, including the fiscal position of the government. Also, during a time of rapid institutional change, monetary targets must be chosen with close attention to how such change may affect particular aggregates and the relationships among them. In this regard, regard, looking toward completion of the major shift into NOW accounts, the

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FOMC now intends to target a single M1 figure in 1982 with the same coverage as the present M1-B. Assuming that shifts into NOW accounts from nontransactions balances are small by that time, a separate shift-adjusted figure would not be necessary.

Reflecting the intent to reduce growth in money over time, the FOMC tentatively agreed on an M1 range of 2-1/2 to 5-1/2 percent for 1982. This would involve reductions in the upper and lower ends of the range for M1-B (as shift adjusted in 1981) of 1/2 and 1 percentage points, respectively. The growth ranges for M2 and M3 would be left unchanged from those in effect for 1981, a specification that would be fully consistent with a reduction in the actual growth of those aggregates in 1982. Thus, the tentative ranges for the broader aggregates in 1982 are as follows: for M2, 6 to 9 percent, and for M3, 6-1/2 to 9-1/2 percent. The associated range for bank credit would remain at 6 to 9 percent.

While the level of the range for M1 is a reduction from the M1-B range for 1981, it also is widened by 1/2 percentage point. Interest-bearing transaction accounts are in the process of becoming a sizable component of M1-B. To a certain degree, those accounts have a greater savings component for individuals than noninterest-bearing demand accounts. Because of its changed composition, some time will have to elapse before the behavior of M1 with this component can be related with confidence to changing economic and financial circumstances. Moreover, it is also uncertain when this shift in the composition will end. At present, we are assuming that the great bulk of the growth in NOW accounts will have been completed by the end of 1981, with only a small amount of funds continuing to be shifted from nontransaction balances. A firmer judgment about the transition can be made, of course, in

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light of added experience when the 1982 targets are re-evaluated early next year.

The decision to leave unchanged the ranges for M2 and M3 reflects in part the likelihood that the proportion of credit demand financed through depository institutions rather than market instruments will be modestly increased by the trend towards reduced regulatory constraints. It is expected, though, that actual growth in the broader aggregates may fall somewhat lower in their ranges than this year.

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Section 3: The Outlook for the Economy

The economy entered 1981 on a sharp upward trajectory, but it appears that there has been little further growth in activity since early in the year. Auto sales fell with the termination of price concessions this spring, and real retail sales excluding autos have declined in the second quarter. Housing construction activity also has slackened appreciably, while business spending for capital goods apparently has edged down after allowing for inflation. Preliminary estimates suggest that real gross national product showed no increase in the second quarter, and it now appears that economic activity will remain sluggish at least in the near term.

In the investment sectors, the weakness in residential construction likely will persist for some time. Declines in housing starts, such as occurred in the first half, typically are reflected with a lag in reduced construction activity. Thus, even if market interest rates should ease soon, homebuilding would tend to be sluggish for a while. Business fixed investment also displays some signs of weakening, although energy remains a strong sector. Contracts for business construction and orders for new equipment have been on a downtrend in real terms. In addition, the Commerce Department's survey of capital spending intentions indicates that, for the second time this year, firms have scaled back their expected outlays, and at present their spending plans imply almost no growth in real terms for 1981 as a whole.

Consumers also may hold down spending in response to slower growth in real income and to indications that finding or retaining a job may become more difficult as the year progresses. Recent surveys indicate that there has been some retrenchment in anticipated expenditures for consumer goods by households, in part owing to concerns about restrictive credit conditions.

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The recent appreciation of the dollar, combined with only moderate economic growth abroad, points to a slowing in the growth of exports. Over coming quarters, the real volume of exports could well decline a bit.

Government expenditures in real terms should rise relatively little. Outside the defense area, spending by the federal government is expected to contract in real terms, based on proposed budget cuts for fiscal year 1982. And state and local governments currently are seeking ways to curb expenditures in response to reduced income from federal grants and to slower growth in tax receipts. Some stimulus to private sector demands would be provided by the reductions in personal and business taxes currently under consideration by the Congress; however, at this time it seems that most of the impact of the proposed tax cuts would affect private markets in the second half of 1982.

While the near-term outlook suggests a flat economy, it is more difficult to foresee the path of developments in 1982. A crucial element affecting this outlook is the speed with which progress is made in reducing inflation. As noted in the introduction, there has been some slowing in the rate of inflation thus far this year, and the near-term outlook is that prices will continue to rise at a more moderate pace than last year. The recent decline in food prices probably will be reversed in the second half of 1981 in response to tightening supply conditions in some areas. But other factors should work to offset these movements. In particular, the current weakness in world oil markets appears to militate against any substantial rise in petroleum prices over the next few quarters. Also, the increase in the foreign exchange value of the dollar since the end of last year, unless reversed, should further reduce domestic price pressures.

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The pace of wage increases has abated only a little despite relatively high levels of unemployment. The rapid increases in consumer prices in 1980 have been a factor in large upward wage adjustments this year, as workers have attempted to recapture losses of real income. Strong productivity gains, such as occurred in the first quarter of this year, can hold down unit labor costs even when nominal wages rise rapidly. But a sluggish pattern of activity, such as is anticipated for the remainder of this year, is likely to be associated with small productivity gains, suggesting relatively little alleviation of labor cost pressures in the period immediately ahead.

The members of the Federal Open Market Committee, in assessing the economic outlook, have formulated projections for economic performance in the current year and in 1982 that fall within the ranges indicated in the table below. In addition to the monetary growth rate targets, the principal assumptions underlying these projections are that there will be a cut in business and personal income taxes, most of which occurs in 1982, and that growth of federal expenditures will slow.

FOMC Members' Economic Forecasts

	Actual	Projected	
	1980	1981	1982
Change from fourth quarter to fourth quarter, percent			
Nominal GNP	9.4	10 to 11-1/2	9-1/2 to 12-1/4
Real GNP	-.3	1 to 3-1/2	1 to 4
Implicit GNP deflator	9.8	7-1/2 to 9	6-1/2 to 8-1/2
Average level in fourth quarter			
Unemployment rate (percent)		7-1/2 to 8-1/4	7 to 8-1/2

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Most of the members believe that economic growth will remain sluggish in the second half of this year, resulting in some further rise in the unemployment rate by year-end. The outlook for 1982 reflects the broad range of views among members of the Committee about the pace at which the rate of inflation will be reduced. While most expect growth in nominal GNP to slow somewhat next year, views on how the composition of expenditures will be divided between prices and output are less uniform.

The Administration, in association with its midyear budget review, has updated its forecast of the behavior of major economic variables for 1981 and 1982. The revised figures are shown below.

The Administration's Forecast

	1981	1982
Change from fourth quarter to fourth quarter, percent		
Nominal GNP	11.8	12.9
Real GNP	2.5	5.2
Implicit price deflator	9.1	7.3
Average level in fourth quarter		
Unemployment rate (percent)		[illegible]

As compared to the projections of FOMC members, the Administration's forecast for 1982 indicates a greater expansion in nominal GNP. The forecast for the GNP deflator is within the range indicated by Committee members, but real growth is higher. Such an outcome would seem to depend on a substantial rebound in productivity in the wake of the tax and regulatory changes now in prospect, and, relative to historical experience, on a considerable willingness by the public to economize on cash balances in response to continuing changes in financial technology and other factors.

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CHAPTER 2

A REVIEW OF RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

Section 1: Economic Activity During the First Half of 1981

The snapback from last year's brief but sharp recession carried into the early part of 1981; however, the economy clearly lost its upward momentum during the first quarter. Over the past several months, activity has been about unchanged on balance. The initial strength of aggregate demand this year was centered in consumer durable outlays and business fixed investment. Spending in these sectors began the year on a strong uptrend and was bolstered for a time by the various automobile price concessions. In recent months, however, spending for consumer and business capital goods has flattened out. At the same time, residential construction activity weakened in response to rising mortgage rates, after having been aided this winter by comparatively moderate weather. Inventories appear to be under good control, except for autos, as high financing costs have reinforced the continuing desire of businesses to maintain lean stocks.

Unexpectedly favorable developments in volatile food and energy prices played a major role in a noticeable moderation of the broad measures of inflation during the first half. Nonetheless, there also was some limited evidence of a slowing in underlying cost pressures. Unit labor costs advanced less quickly in the first quarter than last year, reflecting a spurt in productivity growth. The moderation in unit labor costs appears to have continued this spring, as wage increases slowed in a few sectors. The marked appreciation of the dollar in exchange markets also began to reduce inflationary pressures through the lowering of import prices and the associated competitive restraint on domestic prices.

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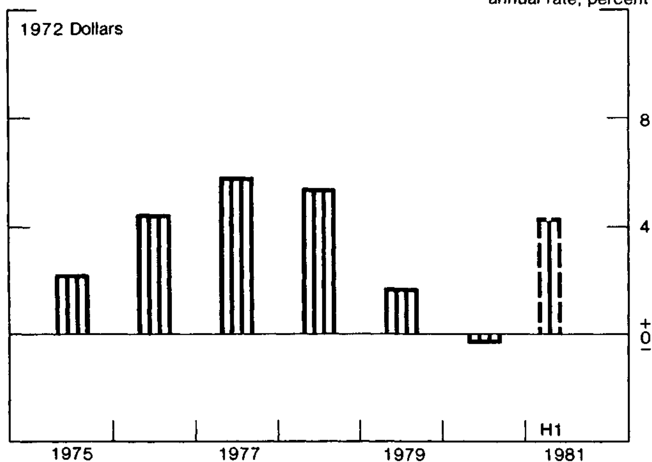
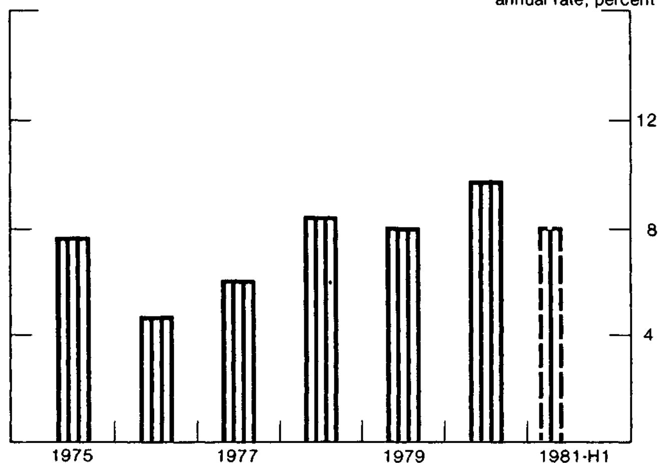
Real GNP



GNP Implicit Deflator



Note: Data for 1981 H1 are partially estimated by the Federal Reserve.

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Personal Consumption Expenditures

Consumer outlays rose sharply early in the year, with strength concentrated in spending for relatively discretionary items such as autos, furniture and appliances, and apparel. This increase in spending was associated with a reduction in the personal saving rate to its lowest level in nearly 30 years. In part, the willingness of consumers to save less and to borrow more may have reflected the reduction in their debt burdens that occurred last year in conjunction with the credit restraint program. In addition, the drop in the saving rate undoubtedly was related to the temporary opportunity to save on auto purchases afforded by the sizable rebates offered mainly in February and March; auto sales accounted for more than half of the increase in durable goods spending in the first quarter.

Once most of the rebate programs ended, however, auto sales dropped sharply and remained at a reduced pace throughout the second quarter. In addition to the cutback in auto demand, spending for furniture and appliances also weakened in the second quarter. At the same time, outlays for general merchandise increased only moderately, and continuing conservation efforts led to cutbacks in the volume of gasoline purchases. On balance, it appears that consumption expenditures declined slightly in the second quarter after allowing for inflation. In effect, following the first quarter surge in durable goods purchases, consumers retrenched to reestablish a more normal spending pattern; even so, the saving rate remained very low by historical standards.

Business Investment

Real business fixed investment increased at a 13 percent annual rate in the first quarter, as temporary developments combined to boost

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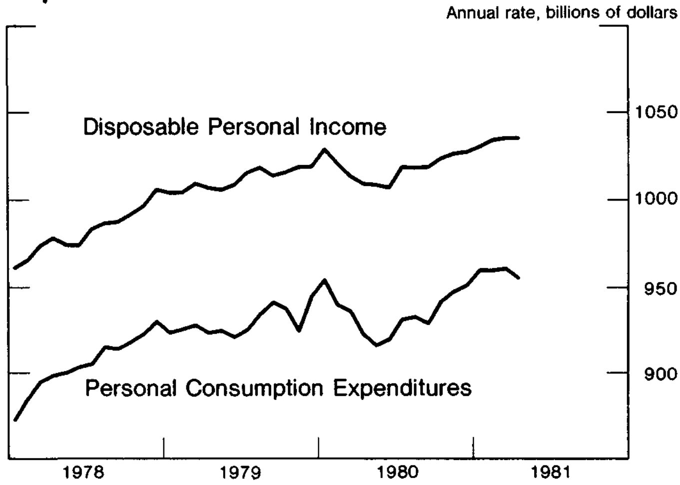
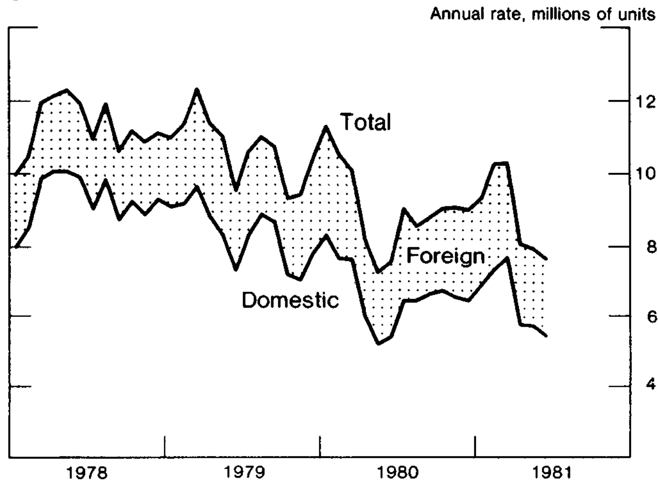
Personal Consumption Expenditures and Disposable Personal Income



Unit Auto Sales



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spending. In the equipment area, businesses took advantage of the rebates offered on cars and added heavily to their fleets. Nonresidential construction also increased vigorously early in the year, aided by the relatively mild weather throughout much of the country.

Following this surge, capital spending appears to have declined this spring. Shipments of nondefense capital goods have been little changed on balance, and business purchases of autos dropped sharply following the end of the rebate programs. Nonresidential construction spending also fell in the second quarter, reflecting in part the sustained tautness in financial markets so far this year. In addition, the quickening of activity that typically occurs in the spring was not as strong as usual following the relatively mild winter weather.

Business inventories declined in real terms during the first quarter, continuing the liquidation that had been underway over the second half of last year. Early this year manufacturers were rebuilding their stocks at a substantial rate, but this accumulation was more than offset by the liquidation of auto stocks that resulted from the various rebate programs. With the end of the price concessions, however, auto sales weakened appreciably and dealer stocks rose quickly during the second quarter. At the end of June, the inventory of U.S. made autos had risen to 87 days supply, only slightly below the peak reported in May 1980. Thus, with sharp increases in auto inventories and with manufacturers' real inventories showing relatively little change in April and May, overall business inventories probably rose in real terms during the second quarter. Apart from autos, however, business inventories still appeared to be well in line with sales in the second quarter.

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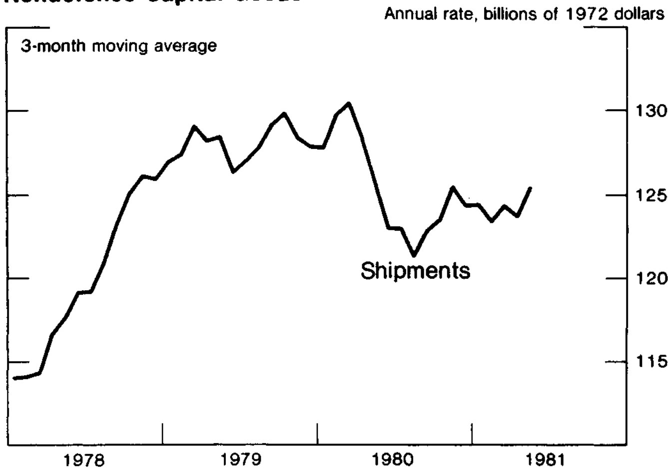
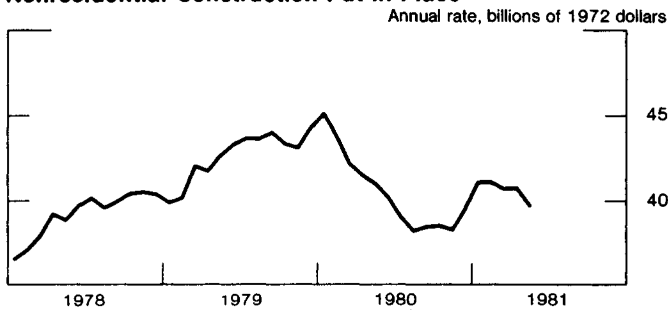
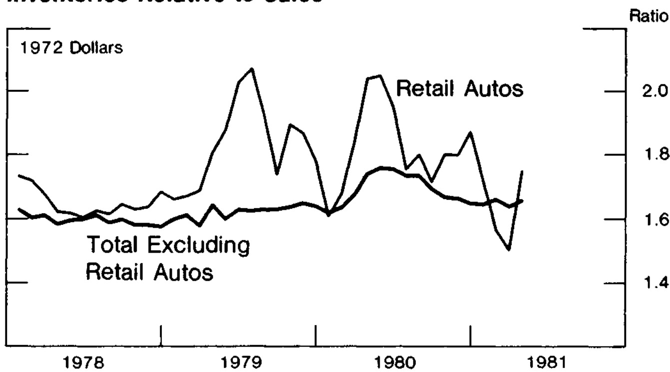
Nondefense Capital Goods



Nonresidential Construction Put in Place



Manufacturing and Trade Inventories Relative to Sales



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Residential Construction

Residential construction activity weakened considerably over the first half of 1981. Housing starts, which had been averaging about 1-1/2 million units at an annual rate in the latter part of 1980, moved down toward a 1 million unit rate over the course of the past six months. Although starts declined early in the year, the value of construction put in place did not begin to fall appreciably until the spring, reflecting in part the favorable winter weather as well as the normal lag between starts and construction activity.

In the single-family sector, starts declined 30 percent from December 1980 to June 1981. Sales of new and existing single-family homes also have dropped sharply this year. With conventional mortgage rates again rising to unprecedented levels, sales activity has been supported to some extent by sellers offering concessionary financing. At the same time, some deceleration in house prices has been apparent; existing home prices increased at a 4 percent annual rate during the first 5 months of 1981 compared with 14 percent last year.

After showing a spurt late last year, multifamily starts also have dropped sharply this year. Activity in this sector has increasingly been devoted to the construction of condominiums and cooperatives rather than rental units. First-quarter data indicate that construction of such "for sale" units was up almost a third from a year earlier and accounted for 45 percent of multifamily starts. The popularity of condominiums and cooperatives probably reflects their attractiveness as a lower cost alternative to new single-family homes.

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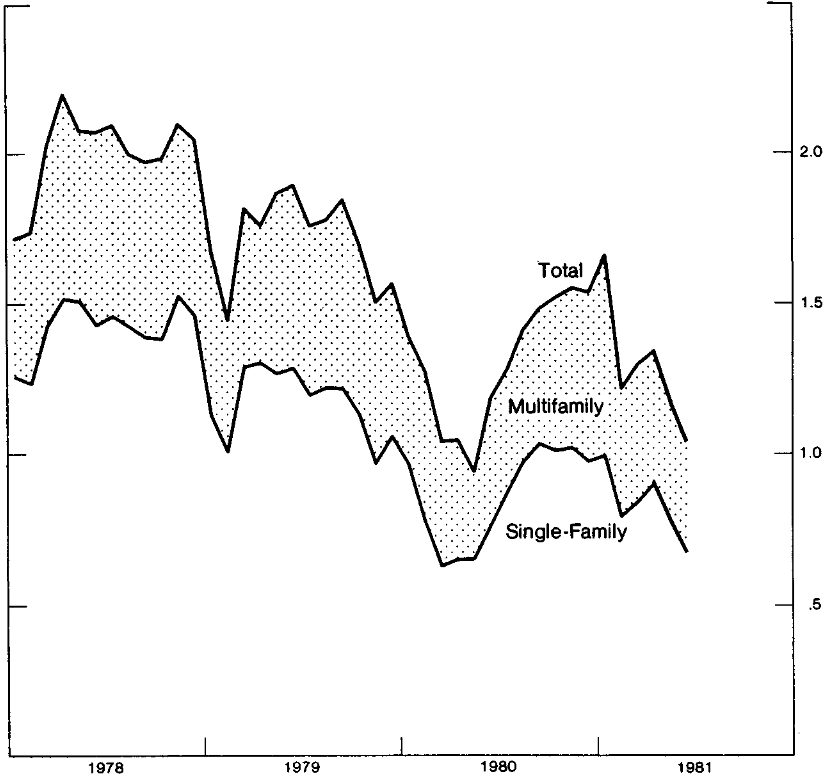

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Government Expenditures

Federal government purchases of goods and services rose at a 15 percent annual rate in real terms in the first quarter and then declined in the second quarter. This volatility was entirely attributable to acquisitions of agricultural inventories by the Commodity Credit Corporation in the first quarter and a runoff of these stocks in the second quarter. Defense spending in real terms was virtually unchanged during the first half of the year, but sustained growth of order backlogs at manufacturers of defense goods indicates continued economic stimulus from this source. Increases on the revenue side of the budget offset this expansionary influence. Large social security tax increases became effective at the beginning of the year, and the rapid growth in GNP at the turn of the year boosted other revenues. On balance, the budget shifted toward restraint. The federal deficit on a national income accounts basis probably shrank by about $26 billion, at an annual rate, between the fourth quarter of 1980 and the second quarter of 1981, while the high-employment budget, which abstracts from the effects of changes in economic activity, became more restrictive by a similar amount as the unemployment rate was little changed over the period.

Real purchases by state and local governments edged down over the first six months of the year, following no growth throughout 1980. In general the continued sluggishness in this sector reflected the effects of fiscal limitation measures passed in a number of areas in recent years, as well as reduced growth of federal grants-in-aid. Employment fell slightly in the first half, with job losses greatest in the federally funded public service employment program. Spending for construction was about unchanged. Despite the expenditure cuts, outlays did not decline as rapidly as receipts, and

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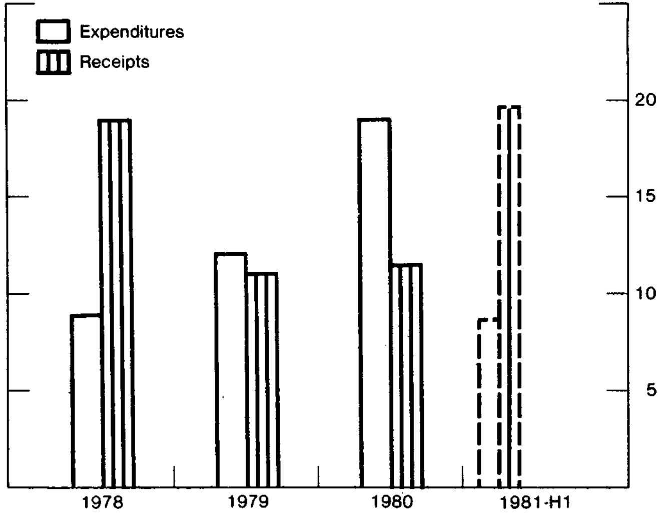
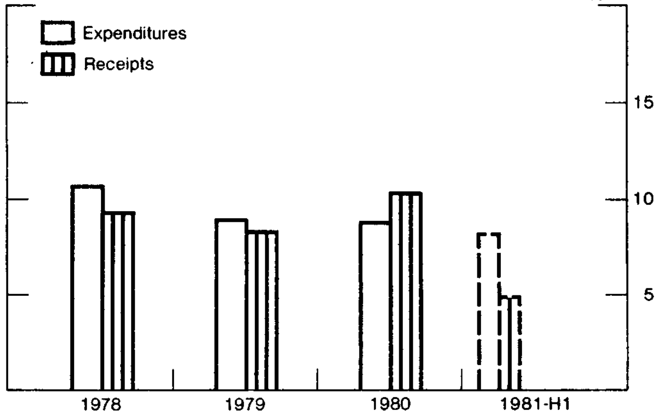
Public Sector Expenditures and Receipts
NIA Basis





Note: Data for 1981 H1 are partially estimated by the Federal Reserve.

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the state and local government sector's operating surplus was almost completely erased by spring after having been consistently positive for several years.

International trade and payments

Real exports of goods and services grew rapidly in the first quarter of 1981, in part because of strong GNP growth in two of our major trading partners, Canada and Mexico. The growth in real exports moderated somewhat in the second quarter in response to a slowing of economic expansion abroad and the appreciation of the dollar. Increases in both agricultural and nonagricultural exports contributed to the growth of total exports in the first half. The volume of imports also has expanded rapidly so far this year. Strong domestic demands during the first quarter and the appreciation of the dollar helped boost imports. Oil imports increased from their year-end levels, although the volume continued to be below the average for 1980 as a whole.

The U.S. merchandise trade deficit declined from about $22 billion at an annual rate in the last quarter of 1980 to roughly $18 billion in the first quarter of 1981. The current account, reflecting this improved trade performance as well as larger net investment income from abroad, changed from a $6 billion surplus (annual rate) in the fourth quarter of 1980 to a surplus of about $12 billion in the first quarter of this year. But with export growth slowing recently, the trade deficit apparently widened in the second quarter and the current account surplus was reduced.

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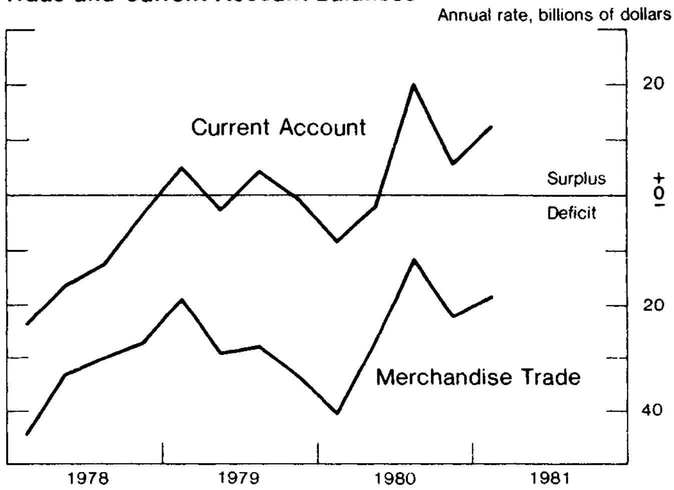
Exports and Imports of Goods and Services

Trade and Current Account Balances



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Employment and Labor Markets

Employment expanded at a much slower rate during the first half of 1981 than during the second half of 1980; in June nonfarm payroll employment was about 565,000 higher than in December, compared with an increase of 860,000 over the preceding half year. On balance, the increase in employment was barely sufficient to absorb the influx of workers into the labor force, and the unemployment rate hovered around 7.4 percent throughout the first half of the year, just below its 1980 high of 7.6 percent.

Employment has continued to rise at a moderate pace in the services and trade sectors, while the number of manufacturing jobs has expanded sluggishly this year and remains below the previous peak in 1979. Employment in the automotive industry has continued at a depressed level, despite some recalls, with 160,000 auto workers still on indefinite layoff at the end of June. In recent months sharp declines occurred among construction workers, reflecting weak building activity this spring. The number of government jobs also has contracted since February, as federal hiring was curtailed and cutbacks in federally funded public service jobs reduced state and local payrolls.

Prices and Labor Costs

The pace of inflation slowed considerably in the first half of this year, receding from double-digit rates for the first time in two years. The consumer price index rose at an annual rate of about 8-1/2 percent through May compared with a 12-1/2 percent pace over 1980. The relief has been concentrated in the food and energy areas; however, a considerable slowing of price increases for consumer commodities more generally also has been evident in 1981 compared with the previous year. Inflation in the consumer service

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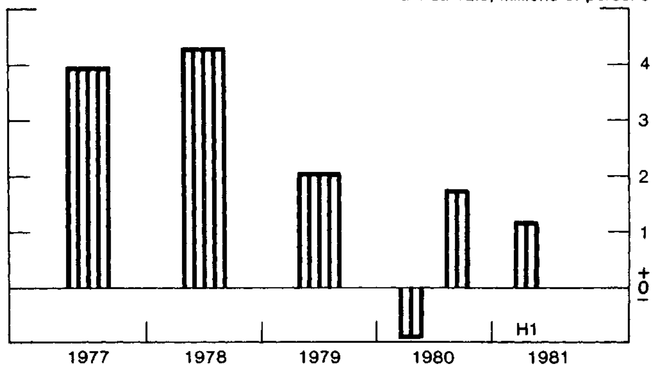
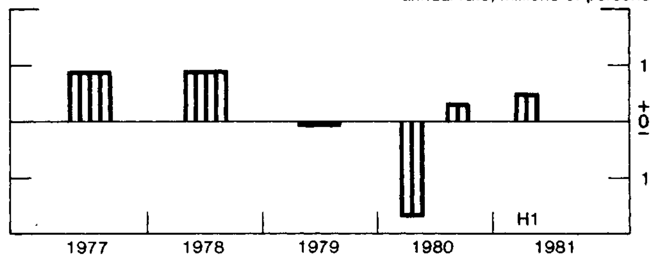
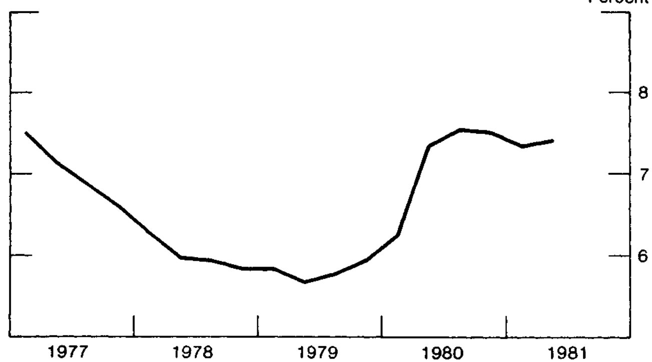
Nonfarm Payroll Employment



Manufacturing Employment



Unemployment Rate



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sector, on the other hand, has diminished little, owing in large part to the substantial weight that rising labor costs have in this sector.

Retail food prices rose at an annual rate of less than 1 percent in the first five months of 1981, in marked contrast to the 10-1/4 percent pace of 1980. The deceleration in food prices in early 1981 was largely confined to sharp declines for meats and related products. More recently, however, the slowdown has been much more widespread. Prices of fruits and fresh vegetables fell sharply in May, and the rise in dairy product prices slowed noticeably.

In the energy area, OPEC price increases, coupled with full decontrol of domestic crude petroleum, led to a surge in energy prices early in 1981; in the first three months overall retail energy prices rose at just under a 50 percent annual rate. Subsequently, however, the rise in energy costs slowed sharply, reflecting the emergence of relatively abundant supplies in petroleum markets. Declining demands combined with high levels of production by Saudi Arabia have resulted in price reductions at both the producer and refiner levels in the second quarter. Even so, energy prices did not decline overall, as prices of natural gas--currently undergoing decontrol--and electricity continued to rise.

Costs of homeownership, as measured in the consumer price index, also have risen more slowly. So far this year, this component has increased at an annual rate near 8 percent, less than half the pace of 1980. The home price measure used in constructing this component has fallen on balance this year, but higher financing costs have more than offset this decline. The CPI measure of home prices is based on a relatively small sample of home sales, and thus, the recent absolute declines in this measure may overstate the degree of

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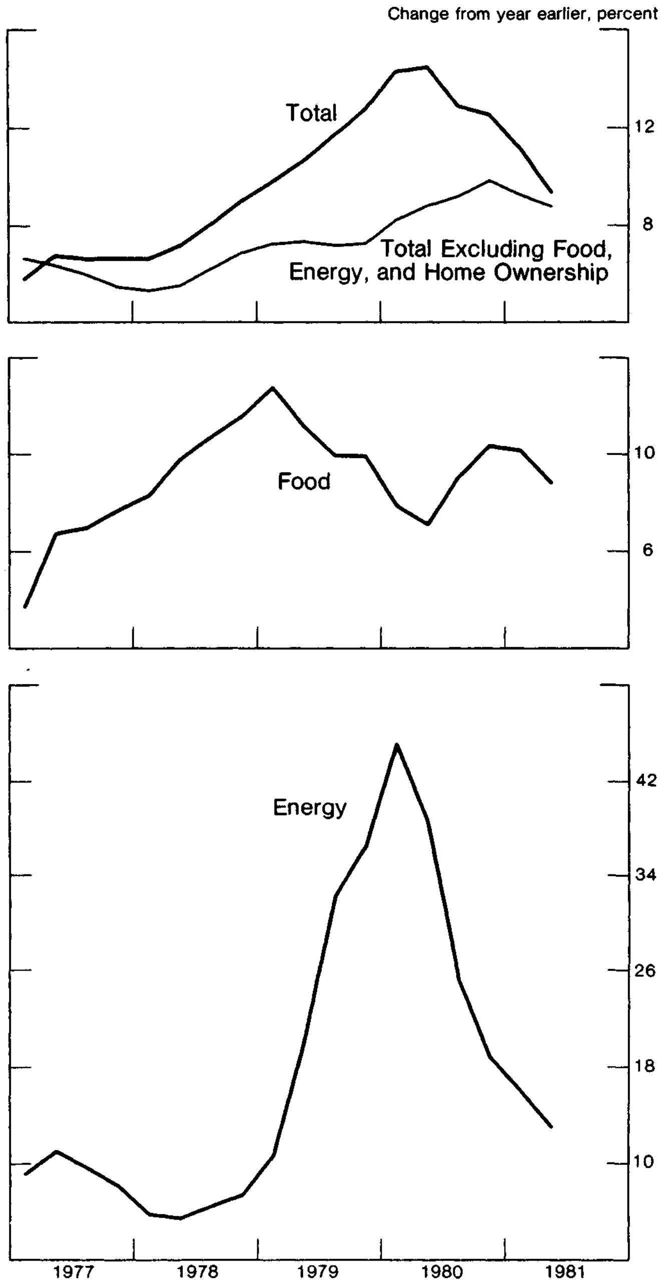
Consumer Prices



Note: Last point shown is April-May average.

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softening in housing prices. However, other broader-based indexes indicate there has been a distinct moderation in the rate of increase in home prices this year.

Prices of consumer items other than food, energy, and homeownership increased at an 8-1/4 percent annual rate over the first five months of 1981, somewhat below the 10 percent pace over the 12 months of 1980. The moderation in price gains for commodities excluding food has been particularly striking; these items decelerated from a 11-1/2 percent pace over the 12 months of 1980 to 8 percent in the first part of 1981. Prices for consumer services other than home financing and energy, however, have barely edged off from the 10-1/4 percent pace of 1980, as increases in these items tend to follow more closely the underlying trend in labor costs.

Movements in labor costs reflected several special factors in the first half in addition to wage and productivity changes. Growth in hourly compensation--which includes employer contributions to social insurance and the costs of fringe benefits--accelerated from a 10 percent pace in 1980 to 11-1/2 percent in the first quarter, owing to an upward adjustment in the tax rate for social security contributions and a rise in the base salary to which the tax rate is applied.

On balance, the pace of wage increases in the first half appears to have moderated somewhat. The index of average hourly earnings, which is a measure of wage trends for production and nonsupervisory personnel, increased at a 8-1/2 percent annual rate in the first six months of the year compared with 9-1/2 percent last year. In manufacturing, moreover, wage increases so far this year have been running well below the 11 percent rate posted in 1980, possibly due to the light calendar for new bargaining settlements. While

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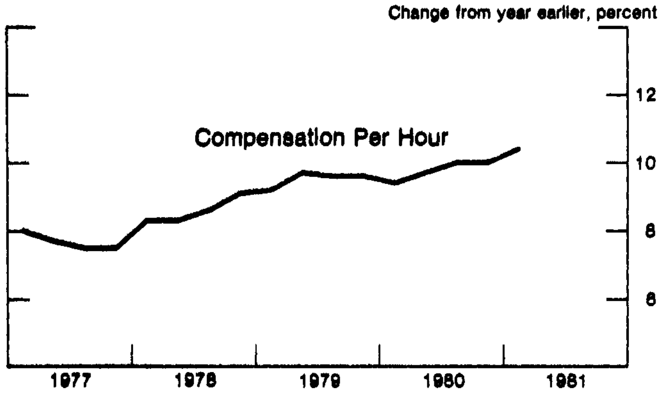
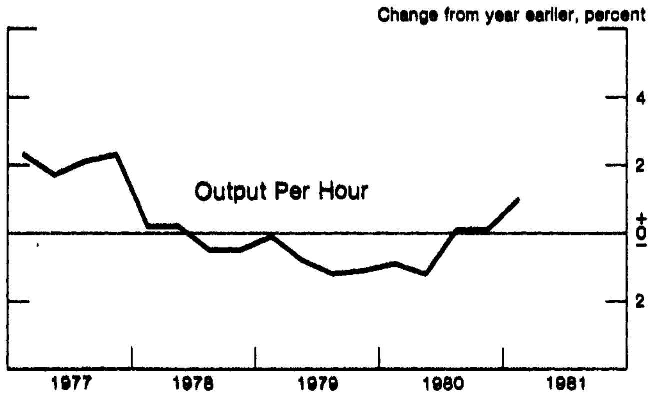
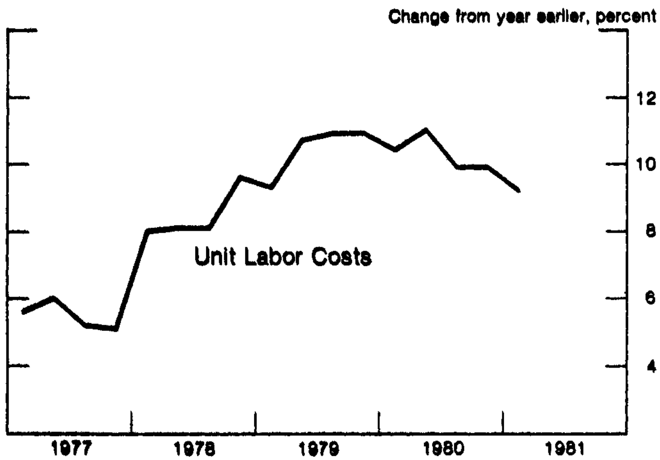
Unit Cost Indicators
Nonfarm Business Sector







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wage increases have abated somewhat, the pace of advance remains strong. Some upward pressures have been generated by catchup adjustments in response to the steep rise in consumer prices last year. In addition, the scheduled minimum wage increase in January boosted wage rates in the trade and service sectors early in the year.

The sharp rebound in productivity had a moderating influence on the rise in unit labor costs in the first quarter, offsetting some of the sizable increases in wages and other labor expenses. Nonetheless, the cyclical recovery of productivity since mid-1980 has been sluggish by historical standards, and by 1981-Q1 output per hour in the nonfarm business sector was just 1 percent above the level a year earlier. Moreover, current estimates of weak output growth suggest that productivity gains provided little, if any, offset to wage increases in the second quarter.

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Section 2: Financial Developments During the First Half of 1981

Interest Rates

Short-term market interest rates began the year at, or only a bit below, record highs after having been on an uptrend since mid-1980 as economic activity rebounded and the Federal Reserve sought to restrain monetary expansion. During the opening months of 1981, however, money growth weakened, and the demand for reserves fell relative to the provision of nonborrowed reserves consistent with the FOMC's monetary targets. Short-term rates began to ease, and by the end of the first quarter, the federal funds rate was 6-1/2 percentage points below its January peak, while other short-term rates were down by 2 to 3 percentage points. Early in the second quarter, growth in money accelerated, renewing pressures in the reserves market. This along with a 1 percentage point increase on May 5 in both the discount rate and the surcharge rate gave an upward impetus to short-term rates. These rates subsequently declined somewhat as money growth weakened in May and June, but in early July were about at the same levels or a bit higher than they were at the beginning of the year.

Long-term interest rates moved quite differently than short-term rates, particularly during the first quarter. Like many short-term rates, bond rates began the year somewhat below the record highs that had just been established in December. However, in contrast to the declines in yields on short-term instruments, long-term rates generally rose over the first quarter. Many financial market participants apparently were concerned about underlying inflationary pressures and about the prospects for continuing large budget deficits in an environment of strong private credit demands. Such concerns,

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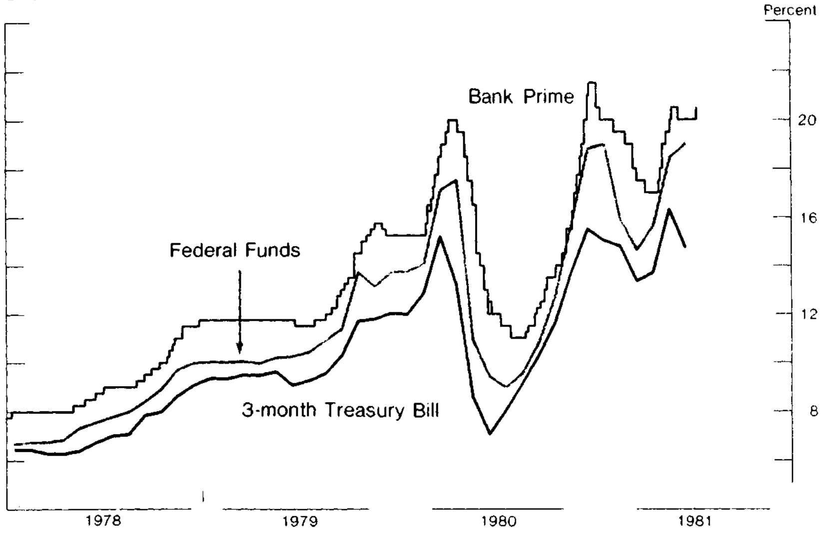
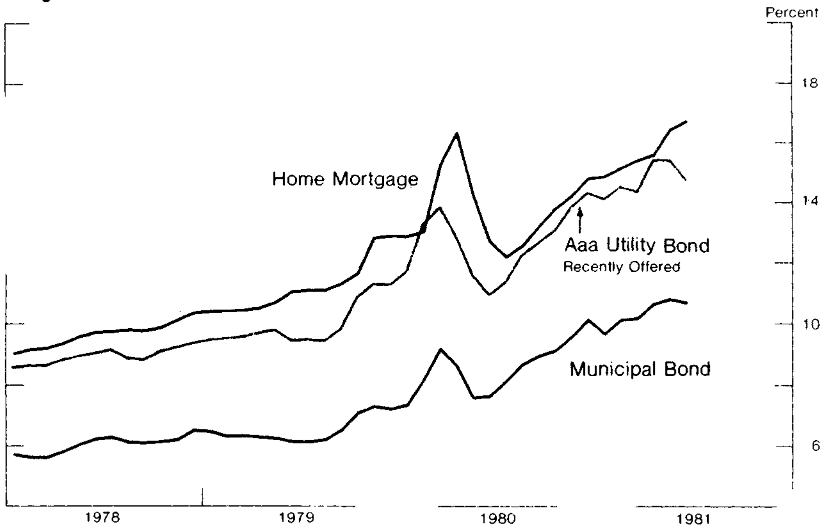
Interest Rates





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including the growing backlog of potential long-term financing, continued prominent in market sentiment during much of the second quarter, and the rise in short-term rates early in the quarter also helped move most long-term rates well above their previous highs. Since peaking in May, however, long-term rates have retraced some of their earlier gains for the year. This improvement seems to reflect in part more optimism about the prospects for reduced inflation as encouraging price data were reported, indications appeared that economic growth has slowed, firmness in monetary policy was apparent and confidence grew that government policy will appropriately restrain federal spending.

Foreign Exchange Markets and the Dollar

The dollar appreciated strongly during the first half of 1981, rising about 15 percent on a weighted-average basis. Increases against European currencies averaged about 20 percent, while the appreciation against the yen was 10 percent. Over some time intervals, short-run movements in exchange rates paralleled the course of differentials between U.S. and foreign short-term interest rates. But over the first half as a whole, the dollar appreciated considerably even though U.S. interest rates fell on balance relative to rates in key financial markets abroad, which have risen markedly. A substantial part of the dollar's buoyancy can be associated with the improved outlook for U.S. inflation and the growing consensus that monetary restraint will be applied over an extended horizon. In addition, the continental European currencies have been weakened by the tensions over Poland and by general political uncertainties in several European countries.

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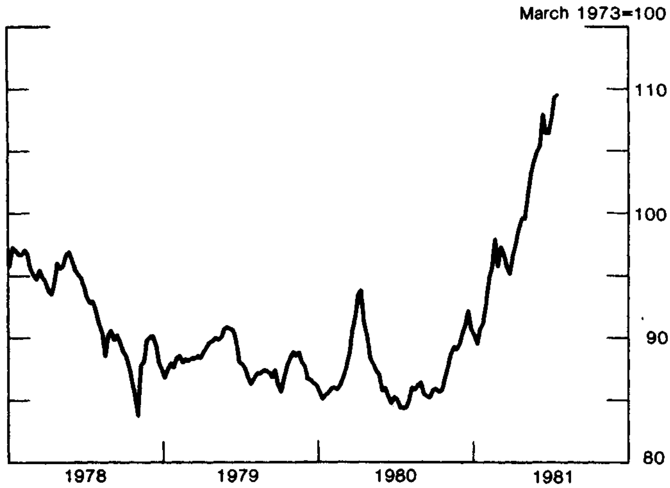
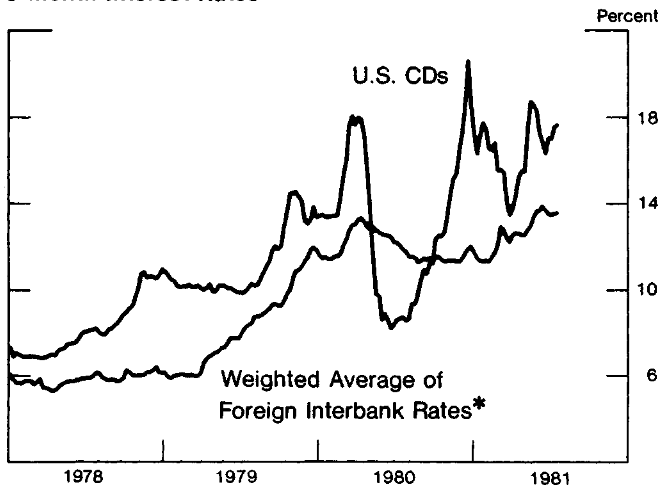
Weighted Average Exchange Value of the U.S. Dollar*



3-month Interest Rates



* Weighted average against or of G-10 countries plus Switzerland using total 1972-76 average trade of these countries.

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Domestic Credit Flows

After rebounding rapidly in the second half of 1980, total funds raised in credit and equity markets by domestic nonfinancial sectors of the U.S. economy leveled off in the first half of 1981, based on preliminary estimates. Firm credit market conditions contributed to some slowing in credit flows to private sectors, especially mortgage flows to households. Borrowing by nonfinancial businesses tapered off in the first four months of the year, but began to pick up in late spring. On a quarterly basis, the pattern of credit flows was greatly affected by the U.S. Treasury, which tapped financial markets for an exceptionally large volume of funds early in the year and then did very little net borrowing in the spring.

The credit requirements of the U.S. Treasury were substantial in the first quarter, owing to a combined (on- and off-budget) federal deficit that exceeded $38 billion. In addition, redemptions of savings bonds totaled more than $2 billion, further boosting Treasury financing needs. The Treasury met these needs primarily by issuing marketable securities and, to a lesser extent, by a further reduction in cash balances. In the second quarter, when normal seasonal tax receipts moved the combined federal budget to a surplus position, the Treasury used inflows to rebuild its cash balances and to pay down an additional $2 billion of nonmarketable securities.

Borrowing by state and local governments remained heavy in the first quarter of 1981 despite a sharp decline in the issuance of mortgage revenue bonds. The volume of housing-related bonds dropped dramatically after January 1, 1981, when statutory restrictions on these offerings took effect. These restrictions, among other things, place limitations on eligible uses of the

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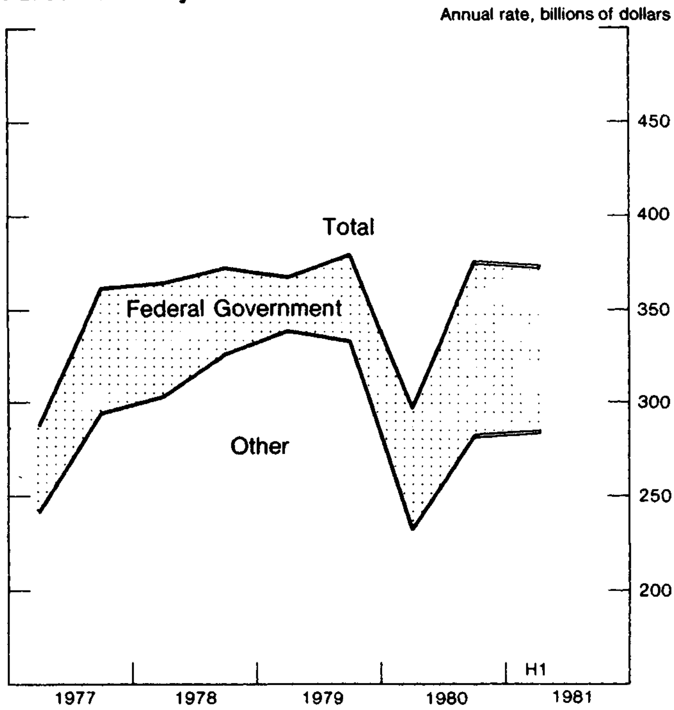

Note: Data for 1981 H1 are partially estimated.

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funds with respect to the value and location of homes and the types of homebuyers, the spread between mortgage rates and the original cost of borrowing; also, the volume of mortgage bonds that can be issued by governmental units is limited. The volume of nonhousing issues early in 1981 was buoyed in part by offerings that had been postponed in the fourth quarter, when a large number of mortgage revenue bonds were brought to market in anticipation of regulatory restrictions and yields on municipal bonds rose to then record levels. State and local governments reduced their issuance of long-term debt in the second quarter as interest costs rose again to record highs. However, financing requirements of many municipal units remained substantial in part owing to declines in revenues resulting from cutbacks in grants in aid to state and local governments.

In the private sector, nonfinancial business firms borrowed at a reduced pace early in the year. The falloff in borrowing was concentrated in short-term credit markets, and, in particular, reflected a sharp deceleration in growth of business loans from domestic offices of U.S. banks. The lag of the banks' prime lending rates behind downward movements in open market rates reduced the relative attractiveness to businesses of bank loans early in the year. During the first quarter, some firms' short-term needs were met by borrowing from foreign branches of U.S. banks at rates tied to Eurodollar rates; commercial paper issuance also increased, though not enough to offset the decline in bank borrowing. Near midyear, more favorable rate spreads for bank loans and a bigger gap between cash flow and investment expenditures--largely the result of increased inventory accumulation--encouraged renewed expansion of business loans at commercial banks. Growth of nonfinancial commercial paper also continued robust in the second quarter.

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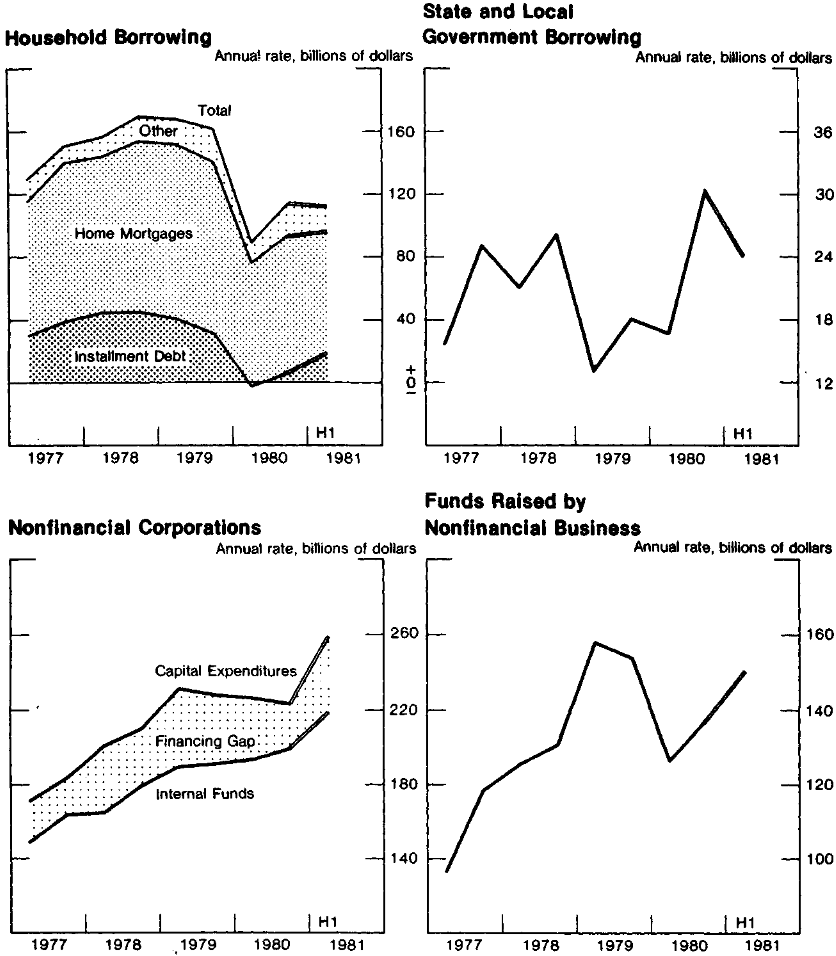

Note: Data for 1981 H1 are partially estimated.

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While short-term borrowing fluctuated, long-term bond issuance by business firms was maintained at a fairly heavy pace over most of the first half. Some companies with major long-range investment programs apparently have elected to come to the bond markets at regular intervals to reduce their risk of having to finance large amounts at particularly unfavorable rates. Firms tapping the bond markets, meanwhile, sought to hold down borrowing costs by adjusting various terms of their offerings. In addition to shorter maturities, there was an increased volume of convertible debentures and bonds with below-market--or zero--coupons sold at deep discount.

A moderate slowing in bond issuance occurred in May when yields on long-term debt reached new highs, and, in June, expectations of near-term rate declines may have led some firms to delay or postpone offerings. But there continued to be indications that bond issuance would increase quickly in the event of improved market conditions as many firms would like to reduce their short-term indebtedness. Flow-of-funds estimates for nonfinancial corporations indicate that their aggregate ratio of short-term debt to total debt has risen well above the previous record level reached in 1974.

Net borrowing by the household sector declined slightly on balance in the first half of the year, as a modest recovery in consumer credit growth only partially offset a reduction in net mortgage formation. Consumer installment credit growth was bolstered in the first quarter by increases in automobile loans, particularly at finance company subsidiaries of the automobile manufacturers. While auto loans slowed in the second quarter in response to slackening car sales, the nonauto consumer goods and personal loan categories of installment credit showed some pickup. Despite the increases in consumer installment debt, the debt position of the household sector continued to

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improve in the first half of the year. The ratio of consumer installment debt repayments to disposable personal income fell further from 1979 peaks in the first four months of 1981, reflecting strong growth in income.

Home mortgage borrowing dropped sharply in the first half. The weakness in mortgage activity was accounted for mostly by reduced lending by thrift institutions. Weak deposit flows and continued erosion of earnings constrained the supply of mortgage funds at thrifts, and rates on new commitments for conventional home mortgages at savings and loan institutions rose to record levels near 17 percent in late May and remained near this level in June and July. Net mortgage lending at commercial banks also fell, and fewer funds for housing were available from municipal units owing to the aforementioned restrictions on issuance of mortgage revenue bonds. The taut mortgage credit conditions have led to increased use of so-called "creative financing" techniques, including wrap-around loans, builder buydown arrangements, and the assumption of low-rate first trusts when house sellers are willing to take back a second mortgage. One effect of such financing arrangements has been to slow the prepayment of old, low-yielding mortgages at the thrift institutions, thus reducing the earnings potential from reinvestment of these funds by these institutions.

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The CHAIRMAN. Senator Heinz.
Senator HEINZ. Thank you, Mr. Chairman.

FINANCING GROWTH AND INFLATION

Chairman Volcker, in your report you indicate that we had a fairly healthy first quarter, a lot of moderation in the second quarter and you indicate that Federal fiscal policy became more restrictive by $28 billion and that there were a number of changes in the money supply which you discussed, that M-2 was growing at close to its upper limit, 9 percent, which I gather amounts to $140 or $150 billion a year on an annual basis—certainly a lot of money—and in your opening statement you said that the Fed is pursuing a policy where you do not finance both inflation and growth.

Now while there was growth, a good deal of it in the first quarter, in the second quarter there hasn't been a good deal of it. To the contrary, it fell down.

So my question is, Where is this money, $130, $140, $150 billion in M-2 measures on an annual basis? What is it financing? It didn't finance growth in the second quarter. What did it finance?

Chairman VOLCKER. In nominal terms, which of course includes both the inflation and the growth, we had an increase in the gross national product of 19 percent in the first quarter and I guess of about 4 percent in the second quarter; the average is 12 percent or so for the half year. If we had a 9-percent annual rate of increase in M-2, we "underfinanced" the nominal growth of 11.5 or 12 percent, if my arithmetic is right here. Normally, I would expect those broader aggregates to grow more or less in line with GNP—obviously it doesn't follow precisely quarter by quarter or even year by year—but there's no particular trend in the velocity of those broader aggregates relative to GNP. I think it's apparent in the first half of the year that, in nominal terms, relative to the growth in the economy the growth in money was quite low.

Senator HEINZ. Well, were you financing growth or were you financing inflation or some of both?

Chairman VOLCKER. Inevitably, you finance both in the short run, because monetary policy in itself is incapable of dividing that up or sorting that out in the short run. One of the problems that's inherent in this situation is that we can't sort it out and say we are going to finance growth or we are not going to finance inflation, because both come into the market in the same way. What we do is underfinance the growth of the nominal GNP.

Senator HEINZ. I'm just asking you what was financed; I'm not asking you what you want to finance.

Chairman VOLCKER. We financed whatever took place because there it is.

Senator HEINZ. So in a certain sense your statement that you won't finance both inflation and growth isn't true. You do finance both inflation and growth. You have no control over it. You necessarily finance both inflation and growth and it's up to the underlying economic conditions to determine the extent to which we finance real growth and the extent to which we finance phony growth, namely inflation.

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Chairman VOLCKER. The extent to which that gets divided up, that's right. The fact is, we are not providing enough finance to let the inflation go up and growth go up at the same time; that's what we're not doing.

Senator HEINZ. Now Senator Garn I think asked the $64 question, which is, why are real interest rates so high above what we believe to be the underlying rate of inflation, 8.5 percent according to your report?

Chairman VOLCKER. I wouldn't say that's the underlying rate of inflation today, if I may just interject. That is the inflation rate during the first half of the year, perhaps, but I think some temporary factors have entered in. We were much above what I would judge to be the underlying rate of inflation in 1979 and 1980. I think we are below what I would judge to be the underlying rate of inflation now, and that's what we've got to get down.

Senator HEINZ. You think the underlying rate of inflation is about 10 percent?

Chairman VOLCKER. Not above 10; no.

Senator HEINZ. So somewhere between 10 and 8.5?

Chairman VOLCKER. Yes.

HEAVY CREDIT DEMAND INCREASES HIGH INTEREST RATES

Senator HEINZ. I would note your point, but a half a point here or there is not what my question is all about. My question is about this: It seems to me that the only way that you can get a 10- or 12-point spread between the real interest rate and the so-called underlying rate of inflation is if there's heavy credit demand.

Chairman VOLCKER. That is certainly one factor operative factor.

Senator HEINZ. Because if there's a demand for credit that sets the price of credit at anything more than a point or two or three above the inflation rate——

Chairman VOLCKER. Let me——

Senator HEINZ. Let me finish. So it seems to me that actually in the dialog between you and Senator Riegle somehow we all missed the point. The point is that it is the demand for credit that is driving the prime up to 21.5 or 20.5, the Federal funds rate to 19 percent, up a point in just a week, the T bills up a point to 16 or 15 and something—I forget which—and is it at all possible that the arrangment for all these loans and lines of credit by these big companies that are afraid of getting taken over by somebody else—and some of whom, by the way, such as Conoco are putting all their officers on 10-year multimillion-dollar contracts—sounds like the major leagues and their problems all over again—sounds like they are signing hockey stars and basketball stars to play center court for all these companies at least. I mean, is it possible that we really are just seeing a corporate wave of excessive preemption of the credit markets to the point where that demand has driven interest rates up because corporation executives have become so fearful that they themselves might lose their jobs because somebody else—American or foreign—might take them over? Is that at all possible?

Chairman VOLCKER. I have expressed my concerns over this; the kind of psychology that you referred to is not absent from this situation, I suspect. How much that is actually the source of inde-

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pendent pressure on the market is at issue. Most of these, as I indicated——

Senator HEINZ. Let's analyze it.

Chairman VOLCKER. All right.

Senator HEINZ. Reported in the front page of the newspaper the other day was $20, $30, $35 billion—$35 billion just in a few weeks.

Chairman VOLCKER. Right.

Senator HEINZ. Now what's M-2's growth in that entire year, $140?

Chairman VOLCKER. Right.

Senator HEINZ. Well, you know, $35 billion in a couple weeks on an annual basis certainly more than exceeds by several times the total expected growth at the upper range of your forecast of M-2 in the entire year. Now you would have to be some kind of a "Pollyanna" to say that that entry into the credit markets is not bidding up the price of credit.

Chairman VOLCKER. This $35 billion has not been taken down, as near as we can——

Senator HEINZ. It's a reservation.

Chairman VOLCKER. It's a reservation.

Senator HEINZ. It means it can't be lent to somebody else.

Chairman VOLCKER. There's a certain elasticity. I don't know what the banks——

Senator HEINZ. There's a certain elasticity, but——

Chairman VOLCKER. I agree, the concept is one of "reservation." I hope you're right, in terms of prudent banking, that the banks making these big other commitments are not making as many other commitments as they otherwise would.

Senator HEINZ. I don't fault the banks per se, Mr. Volcker. All I'm saying is that in the interest of analyzing the problem that we have a brand new factor in the money markets in the last month or two which is suddenly a whole bunch of the corporation executives have gotten panicked from somebody from some other city, whether it's Toronto or New York or Los Angeles or London, may be sitting in their chair and they are reacting in a way we have never seen before. We have never seen people take out $5 billion lines of credit, little companies taking out $2.5 billion lines of credit, and we are sitting here—and it's difficult for me to believe that we could be sitting here saying, oh, well, maybe that really isn't driving up the price of money, of borrowed money; maybe that isn't affecting the prime rate. I mean, do you believe it's not affecting the price of borrowing?

Chairman VOLCKER. I think it may be, but not to the extent that a $35 billion raw figure or whatever the figure suggests.

Senator HEINZ. That's free money. It doesn't cost anybody anything to get it.

Chairman VOLCKER. It costs a commitment fee, and it may, because of the precautions that the bank providing the money or potentially providing has to take, have an effect on the market, but let me go back to the——

Senator HEINZ. Can you really sit there and say it doesn't have an effect?

Chairman VOLCKER. Let me take a case in which we know that the credit line was drawn on—maybe the one that started this

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off—where a foreign company basically got a kind of "war chest" 6 months ago to go out and look around for companies to buy. I don't know if they even had in mind the company they were going to buy, but they contributed to this psychology of which you speak. They drew down this credit line of $3 billion, but the money was reinvested in the money markets. So you had a demand on one side and a supply on the other side. Whatever judgment you make about the net effect that had on interest rates, it is not fair to just take the $3 billion that they drew down on the one side and forget about the $3 billion they put back in Treasury bills or commercial paper at this stage; it went out of the market at one end and came back in the other.

Senator HEINZ. Well, it seems to me if it's true that a $60 or $70 or $80 billion Federal deficit over a year is Federal preemption of the credit markets, and given your monetary policy, drives interest rates up—the preemption of $35 billion in a few weeks by a few big companies must have some effect.

RECYCLED MONEY

Chairman VOLCKER. It must have some effect, but I think there is a distinction. The Federal Government is borrowing that money and spending it for services.

Senator HEINZ. We've recycled it, too.

Chairman VOLCKER. You recycle it to a spender. In this case, it's getting recycled, presumably, to a nonspender. Now you can't identify that——

Senator HEINZ. You know that can't happen.

Chairman VOLCKER. It does happen.

Senator HEINZ. Somebody takes the money and spends it, right?

Chairman VOLCKER. In the case where they haven't spent the money yet, they're putting it right back in the market. If they're buying the stock, then it depends on what the stockholder does with the money. If the stockholder reinvests it in stocks or bonds or the money market, the money is back in the market; if he goes out and spends it, then you've got a situation like the Federal deficit.

Senator HEINZ. Well, my time has expired. Thank you, Mr. Chairman.

Chairman VOLCKER. I don't want it to appear that I don't share many of the concerns that you express in general terms. I just don't think it is correct to say that this is a $35 billion net burden placed on the market.

Senator HEINZ. Whether it's $35 or $25, it's a lot of money for just a few weeks.

Chairman VOLCKER. It's a lot of money and a lot of questions arise from this flurry.

The CHAIRMAN. Senator Cranston, I'll recognize you in just a moment. I did want to recognize Senator Dixon as the one that's giving you his time because I established a procedure—I guess it was from the years that I was a freshman sitting way over there that I would wait and wait and I was here for the whole hearing and John Tower and other senior Senators would come in and after everybody was gone and I was the last one there I would get to ask questions. So I would establish the procedure that we would do it on the basis of when people arrived, but Senator Dixon has gra-

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ciously yielded to you, but I wanted you to know it was not out of the goodness of my heart. It was out of the goodness of your colleague's heart.

Senator CRANSTON. Thank you. I think that's a good policy and I appreciate Alan letting me upset the policy.

Mr. Volcker, I have just a few technical questions about the term of the Chairman of the Federal Reserve Board. I trust you will understand and I ask all members of the committee and others to understand that these questions are not intended to be criticisms of anybody. My purpose is to illuminate a situation which I believe may require action by this committee and the Congress.

Am I correct that you were appointed by President Carter to succeed William Miller and that you're not serving the unexpired years of his term but you are in fact serving a full 4-year term dating from the time you assumed office?

Chairman VOLCKER. There's a distinction between my term as Governor and my term as Chairman. My term as Chairman began with my appointment; my term as Governor is the unexpired portion of Mr. Miller's term.

Senator CRANSTON. Yes. When does that term expire?

Chairman VOLCKER. Oh, enough years ahead so that I don't think much about it, I think the unexpired term was 12½ years when I was appointed.

Senator CRANSTON. Twelve and a half years to go?

Chairman VOLCKER. Yes.

Senator CRANSTON. So you have about 10 years or something like that now?

Chairman VOLCKER. I guess.

Senator CRANSTON. Am I correct, then, that your present term as Chairman expires in August of 1983?

Chairman VOLCKER. Yes, my term as Chairman.

Senator CRANSTON. And if President Reagan reappoints you or names another successor the terms of that appointment will run 4 years until August of 1986?

Chairman VOLCKER. That's right.

Senator CRANSTON. And unless it's interrupted, this pattern of dates of service of the Chairman of the Federal Reserve Board will continue in the future?

Chairman VOLCKER. Yes.

Senator CRANSTON. Therefore, it seems that if the present state of affairs continues and the present system continues, any future President will not be able to appoint a Chairman of the Federal Reserve Board until well into his third year in office.

Chairman VOLCKER. If there were no resignations or changes before.

Senator CRANSTON. Putting aside the personalities and politics of this particular moment, do you think it's wise that a future President should be made to wait until less than 15 months remain in his term of office before he can fill one of the most influential positions affecting economic policy?

Chairman VOLCKER. There's been a lot of discussion of this over the years. The last time the Federal Reserve Board pronounced on this issue I believe they took the position that a change to allow appointment of a Chairman 1 year after the Presidential election

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might be a reasonable arrangment. There are considerations on both sides, but that has been the focus of discussion in the past.

Senator CRANSTON. I think the only major study made on this matter by any influential body outside the Fed itself was by the CED way back in the late 1950's and they came to the conclusion that it would be wise to have the term of the Chairman pretty much coincide with the Presidential term so that soon after a President took office for a 4-year term, soon after January 20, the term of the Chairman would expire and the President could then make an appointment. I think this is a matter that we should consider in order to get somewhat more opportunity for coordination on economic policy.

I have just two other questions on other matters. Some economists feel that high interest rates will be an enduring feature of this administration, while President Reagan and David Stockman say that once the Congress has passed all the spending cuts for 1982 the markets will respond and interest rates will fall.

LACK OF CONFIDENCE IN FINANCIAL MARKET

What I'd like to ask is, in your opinion, is it the Fed's policy at present that although not specifically designed to produce high interest rates, they are producing high interest rates and that the major cause of these high interest rates is a lack of confidence in the financial marketplace in the President's expansionary budget proposals that are causing interest rates to be high?

Chairman VOLCKER. I certainly would not think in any fundamental sense that our policies are producing high interest rates. What's producing the high interest rates is the situation we face, which is an inherited, deeply imbedded inflation, heavy credit demands, a pattern of high deficits. I do not think there is a Federal Reserve policy, given that background, to produce low interest rates; if one considers the basic options available to the Federal Reserve, to create money or not create money, I don't think, over any reasonable period of time, creation of more money is going to produce lower interest rates.

Senator CRANSTON. Well, do you not feel that the tight money policies of the Fed are having a consequence that, if not alone, certainly helps produce high interest rates?

Chairman VOLCKER. There are a lot of psychological factors that affect what happens to interest rates in the short run. You would ordinarily think that an increase in the money supply would produce lower interest rates in the short run; that's the traditional analysis. The expense of that would be higher interest rates over a period of time. But I think with the market sensitivity to inflation, it is questionable whether you would even produce those lower rates in the short run by expanding the money supply.

Senator CRANSTON. If the Congress makes plain that it is going to follow through on budget cuts and if it becomes rather evident that we are determined to and will achieve a balanced budget by the end of the current President's term, do you think that will cause interest rates to go down or how much effect would that have on interest rates?

Chairman VOLCKER. That would be an important factor in encouraging a decline in interest rates. I don't think that's going to

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happen from any one particular action; people are quite skeptical and, as you said, you have to create the conviction that that is going to happen, which takes time.

Senator CRANSTON. One other matter. The Depository Institutions Deregulation Committee is required to vote by September 30, 1981, on an increase in the interest rate payable on passbook savings accounts and, of course, any such action like this could have the effect of putting the thrift industry conceivably further in to the red. Looking ahead to possible interest rates in areas over the next year, how do you expect to vote on any proposals to raise the passbook rate by any amount during the next year?

Chairman VOLCKER. I certainly will look at that very carefully and have been looking at it very carefully in connection with the very problem that you indicate. It's obvious that the passbook rate has not been increased, even though I think the general tenor of that legislation in effect mandates the Depository Institutions Deregulation Committee to look at an increase very sympathetically; that's the philosophy of the legislation. That has not been done and, of course, we will look at it in that context in September because of the very problems you suggested.

Senator CRANSTON. Thank you very much. Alan, thank you; and thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Thank you, Mr. Chairman, and I'm delighted to have yielded my time to my distinguished colleague, Senator Cranston.

The CHAIRMAN. Well, you didn't really give it to him. You just deferred a little bit.

Senator DIXON. Chairman Volcker, I'm glad to see you back before the committee again. We thank you for your testimony and the benefit of your expertise.

My recollection of your testimony on each occasion I have heard you is that it's your profound belief that the tight monetary policy you're following together with the appropriate fiscal restraints by the administration and the Congress will ultimately result in lower interest rates.

Chairman VOLCKER. Precisely.

Senator DIXON. Would it further be a fair statement that that has been your policy right along?

Chairman VOLCKER. Yes.

Senator DIXON. Your own personal policy, and while the distinguished chairman may differ with this statement, its my impression that you have followed a tight monetary policy during your term as Chairman. There may be some differences of opinion about a time or two in the past, but basically that has been regularly your policy?

Chairman VOLCKER. Yes; interpreting a tight monetary policy as bringing down the growth of money and credit.

Senator DIXON. Would it be fair to state that what you're suggesting on the other side, the responsibility of the administration and Congress, is being fulfilled by the administration and Congress at this point?

Chairman VOLCKER. I think the administration and the Congress are making a tremendous effort. I think they have inherited a

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situation of tremendous momentum on the spending side of the budget, so it's an enormous challenge to actually get that turned around and slowed down. I see signs that that's being done and it's been a very big and gratifying effort.

Senator DIXON. And even in the last administration, I think it would be a fair statement—there were some efforts made to make substantial budgetary cuts?

Chairman VOLCKER. Yes. I think, if I may just interject, that's indicative of the difficulty of doing this. I think the efforts did go back to the last administration; but what was the budget forecast 15 months $613 billion, I think, for spending for the current fiscal year?

The CHAIRMAN. That wasn't a forecast. That was the first budget resolution passed by the Congress of $613 billion.

Senator DIXON. So I guess my question would be, given the fact that this policy, in due respect to you and certainly the administration and the efforts toward the end at least of the prior administration—this policy has been followed pretty religiously now for some period of time, and I guess my question would be, in your opinion, why is it failing? Why have we seen no decent results? In fact, I would have to say that the public perception is that things are worsening instead of getting better over a substantial period of time now.

HOPEFUL SIGNS

Chairman VOLCKER. In a sense the question answers itself. There has been this effort extending back into the last administration, but—and this is not at all counter to the remark that a very great effort is being made—the results haven't been apparent yet in budgetary terms, because there has been so much momentum in the budgetary picture, just to look at that aspect. I would extend that more broadly; looking beyond the budget, there's been a tremendous inflation and psychology built into the whole inflationary momentum, and it's been built up over more than a decade and it's going to take more than a year or two to get that tide turned. I think we are in that crucial period where the tide is being turned; it is not easy and nobody should have suggested that it was going to be easy.

Senator DIXON. I don't think anybody here feels that it is, Mr. Chairman. I think that we recognize that you share our genuine concern for the problem. I was interested in something my friend from Michigan asked of you and your response where you both talked about the sick person, the cure and the hospital stay, and I'd be inclined to suggest that there have been a couple of remissions from time to time in the last couple years, but nobody really sees the cure. But I believe you're telling us you think there are some underlying factors that suggest that the cure is apparent, at least to you.

Chairman VOLCKER. Yes; I think you can see the signs of that, and there are more hopeful signs than we have seen at any time in recent years. I think it's just critically important that we carry through on that.

Senator DIXON. Now along the lines of what my friend from Pennsylvania was talking to you about, regarding the use of credit

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allocation, I think at least the public perception is—and certainly this is the perception when I go back home and visit among my constituency—that these high interest rates are discouraging people. People are not buying houses. They are not buying automobiles. They are refraining from making many of the moves they would like to make because of these interest rates. So that I would ask you if this is the case, is it possible that there's some other remedy we should be looking at with respect to the problem? That is to say, obviously these high interest rates caused in part by the tight monetary policy are discouraging a great many Americans, ordinary citizens, from doing the things they would like to do. Clearly it is, yet the interest rates are not coming down. Millions of Americans aren't buying because the rates are discouraging, but the rates aren't coming down. Is there something else we ought to be doing?

Chairman VOLCKER. Let me just suggest the other side of that coin. You're undoubtedly correct that high interest rates have got some restraining influence, and I think we see it in economic development, but the other side of that coin is that it is interesting to observe how much pressure it took to create that reaction, which is far from complete. The savings rate is still very low. The economy expanded quite rapidly in total the last few months, even though by and large we have had these kinds of interest rates now for many months. I think that is symptomatic of the fact that an awful lot of people were willing to borrow and spend even in the face of this kind of restraint. That's another way of saying how much momentum and how much inflationary expectation was built into the economy.

What else should we be doing? I would put the emphasis somewhat differently. The critical thing is that we carry through on what we are already doing. That doesn't mean that interest rates have to stay at this level continuously. They are going to reflect, in the short run, business activity—which certainly seems to be sluggish at the moment. But we are not going to be successful unless we carry through on the fiscal side, and unless we carry through on the monetary side, not in the sense of deliberately keeping interest rates up—that's not the object at all—but of maintaining the restraint on money and credit growth.

I do think that this process will be greatly assisted to the extent there is understanding of some of the other implications. We've got to see this work through into the general wage-price-productivity relationship. You referred to the effect of the restraint of credit and high interest rates on the automobile industry. High interest rates are certainly a factor. I would suggest the overwhelming factor in the automobile market is simply the high price of cars, which is a particular example, very evident in that particular industry, of a real competitive problem in that area through a period of years, for a variety of reasons. There's quite a lot that the industry and its workers can do to correct that situation, in the interest of jobs, markets and profits over a period of time.

Senator RIEGLE. Would the Senator yield briefly at that point?

Senator DIXON. Of course.

Senator RIEGLE. I talk with a lot of auto people, Iacocca being one, and many other automakers. When the prime rates go above

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20 percent, traffic in dealerships stops. There's a tremendous psychological and real impact of high interest rates on people's feelings that they can buy and afford cars. I think you kid yourself if you just put the responsibility off on the high price of cars. Everything has gone up in price, houses have, cars have and so forth. But if you're missing the impact of the high interest rates I think you're doing yourself a disservice.

Chairman VOLCKER. I don't want to miss the impact of high interest rates; they are obviously a factor; I think I said so. In some ways, they may be as much a psychological factor as a real one. Interest rates on cars have gone up; that figure of 20 percent is the magic level psychologically; I do not deny that that is a factor. All I'm suggesting is that if you're dealing with this problem over a period of time—and I just use this industry as an example, but it is a prime example—to put it quite simply, you can't have price stability and 12-percent wage increases at the same time; they can't go together.

Senator RIEGLE. I thank the Senator for yielding.

Senator DIXON. One last question, Mr. Chairman, and I thank Chairman Volcker once again for giving us the benefit of his views on this important subject.

THIRD YEAR TAX CUT QUESTIONED

Chairman Volcker, it has been suggested by some—and particularly by many people I talked to in the financial community—that some of the concern that's causing the continued high interest rates is the belief of many people in the money markets that in fact the third year tax cut, given the circumstances of our economic situation now, might be a questionable act, that there is some concern that the third year tax cut done now by the Congress may come into play at a time when interest rates are still too high, when the budget deficit is still too high, and when inflation is still too high, and so it has been suggested by some that a wise way to approach that problem with respect to the third year would be to put into that third year tax cut some trigger device by virtue of which we would say with a certain interest rate, a certain budget deficit position, and a certain inflation rate, either the administration's figures or OMB's or whatever it might be, that the tax cut would take place. But if these other circumstances were not as suggested that there would be some modification in the cut in the third year.

My question to you is, Do you think that that kind of an activity by the Congress would restore the confidence in the financial community in what is being done here and perhaps, psychologically at least, suggest to them the probability that things are going to be as good as is hoped and encourage a reduction in interest rates?

Chairman VOLCKER. I think the kind of comment you hear from the market reflects the fact that, despite the enormous efforts made by the administration and the Congress on the spending side, there is still a good deal of skepticism about how the budgetary picture is going to unfold over that time period. I think the suggestion that you make could give some sense of reassurance on that score, but I would not want to suggest that any single action that you can take of that type is going to have a dramatic influence on

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psychology or that you would wake up the next day and find that the financial markets were transformed by any single action of that kind. I'm afraid there is no escape from the proposition that there are a lot of people from Missouri out there who are going to want to be shown over a period of time. The kind of conditional cut that you suggest would be one element in showing them, but it would not make a sweeping difference, in my judgment. It also has to be placed against the arguments that are presented on the other side for more assurance in the future, which that if the cut is put in place now you have even more chance of reducing expenditures; that's the balance.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Chairman Volcker, a lot of people across the country obviously listen to see what signals you as Chairman of the Fed are sending about monetary policy. That's particularly true, I think, in the housing industry and the auto industry, because they are impacted by monetary policy in a much more extended and direct way than some other sectors of the economy. I take it this message you're telling them is that they are going to have to continue to face these very high interest rates for a sustained period of time. Is that correct?

Chairman VOLCKER. I would put it differently. I think they should expect to face and count on the fact that we are going to continue to restrain the growth of money and credit. I would hope that that would be a signal over time that interest rates would be lower than they otherwise would be.

Senator SARBANES. Well, you say over time. What period are you talking about?

Chairman VOLCKER. I can't identify that precisely because I do think that within that context what interest rates do in the short run will be most of all influenced by fiscal and business costs.

Senator SARBANES. Is that 1 year or 3 years?

Chairman VOLCKER. I would think, if we stick with it as we intend, if we can look toward a reasonably favorable fiscal outcome as well—by which I mean the balance of spending and taxes—that we will see favorable impacts certainly within the time period of a year you're talking about.

Senator SARBANES. Within a year?

Chairman VOLCKER. Yes.

Senator SARBANES. What is the fiscal policy that you think is necessary in order to get a better monetary policy than we now have?

Chairman VOLCKER. In order to get a better monetary policy than we now have?

Senator SARBANES. Yes.

Chairman VOLCKER. I don't know as that's conceivable, but—— [Laughter.]

Senator SARBANES. I think there are a lot of people in the country who disagree with you.

Chairman VOLCKER. You're thinking of the interest rate outlook, I suppose. I think the more you can do on the expenditure restraint side, the more some tax reduction can be fit in, but the tax reduction has to be restrained.

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Senator SARBANES. Well, do you think the fiscal policy that the administration and the Congress, and its contours I think are pretty clear, is a fiscal policy that will enable you to make shifts in monetary policy so we get a more reasonable interest rate?

Chairman VOLCKER. If the entire concern is over getting interest rates down as quickly as possibly, you could obviously have a tighter fiscal policy; and if that is the whole cbject of economic policy, one would say you could take more actions to try to reduce the deficit quickly. I don't think, as I understand it, that the economic strategy of the administration puts its entire weight on that particular object. They see advantages in reducing taxes, for instance, for the long-run health of the economy. You have to have some balance of priorities here. If you put the whole object there——

Senator SARBANES. Do you support the current outlines of the fiscal policy?

Chairman VOLCKER. I can support a limited tax reduction.

The CHAIRMAN. Is a tax reduction which seems about to come sufficiently limited in your terms?

Chairman VOLCKER. I have had some concern—and I don't know just where the package stands at the moment—that losses of tax revenue were being added to what the administration proposed as the package moves its way through Congress, and I would hope, if that's true, you could resist it.

Senator SARBANES. Mr. Chairman, I really want to get you on the record. If this economy goes bad—and I think there's as much chance of that as if it's going good—somebody is going to be the fall guy for it. Are you concerned that you are being set up to be the fall guy?

Chairman VOLCKER. That's not the way I look at it at all.

Senator SARBANES. OK.

Chairman VOLCKER. I think the Federal Reserve has inevitably, through the years, been put in a position where it can be pointed to as absorbing the blame for whatever happens; I suppose that's our function in life, to some degree. But if you're suggesting this as a kind of deliberate strategy, I don't share that view at all.

Senator SARBANES. Is it your view, then, that the current fiscal policy will enable the Fed to adopt an easier monetary policy, or is that fiscal policy not tight enough?

Chairman VOLCKER. I've got to define our monetary policy. Our intent is, I hope, quite clear; we do want to work toward getting these monetary and credit aggregates lower. That's true regardless of what the fiscal policy is.

Senator SARBANES. Do you think the spending cuts on the domestic program should be greater than those Congress is proposing to make?

Chairman VOLCKER. This is the flip side of the tax question. If all you're interested in is getting interest rates lower, those spending cuts should be bigger, and much bigger. There are other considerations that enter into this. There are social considerations. You've got a whole range of considerations in concerning spending. If you just want to consider cutting interest rates, cut down the defense program. I'm not suggesting that's feasible public policy because national security——

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Senator SARBANES. What I was going to ask you is whether you think the increase in defense spending should be larger or smaller than it is.

Chairman VOLCKER. From the standpoint of the performance of the economy and the performance of the credit markets, of course, I just looked at that end, I said I would like to see a much lower defense program because that's going to help the credit markets; but, as a citizen, I don't think I can ignore the national security. Those are the judgments that have to be made. If I could sit here and manipulate everything for the single——

Senator SARBANES. Do you think the tax cut should be smaller or larger?

SMALLER TAX CUTS

Chairman VOLCKER. I certainly do not think it should be larger.

Senator SARBANES. Do you think they should be smaller?

Chairman VOLCKER. I would like to see them as small as you can make them, recognizing that there are good and legitimate reasons in terms of economic policy for getting some tax reduction just as soon as you can, consistent with the declines in the budget deficit. I hope that that's possible.

Senator SARBANES. Mr. Chairman, I'd like to put in the record an article by Hobart Rowen in the Washington Post this past Sunday, July 19. He quotes from Henry Kaufman that the record real interest—rate level " 'reflects the heavy burden being placed on monetary policy'. In the next 12 months, we'll have a major tax cut, increased defense spending and bigger Federal deficits. In that environment, what can you expect from interest rates?" Kaufman predicts that within a year, unless the Government curbs the big military buildup, the prime rate will top the 21.5 percent level set last year. Kaufman's basic theme isn't challenged at the Fed when officials speak off the record. A well-posted source uses these plain words:

> We face a real dilemma. The financial markets don't believe Reagan will be able to cut the federal deficit. If they—the Reagan administration—were to cut their proposed defense spending increase in half, you'd see an immediate reduction in interest rates.

Do you agree with that, Mr. Chairman?

Chairman VOLCKER. That quotation certainly did not come from me. I would repeat, if you cut spending by that kind of magnitude you would see a favorable effect on the markets. The unfortunate problem we have is that other purposes are served by the spending.

Senator SARBANES. I guess what we have to conclude from this is that the Chairman of the Fed is not really raising any significant warning signs about the fiscal policy being pursued, but at the same time is telling us that that fiscal policy, for one reason or another, is not adequate to enable the Fed to shift its monetary policy in such a way as to ease the sham placed on the economy by these high interest rates.

Chairman VOLCKER. I think we're saying——

Senator SARBANES. Do you think it's reasonable that the auto and the housing and other industries should be experiencing what they are now experiencing?

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Chairman VOLCKER. Reasonable? I think that is an inheritance of the problems that we have.

FED ON THE HOOK

Senator SARBANES. Well, we're asking you for your counsel, Mr. Chairman. If you're not prepared to say where the fiscal policy is inadequate to enable you to make a shift in monetary policy to address some of these problems, then you're on the hook with respect to the fiscal and monetary policy.

Chairman VOLCKER. Wait a minute. You keep saying "a shift" in monetary policy. Monetary policy is a term that brings different visions to different people's minds. I will interpret monetary policy, for this purpose, as restraint on money and credit growth, and that is not going to change.

Within that context, if you can reduce that budget deficit, reduce spending—reduce defense spending or any other kind of spending—limit the tax reduction, all of that will have a favorable impact on interest rates and you should understand that, to the extent that is not done, interest rates are going to be higher than they would otherwise be.

Senator SARBANES. Well, is the Fed ready to say that they can address the problem of these extraordinary high interest rates, and their effect on certain sectors of the economy, if they could get a fiscal policy that did such and such? You're not saying that. You're on the hook for the current fiscal policy and therefore I think you're going to bear the consequences of all that follows.

Mr. Chairman, let me just, before you respond—I'd also like to include in the record two articles from the Washington Post by Hobart Rowen and John Kenneth Galbraith.

[The articles follow:]

[From the Washington Post, July 19, 1981]

HIGH LOAN RATES MAY BE TOO COSTLY FOR ECONOMY

(By Hobart Rowen)

Interest rates are much too high. They threaten a national economic crisis, especially in the auto, housing and thrift industries.

Quite apart from the recent well-publicized complaints of European leaders that high U.S. interest rates are creating problems for them, the objective evidence is that a monetarist policy being pursued by the Federal Reserve Board has pushed interest rates higher then they ought to be—and higher then the Fed itself expected them to be.

Even President Reagan's economic advisers, according to one of them, are "puzzled" and "confused" about the persistence of high interest rates although they propose to stick with present policy, a decision based "more on confusion than conviction." This is the view of William Niskanen, one of the three members of the Council of Economic Advisers.

One gets the feeling that Federal Reserve policymakers are compulsively flirting with economic disaster because they are afraid to shift gears, believing that as bad as things are now, they would be even worse if policy were prematurely eased.

In part, the puzzlement cited by Niskanen arises because interest rates have continued to soar even though inflation has come down dramatically. The Consumer Price Index is running at an annual rate of 8.2 percent, compared with 13.3 percent two years ago. When measured against a 14½ percent Treasury bill rate, the "real" interest rate is more than 6 percent, well above the conventional level of 2 to 3 percent.

Even if one decides to measure inflation not by the CPI but a higher, assumed underlying inflation rate of 9 percent or so, the "real" interest rate is at an historic peak. It's a complete reversal of the pattern two years ago when "real" interest

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rates were negative because a 10 percent yield was running behind the 13.3 percent inflation rate.

The consequences of a policy that keeps interest rates this high are dramatic. Domestic auto sales have collapsed to an annual rate of about 5 million, a 20-year low. Meanwhile, the savings and loan industry has been pushed to the edge of a disaster that could force the government into a bailout costing as much as $50 billion, according to economist Alan Greenspan.

Niskanen says that at a recent informal session among six government economists, including some from the Fed. "there were eight different explanations (for the peak level of real interest rates)—and we didn't have one good one."

It doesn't seem all that mysterious: In a telephone interview, Salomon Bros. money expert Henry Kaufman said the record real interest-rate level "reflects the heavy burden being placed on monetary policy. In the next 12 months, we'll have a major tax cut, increased defense spending and bigger federal deficits. In that environment, what can you expect from interest rates?" Kaufman predicts that within a year, unless the government curbs the big military build-up, the prime rate will top the 21½ percent level set last year.

Kaufman's basic theme isn't challenged at the Fed when officials speak off the record. A well-posted source uses these plain words: "We face a real dilemma: The financial markets don't believe Reagan will be able to cut the federal defict. If they (the Reagan administration) were to cut their proposed defense spending increase in half, you'd see an immediate reduction in interest rates.

But if we were to change monetary policy now by pumping more reserves into the market, we would lose all our credibility, and long-term rates would rise at least 2 or 3 points. It's one hell of a problem because autos, housing, and the S&Ls are in trouble. But so long as Reagan puts all of the burden on us, we've got no choice."

In effect, the Federal Reserve has consciously made a decision that the economy overall is resilient enough to take its austere policy even though the interest-sensitive sectors such as housing and the thrifts are in serious trouble. "In a way," says a Fed source, "as we continue this policy—although I hasten to say that's not why we are doing it—we're putting pressure on the Reagan administration. We're forcing them to face up to the significance of the big budget deficit."

But how long can this lethal game go on? The economy appears to be entering a general downturn or recession. Richard Pratt, head of the Federal Home Loan Bank Board, says that fully one-third of the nation's 4,700 S&Ls "are not viable" under today's conditions of high interest rates.

Greenspan reports that because there is a limit to the number of strong institutions that can absorb weak ones, many S&Ls will have to be liquidated rather than merged out of existence. Insurance will protect depositors (up to $100,000), but the government may have to put up so much cash or credit that it could "seriously threaten the success of the president's anti-inflation program," Greenspan concludes.

Thus, the wisdom of blindly following a high-interest-rate policy needs to be reexamined. The Reagan administration is beginning to worry enough about the problem to be predicting that interest rates will be coming down. But you don't get that kind of soothing assurance from the Fed. In the end, if may take a corporate bankruptcy or an international financial crisis to force a change in policy, and in the underlying monetarist dogma.

[From the Washington Post, July 20, 1981]

What the Monetarist Textbooks Don't Teach

(By John Kenneth Galbraith)

"There is one aspect of the British experience that, to our sorrow, we are less likely to notice. That is the relationship between economic policy and urban distress and disturbance."

The lessons from the civil disorder in the British cities will not be lost in this country. It is something on which, more than Englishmen, we have had experience. Where people have jobs, reasonably good housing, other urban amenities, and find life, if not perfect, at least bengin, these outbreaks do not occur. Where there is despair and especially among the young, there is risk. This we know, but there is one aspect of the British experience that, to our sorrow, we are less likely to notice. That is the relationship between economic policy and urban distress and disturbance. It is a relationship that all, liberal or conservative, should recognize, and the British experience is a powerful signal as to its importance.

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In most discussion and in much university and textbook teaching, monetary policy is pictured as socially neutral. It is a technical arbitration between the central bank, the bankers and the business community; it may work or not work, but there is no remarked difference in its impact on different income groups or otherwise on the social structure. Decisions in the calm boardrooms of the Federal Reserve System or the Bank of England are safely distant from such concerns. This is badly, seriously and dangerously wrong, and the British reliance on monetary policy in these last years, the most committed in the industrial world, makes it a matter not of theory but of harshly realized experience.

Monetary policy works, and on this there is general agreement, by restricitng bank and other lending and by rationing the credit so allowed by high interest rates. It will occur to most that those who receive the high interest rates—banks and individuals with loanable cash—do not suffer from such rates. On the contrary. And neither do affluent citizens who do not need to borrow money. Or cash-rich corporations that are similarly situated. Or those that, though they borrow, have the market power and position that allow them to pass the higher costs of money along to the public.

But, as one passes down the income scale, there comes the deprivation and restrain that it is the purpose of monetary policy to induce. Those who must borrow money for their business, to find housing, to replace an automobile are subject to its effects. Again, this is a matter of experience. In this country the effect of high interest rates on the housing industry, other small business and automobile purchases has been evident to all. In British, it has produced the largest failure rate among small businesses in half a century. But the really disastrous effect is yet farther down the income scale.

Senator SARBANES. Now, Mr. Chairman, I would understand if you came in and said, look, we think under the circumstances we have to adhere to this monetary policy, but if we could get a different kind of fiscal policy we could ease the monetary policy and get to some interest rates that would enable important sectors of the economy to avoid the prospects of a major depression. You're helping to contribute to your own problem. A newspaper article here says that high interest costs add $17 billion to what the Government is going to pay in borrowing costs. You sit on the Chrysler loan board, isn't that correct?

Chairman VOLCKER. Yes, sir.

Senator SARBANES. Well, Mr. Iacocca was in here yesterday and he said that if Chrysler can get reasonable interest rates they could make the company fly. They were in the black for the second quarter. The third quarter is always the tough one. At some point, if the Fed is on the hook for what's happening, fine; then the Fed will bear the responsibility if we're gathered here a year form now with an economy with high unemployment, continued high inflation, and other difficulties throughout the country. Look at other countries. There's no guarantee this program is going to work. We need to know from the Fed and the Fed, ought to say, what it is that we need in terms of fiscal policy to get more reasonable monetary policy.

Chairman VOLCKER. I want to see fiscal policy as tight as it can be. The implication of some of your comments would be that the Federal Reserve should, for instance, be the arbiter of defense policy. Well, we're not. We do say that, obviously, the higher defense spending is, all things being equal, the greater, the pressure in the money market. That's a congressional decision; I think you ought to understand that.

The CHAIRMAN. Mr. Chairman, I'll have to interrupt you. We have the last 5 minutes of a vote and so we will recess for 15 minutes.

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ADMINISTRATION SUPPORTS MONETARY POLICY

Senator SARBANES. Mr. Chairman, could I ask one quick question? Is it correct to say, as I understand it, the administration supports the monetary policy you're pursuing? Is that correct?

Chairman VOLCKER. That's my impression.

Senator SARBANES. Pardon?

Chairman VOLCKER. That is my impression.

The CHAIRMAN. I'll only make one comment before we recess, that whatever criticisms that can be made of the so-called new Republican majority in the Senate and this administration on fiscal policy, had we not been here, fiscal policy would have been incredibly higher, like $15 billion more this year, some $40 or $39 billion more for next year. So I only say that in the context of my colleague—whatever criticism he has of fiscal policy and interest rates and everything else, I wonder what condition we would be in with all their additional spending, and I would agree there should be more in other areas.

Senator SARBANES. Mr. Chairman, just let me add at that point that the fiscal policy being pursued consists of domestic spending level, military spending level, and tax cuts.

The CHAIRMAN. But the net effect is the $39 billion decrease.

Senator SARBANES. No. The administration is $45 billion down on domestic and $30 billion up on military on the spending side, and the tax proposal amounts to, depending on how you look at it, some $45 or $50 billion.

The CHAIRMAN. The fact remains the net——

Senator SARBANES. It's highly likely that a different administration would in fact have had a tighter fiscal policy.

The CHAIRMAN. The Carter administration, a different fiscal policy? My God, that's what we have been cutting.

Senator SARBANES. Well, I'll stay. This is a nice opportunity. The fiscal policy is the net of all those things. We might have cut domestic spending less. We might well have boosted defense less and we might not have made a sweeping tax cut, and all of that might have added up to a tighter fiscal policy than the one this administration is pursuing. In fact, I think it can be argued that this administration, when it's all added up, is pursuing a very loose fiscal policy. They are therefore imposing a heavy burden on the Fed, and the consequence of adding up all of those policies together may be very serious economic difficulties in this country over the foreseeable future.

[Recess.]

Senator PROXMIRE. The committee will come to order. I'm going to take advantage of my prerogative of a Senator who's voted and come back and break up this news conference. I apologize for not being here for your opening statement and during the questions, but this is an opportunity to proceed and I want to do so.

As you may know, Mr. Volcker, I have consistently supported you and still do. I think you're doing something that is very difficult to do, taking a whale of a lot of criticism. You took a lot yesterday in the House of Representatives I noticed, but I think you're doing something that is extremely difficult but very necessary.

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At the same time, I think you're doing it based on assumptions that may or may not be realistic. You pleaded with the Congress to reduce spending and move toward a fiscal balance more vigorously than we're doing it, and I think you're proceeding on assumptions that we are going to balance the budget. Supposing we assumed we were not going to do it. That might be a much more realistic assumption. The Congressional Budget Office says we're going to have deficits of $60 billion for each of the next 4 years. President Carter wasn't able to balance the budget. President Reagan may not be able to do it. We have an economy now that's operating at far below capacity. We a have very serious tragic situation in the homebuilding industry and construction generally and the automobile industry is operating at about 65 million units a year annual rate and housing about a million and the costs are high in those industries because they are operating so far below capacity.

They have their fixed costs and they'd be far more productive in every way if they could move closer to capacity. If we make the assumption that the budget is not going to be balanced, as the Congressional Budget Office tell us, and we are going to have consistent deficits of $60 billion or more and you persist in your policy of restraint which would make sense if we were moving toward a balanced budget, aren't we likely to be in the same kind of dilemma we are in this year for the next 5 or 10 years? Aren't we going to restrain homebuilding and increase the cost of doing so, restraining the automobile industry, restrain our economy generaly, increase unemployment; and under those circumstances, is the policy that you're following one that we can continue?

Chairman VOLCKER. I don't believe we really have any alternative. I don't think we'll be quite in the same position, looking as many years ahead as you're suggesting. I think it is true the bigger that deficit is, the less money there's going to be left over for other sectors of the economy, by definition. Given an amount of savings, if the Government is preempting a proportion of it, there's going to be less for other people and more pressure on the financial borrowers. But that's not quite the same as saying the future is going to be as now, because I think we can make progress on the inflationary side and, to the extent we do so, interest rates should be lower and financial markets less strained than they are at present. I don't at all challenge your basic concern that fiscal policy may turn out to be more expansive than the most optimistic of the current estimates.

Senator PROXMIRE. Then how do we really make progress on the inflationary side?

Chairman VOLCKER. I think we're making some progress now.

Senator PROXMIRE. We are now, but——

Chairman VOLCKER. Even in the face of that.

Senator PROXMIRE. It's hard to trade that to monetary policy. Certainly not to any fiscal policy. The progress we are making on the inflationary side is in two components primarily, is it not, energy, No. 1, and food, No. 2, neither of which seem to be influenced by monetary or fiscal policy?

Chairman VOLCKER. I would deny that.

Senator PROXMIRE. Well, which is influenced by monetary or fiscal policy?

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Chairman VOLCKER. I think both of those to some extent.

Senator PROXMIRE. To what extent is food influenced, not by climate or not by long term——

Chairman VOLCKER. In food, the most important break we have had is, obviously, better weather than could have been expected. But the commodity markets generally are deflated compared to what they were a year ago; look at the commodity markets, outside the food area, and I think you'll find monetary policy has had something to do with that.

Even as regards the oil situation, while the fundamental fact is that the price was way up, we have had some encouraging conservation. We have had some production surplus in the world. Even there, one factor has been that there has been more pressure on oil inventories than there otherwise would be, and more concern about oil surpluses than there otherwise would be, reflected in price declines, because of the pressure on financial markets. You aren't going to keep that up forever, but I don't think you can say that even that area is isolated from the indirect influence of monetary policy. The strength of the dollar itself probably helps in stabilizing the energy situation.

Senator PROXMIRE. But the theory has always been that by easing demand pressure on prices, a conservative monetary policy, and a fiscal policy will tend to bring down the inflation rate.

Chairman VOLCKER. Yes; we are seeing some of that.

Senator PROXMIRE. We are seeing some of that maybe, possibly in a marginal way in energy and food. You aren't seeing much of it in the labor area as far as wages are concerned.

Chairman VOLCKER. I agree.

Senator PROXMIRE. And it's hard to see there's any in the automobile area or even the homebuilding area where you have tremendous slack and undercapacity.

Chairman VOLCKER. I agree very strongly that we have to see it in those areas to imbed the lower inflation rate—to turn the corner in the underlying rate of inflation and to have confidence in a declining rate of inflation over time. The evidence in the areas that you cite is still either absent or very fragmentary. The burden of much of my statement is that we have to move ahead and get it imbedded in those areas of the economy if we're going to be successful.

Senator PROXMIRE. If you were sitting where I sit, would you vote for the proposed tax reduction the administration has got before us?

Chairman VOLCKER. I have a little feeling that more, goodies, so to speak, are being attached to the basic tax program than were proposed, and they certainly should be resisted.

Senator PROXMIRE. Let's take the bare bones of it. First, the permanent tax cut, 5-10 and maybe 10—15 percent personal tax cut across the board. Is that wise?

Chairman VOLCKER. I feel more comfortable with that than I did with the proposal 6 months ago.

Senator PROXMIRE. You mean it's better than 10-10-10?

Chairman VOLCKER. It's beginning to——

Senator PROXMIRE. You feel more comfortable. Are you still uncomfortable with the whole thing?

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Chairman VOLCKER. In the end, it all depends on what you do on spending. If you accept the corollary on spending, I feel comfortable with the tax proposal; I feel uncomfortable only in that I think it does imply, as you know, fairly big spending cuts next year.

BALANCED BUDGET UNREALISTIC

Senator PROXMIRE. I introduced what I feel is a kind of vulcarian fiscal policy. I proposed a balanced budget. I put in an amendment to do so in 1979 for 1980, in 1980 for 1981, and this year for 1982. I got exactly 13 votes for it, practically no support at all. So it's clear the Senate doesn't want to balance the budget this coming year. They don't think it's realistic. If we don't do it this year, it's hard to do it any year.

Chairman VOLCKER. I don't think it's realistic for next year, but I think you've got a good fiscal policy with quite a lot of emphasis on the business side, with some cuts in personal tax rates that I do think are meritorious when you can fit them into the fiscal situation, and I think you can fit them into the fiscal situation if you accept the corollary of further expenditure cuts that are needed next year. That's the key.

Senator PROXMIRE. Does it really serve any economic purpose to have the home building industry in the tragic straits it's in today, a million housing starts, the many homebuilders, as you know, characterized as small firms by and large, fine and competent and able people dropping out, losing that kind of talent, that kind of ability, operating with 16 or 17 percent unemployment—does that really serve any useful purpose?

Chairman VOLCKER. No, if you just look at that industry.

Senator PROXMIRE. Going on for months and maybe years?

Chairman VOLCKER. It does not serve any particularly useful purpose, if you just look at that particular sector of the economy. Then you have to ask yourself what do you do about that? It's destructive to take action out of concern for that sector, real as that concern must be, if it is going to create conditions in the economy that are going to prolong that situation or return us to that situation again and again. That's the kind of dilemma we have.

Senator PROXMIRE. How would it hurt your position if we were able to direct credit into homebuilding in such a way as to increase homebuilding to 1.5 million starts?

Chairman VOLCKER. I don't know how you would do that in the overall framework of the credit markets. I don't think any of us is wise enough to sit here and decide that somehow we should put x billion more credit into this area and take it out of another area—even if we knew how to do it. I just don't know how to do it.

Senator PROXMIRE. Well, you could do it if you simply bought mortgages and brought the mortgage rate down to 11 percent or 12 percent.

Chairman VOLCKER. I don't know whether bringing the mortgage rate down to 11 percent without flooding the country with money——

Senator PROXMIRE. You have to pay that price.

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MORE INFLATION

Chairman VOLCKER. That's precisely the point. If that's what we did, we would just end up with more inflation and ultimately a worse situation, even for that industry, so we would not have even delivered on the purpose of the policy.

Senator PROXMIRE. That's an enormous industry. It's not a little part of the economy. It's one of the biggest parts, as you know. Home building is a colossal industry overall. The automobile industry is one-sixth of the economy, directly or indirectly.

Chairman VOLCKER. It's the one that has the most stake in getting this inflation down.

Senator PROXMIRE. It's the one most sensitive to high interest rates and the kind of policy that's been forced on you I think.

Chairman VOLCKER. The only point I'm making is that I don't think there's any escape from that policy by inflating. I think it would just bring the pressures back on that industry. That's fundamentally what they are suffering from; they are suffering from the fact that we have to change this trend around. They are going to be the beneficiary in the long run, but it's awfully tough while it's happening.

Senator PROXMIRE. If you eased up on credit so the credit availability substantially increased and interest rates for the short-term declines, the result would be first in the homebuilding industry, second in the automobile industry, both of which are operating far below capacity. Why would that have a perverse effect on inflation?

Chairman VOLCKER. I'll tell you, I don't know whether it would last long enough for the homebuilding industry to benefit really. If we make a considered decision that to not do what we say we're going to do and to not do what we're going to do, but rather to increase the money supply, in fact, we don't know what the effects would be on the money market and for what period of time. You might get a great rally in the markets and an easing of pressures, but when you consider the time lags involved in home building, in particular, I would be extremely skeptical that that would last long enough to really benefit that industry. People are pretty immediately going to say,

> Well, I had a few glimmerings of hope that inflation was going to be dealt with, but I was a fool for thinking that in the first place; they're off inflating again and I haven't got any confidence in the future; I haven't got any confidence in the future of inflation and I'm not going to lend my money very freely; I'm going to go out and borrow a lot to do whatever I feel like doing.
>
> And the interest rates are going to go up again.

Senator PROXMIRE. I wonder if this isn't tunnel vision, though. People don't pay attention to what M-1 does or the complicated measures of the money supply. If the credit is more available in the short run, interest rates begin to fall, why wouldn't you expect people to have more confidence, especially in view of the fact that energy prices moderated and food prices moderated?

Chairman VOLCKER. I think we had a small test case of that last year when there was what you have not put in your scenario, a very sharp decline of business activity which certainly was consistent with the decline in interest rates; interest rates did decline sharply. In fact, the homebuilding industry did, in that period,

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begin to rebound, but the atmosphere in much of the country was wrapped up in inflation—"inflation isn't being taken care of"—and interest rates very properly went up again, and we were back where we started from. I think that is, perhaps, some reflection of the kind of concerns that I have.

Senator PROXMIRE. My time is up, Mr. Chairman. I wonder if I could just ask one more question before I leave.

The CHAIRMAN. Yes.

Senator PROXMIRE. Thank you. Isn't there something in between here? This seems to be kind of an all or nothing policy. Isn't there something we could do to supplement what you're doing in addition to hoping and praying for a fiscal policy which never seems to have much prospect of improving? How about jawboning? How about merger policy that might be more effective in holding down prices and in holding down the demand for credit? We have a situation with Conoco where the people are proposing to borrow billions and billions of dollars. Aren't there other supplementary actions we could take that would help you in addition to trying to reduce spending which all of us would like to do?

Chairman VOLCKER. I think about those possibilities all the time. I would like to think that there are possibilities, but if I had had any brilliant ideas that I was convinced were workable, I would not have been bashful about setting them forward. The major idea that comes up repeatedly is that of an incomes policy. You know, the concept sounds wonderful and, from an overall economic standpoint, it makes all kinds of logical sense. In practice, none of the particular forms that anybody has been able to think of have been effective and workable. I think you have to be a bit discouraged when you look at that kind of record.

What we can do and what we must do, in my opinion, is point out the relevance of these kinds of decisions for the overall problems that we have, and I would hope that there would be some recognition of that need. For instance, crucial wage settlements are coming along, and I think things can be done to encourage settlements that are beneficial to the economy as a whole, and ultimately beneficial to the people engaging in the process, that are consistent with any market-oriented view. I don't think people should feel that they can be protected by governmental action from actions of their own that have damaged their own competitive position. There are a lot of examples of that in the economy and there's a tendency to say, "Well, we've got a problem so we'll run to Washington for a solution." If that's encouraged, you're not going to get the kind of settlements that are ultimately necessary. I'm not going to put it all on wage settlements; there are questions of pricing policy and industrial policy, generally.

Senator PROXMIRE. Mr. Chairman, thank you.

Mr. Chairman, I have a statement which I would appreciate if you would put in the record.

The CHAIRMAN. We would be happy to put it in the record. Also, Senator D'Amato will be asking you questions for response in writing.

[The statement of Senator Proxmire follows:]

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STATEMENT OF SENATOR PROXMIRE

Thank you Chairman Garn. Chairman Volcker, your appearance before this committee today is significant because our economy and the Federal Reserve, are at a crossroads. The economy has seen a significant, but short, drop in the inflation rate in recent months thanks to moderation in fuel and oil price increases. The nation's money supply, which is under your control has shown similar reductions in growth. Both of these are good news. But, the crossroads is here because of the very high interest rates we face, in real terms the highest interest rates we have had in many, many years.

The banner headline in this morning's Washington Post, "Fed Chairman Faces Violent Attack on Tight Money" is an indication of the problems you face. The Federal Reserve is virtually the only anti-inflationary weapon we have at this time. The mix of tax and budget policies recommended by the Reagan administration are disappointing because it is likely that budget deficits will continue and that the debt ceiling will go above $1 trillion putting heavy pressure on financial markets. Expectations, therefore, that inflation will continue are high, and thus interest rates—the price we pay for borrowing in today's dollars and paying back in tomorrow's are high. Personally, and I have said this before, I believe inflation is our most serious economic problem—other problems flow from it—and until we have fiscal policies that are also strongly anti-inflationary, criticism of your policies offering no alternatives, are counterproductive.

We all dislike high interest rates. They unfairly place more of the burden of fighting inflation on the credit sensitive sectors of our economy. They cause great difficulties for small businesses, housing, agriculture. But, they are an indication of our inflationary problems. And, perhaps most important the abnormally high interest rates are a signal that people do not expect inflation to abate anytime soon.

So, Chairman Volcker, the burden on monetary and fiscal policy at this junction is to find a solution to break inflationary expectations. How do you accomplish that?

There is no hard and fast way. But, we must proceed by:

One—supporting your efforts to restrain the growth of money and credit and to gradually reduce the annual rates of increase. To do otherwise, to back off in the face of domestic and foreign criticism of high interest rates would lead to lower interest now, but also to a burst of speculative credit expansion, and eventually even high interest rates because of the impact on credit markets caused by persistent Federal deficits.

Two—we must recognize that this is a multi-year proposition not something that can be accomplished overnight and that along the way there may be ups and downs. You must deflect attention from weekly changes in M1 that have little long-run significance, and emphasize your annual targets and goals. My preference is for a dramatic shift away from publication of weekly money stock data.

Finally—the Congress and the Administration must recognize that the Federal deficit and credit programs have an effect on credit availability for the private sector and tend to push interest rates up. We must do our part to help bring inflation and interest rates down. We must balance the budget.

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I know you are up to the task, and I give you the continuing support of this Senator.

The CHAIRMAN. I certainly don't intend to have a debate on military versus domestic spending with Senator Sarbanes, particularly when he's not here, but I do feel on the closing comments as we were leaving for the vote that I need to make a comment about his saying that we might have had a tighter fiscal policy under President Carter and we might have and the second coming might also be tomorrow and Christ may appear in this room as well. I don't know, but I think the record speaks for itself.

So far there has been no Reagan budget. There have been recommendations and actions in the Congress to cut the Carter 1981 budget and the Carter 1982 budget. That's not a disputable fact. That's what has been going on.

I would also say to those who say that the Reagan and Republican initiatives will not accomplish all they are said to accomplish, they may be right. They may be overly optimistic, but I would suggest that if we had all of that additional spending, I don't know what the prime rate would be or what condition we would be in.

So whatever it is, I believe it has to be better. It would be very much like me saying to my wife if we were overspending by $20,000 a year and we examined our budget and said, well, we can only eliminate $10,000 of the spending, therefore it isn't worth doing at all. I would suggest that whatever the Reagan program does, whether it's overly optimistic or not, will be an improvement over the continued spending, whether it was Carter, Ford, Nixon or previous Congresses, and if we don't start that process the prime interest rate may be 30 percent and inflation may be 20 percent. I don't know. I just couldn't leave hanging the suggestion that we might have had a tighter fiscal policy under the previous administration. I think that maybe the fiscal policy is one of the reasons that we have a new administration. Again, it's possible we might have had a tighter fiscal policy, but I rather doubt it.

TIMING OF RELEASE DATA ON M-1

Earlier this year Senator Proxmire and I wrote to you, Mr. Chairman, with regard to the desirability of altering the timing of the Federal Reserve's release of data on M-1 aggregate growth. You responded, saying that the Board of Governors had asked for public comment on the issue. Increased concern has certainly arisen over the consequences of market overreaction to weekly monetary data.

In light of the market reaction to last Friday's announcement in the jump in M-1B. Bond prices fell as much as two points, industrial averages fell as much as 18 points.

In light of the public comments you have received on altering your procedure on releasing M-1 data, in light of your announcement of last Friday of the $5.9 billion M-1B jump, what is your feeling on changing your procedures in this area?

Chairman VOLCKER. I have a letter to you, Mr. Chairman, in response to your most recent inquiry, which you might want to put in the record, summarizing the kind of responses we got to our public invitation. In terms of specific responses, most people said, "Do what you're doing now;" that was about half of the total

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responses. The other half were very much scattered in their recommendations as to what we should do.

I think you will find generally that those closest to the market who trade off these numbers want them to continue to be published. We will be taking this up at the Board fairly shortly now, because enough time has passed to get the responses and to analyze them. I won't prejudge the Board's decision; I will just speak for myself. I have had a certain predilection toward maintaining them, because I'm not sure we can escape the kind of aggravating problems that are involved in publishing them. There is an argument strongly pressed upon us that since we collect the figures we have a responsibility to give everything we have to the market and let them make their own assessment.

The CHAIRMAN. I'm not suggesting you not release them. I'm only talking about the timing.

Chairman VOLCKER. Of course, we would eventually publish the money supply numbers under any of the options. The question is the form in which they are published. I've not been totally convinced, myself, that we can improve the situation greatly in terms of the market reaction. We have been experimenting with different formats to use in publishing the figures, trying to put them in a little longer perspective so people don't react too much to weekly figures. But I suspect the inherent problem is that the market is more concerned about the basic direction; they will cling to every little bit of evidence in the short run, misleading as it may be, because they feel other people are reacting to it. You get a mutual, anticipatory kind of flavor to this. It's an unfortunate situation, but I have not found the magic way both to get the numbers out and to avoid this kind of reaction.

The CHAIRMAN. Well, we will place your letter in the record.

[The letter follows:]

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

PAUL A. VOLCKER
CHAIRMAN

July 22, 1981

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Garn:

In your letter of July 9, you requested a summary of the public response to the Board's invitation for comment on possible modifications of the present system of monetary data publication. You also asked for an outline of the Board's current thinking on the matter.

Enclosed is a simple tabulation of the letters we have received, as well as a copy of the original press release listing the proposed changes. While some responses could not be unambiguously classified, most could, and the summary table is a reasonable characterization of the returns. (Some responses communicated the collective views of groups, and no attempt has been made to assign weights in accordance with the numbers of people or institutions represented.)

As you can see from the first column of the table, about half of the responses supported retention of the current approach to publishing the monetary aggregates. A few of the responses in the "other" category shown in the last column supported the release of more frequent or additional data, while two respondents preferred that the data not be seasonally adjusted. About one-fourth of the responses suggested that we publish only monthly data.

As might be expected, respondents most actively involved in money markets felt most strongly about maintaining the current publication schedule. In general, those less directly involved in money markets on a day-to-day basis were more favorable to some change. I think it fair to say that comments given us orally in various forums were along the same lines.

The most frequently cited argument for retaining the current approach to publication was that, the more ample the data flow, the less likely it is that release of any single number will have large market impacts. It also was noted frequently that, in the absence of our publication of the data, private analysts would fill the void with their estimates and that the situation might prove no better--or perhaps worse--than that now existing.

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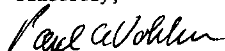
I expect that the Board will shortly consider the various questions raised in connection with weekly publication of the money supply. It is our objective to provide the public with meaningful, timely information in a manner that avoids undue disruption of the financial markets. This requires an assessment not only of the market's use of the information, but of the internal problems of producing high quality data on a regular schedule. We shall, of course, communicate to you promptly the outcome of our deliberations.

Sincerely,



Enclosures

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PRELIMINARY SUMMARY OF PUBLIC COMMENT
ON PUBLICATION OF MONETARY AGGREGATES

July 20, 1981

Type of Respondent	Retain Current Schedule	Delay 1 Week	Publish Not Seasonally Adjusted Data	Publish Only Monthly	Other[1]
Commercial Banks	13				
Banking Organizations					
Thrift Institutions					
Securities Dealers & Other Financial Institutions					
Other Corporations					
Academic	2				
Other Individuals	6				1
Total:	34				12
Total Responses:	66				

1/ Includes a wide variety of responses ranging from publishing money stock data on a daily basis to discontinuing the publication of monetary statistics altogether.

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FEDERAL RESERVE press release

For immediate release April 2, 198

The Federal Reserve Board today invited public comment on the desirability of continuing to report money supply data on a weekly basis, or whether another reporting procedure should be used.

Weekly money supply statistics are erratic and often poor indicators of underlying trends, Board Chairman Paul A. Volcker said in a recent letter to Senators Jake Garn and William Proxmire, the chairman and former chairman respectively of the Senate Banking Committee.

The Board has not concluded that the present procedure should be changed and will continue to publish money supply data each Friday, as it has in the past.

In his letter, the Chairman said:

"There is considerable merit to the view that weekly data as such convey little information and that weekly seasonal adjustments are subject to substantial uncertainty. However, the Board is not certain at present that the public interest would necessarily be better served if any of the alternatives noted (in the letter) were adopted."

As possible alternatives to the present procedure, the following options are being considered:

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1. To delay weekly publication an additional seven days to incorporate more data.

2. To publish only data that are not seasonally adjusted.

3. To publish data only monthly--as is now the case with the broader definitions of money--or use moving average data.

To assist in the assessment of the publication schedule, the Board requested comment on the desirability of continuing the present procedure or of shifting to another option. Comments, which need not be limited to the options above, should be sent to Thomas D. Simpson, chief of the Banking Section, Division of Research and Statistics, Federal Reserve Board, Washington, D. C. 20551.

A copy of the Chairman's letter is attached

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

PAUL A. VOLCKER
CHAIRMAN

March 24, 1981

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Chairman Garn:

The concerns and questions raised in the recent letter from you and Senator Proxmire about weekly money supply data have been discussed and debated by the Federal Reserve Board, the Federal Open Market Committee, and the staff for some time. The issues are extremely important and strong arguments--other than Freedom of Information Act implications--can be made for and against publication of weekly data.

There is nearly unanimous agreement by all observers that weekly money statistics are extremely erratic and therefore poor indicators of underlying trends. While monthly data can often deviate considerably from such trends, the weekly observations are particularly "noisy". Week-to-week changes are quite large and recent estimates indicate that the "noise" element--attributable to the random nature of money flows and difficulties in seasonal adjustment--accounts for plus or minus $3.3 billion in weekly change two-thirds of the time. Such a large erratic element appears intrinsic to money behavior, rather than implying poor underlying statistics. In 1980, weekly M-1A and M-1B statistics revised on average only about $300 million between the first published and "final" data several weeks later, though in twelve weeks, revisions were larger than $500 million, and the largest single revision was $1.6 billion.

The great preponderance of active market participants are by now aware of the highly volatile nature of the weekly series. Publication has had that educational advantage, and the data to be used with a certain caution. However, from time to time overreactions have occurred.

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As a result of concerns about the reaction to and significance of weekly figures, the Federal Reserve has considered possible revisions to its current publication schedule or to its method of presentation. One option might be to delay weekly publication an additional seven days to incorporate more data--an important issue with additional reporters under the Monetary Control Act. This could reduce revisions to the weekly statistics. On the other hand, this option would increase the risk of inadvertent leaks and would increase the interval over which market participants might react to guesses and rumors of money stock changes, based in part on fragmentary data such as may be available in the weekly figures from large banks on deposits and loans. Even if no greater volatility in interest rates occurred over the unpublished interval, lagged publication of a more accurate, but still different than expected, change in weekly money might simply postpone the market reaction. In any event, weekly revisions are usually small, as noted above, relative to the underlying volatility of the series.

Another option might be to publish seasonally unadjusted money data in order to reduce the "importance" of the statistics. Our concern here is that market participants would then create their own seasonally adjusted series. The availability of a large number of conflicting series would only heighten market confusion, and might inevitably lead to questions to the Federal Reserve about what it considers to be the "normal seasonal" change in a particular week if what might seem to be an unusual change occurs in a seasonally unadjusted figure.

Another approach might be to publish data only monthly--as is now done, because of data reporting problems, with M-2 and M-3--and/or to publish weekly, but only a moving average series of weeks. Under the monthly approach, market participants would still try to estimate weekly series from bank balance sheets and clearing house data, and the market could be swept by rumors and guesses on movements in the money supply. And they would also probably attempt to glean the weekly number from a moving average series. In any event when a monthly figure was finally published, deviations from market expectations could cause yet further changes in interest rates as the new information was incorporated into market expectations. I might note that this has not been a significant problem with monthly publication of M-2 and M-3. A relatively small portion of these aggregates are supported by reserves, and they have played a less important role in the day-to-day targeting process than M-1.

In general, there is considerable merit to the view that weekly data as such convey little information and that weekly seasonal adjustments are subject to substantial uncertainty. However, the Board is not certain at present that the public interest would necessarily be better served if any of the alternatives noted above were adopted. While no one can be sure of their judgment in this respect, it does

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seem possible that volatility of money market conditions could be encouraged by misinterpretation of fragmentary data as well as by the continued availability of the present weekly data.

We will, of course, continue to review the money supply publication schedule, taking account of the constraints imposed by the Freedom of Information Act. To aid in our assessment of the value of weekly money supply data, we plan to ask for public comment on the desirability of continuing the weekly series, or of shifting to the options noted above. Our decision will be taken in the light of those comments. Should Freedom of Information Act requirements present difficulties in the light of the appropriate course, we will consult with you further.

I appreciate your interest in these questions. They are of concern to all of us.

Sincerely,

Identical letter also sent to Senator Proxmire.

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The CHAIRMAN. What's your current feeling on the desirability of replacing your current system of lagged reserve accounting with a contemporaneous reserve accounting system?

Chairman VOLCKER. That's another matter which is going to be coming up fairly shortly. One of the reasons we haven't acted yet is that that particular change by itself is not likely to make a terrible difference one way or the other; it's got small pluses and minuses attached to it, but I haven't been convinced it's fundamental to our operation. It could become more important in connection with other kinds of much more important reforms—I don't want to suggest any other than neutrality—in the management of the discount window.

LINE OF CREDIT TO HOME LOAN BANKS

The CHAIRMAN. I understand that Chairman Pratt of the Home Loan Bank Board recently sent you a letter stating that short-term and long-term credit from the Federal Reserve would be a useful backup to lending by home loan banks to thrift institutions. To accomplish this, Chairman Pratt recommended, among other things, that the Federal Reserve provide a line of credit to home loan banks, which could then lend such funds to thrift institutions.

What is your opinion of Chairman Pratt's suggestions?

Chairman VOLCKER. He suggested to us that the attitude that they had earlier—they felt they had the capacity to take care of all these current and potential lending demands from the savings and loans—has changed. As has been fundamentally the case all along, we are ready, willing, and able to lend to thrift institutions that have liquidity problems. We have had discussions with Mr. Pratt as to precisely those demands that he would like to take care of and those that would spill over to us; those arrangements are pretty well fixed. There should never have been any question about our willingness and ability to take care of those liquidity requirements.

On the aspect of lending to the Home Loan Bank System itself, I don't think that's a relevant question at the moment. I think he agrees. They have access to the market. They have, in the first instance, a backup line with the Treasury, and I think the framework of their law suggests that if they did have to look within the Government the logical place to look would be to that backup line which is established. They are not at this point, and they don't anticipate they will be at the point, where that is needed, but that is the statutory framework for them.

The CHAIRMAN. Is the Federal Reserve considering any easing of its discount window policy in which thrifts have to approach the home loan banks for loans (priced at 16 percent or 17 percent) before approaching the Fed for loans priced at 14 percent?

Chairman VOLCKER. I wouldn't say "easing" is the right word. Our position all along has been that you can borrow from us if you don't have available credit elsewhere. The Home Loan Bank Board took the position that the credit was available at the Home Loan Bank Board, but that's what's changing.

The CHAIRMAN. But at 2 or 3 percent higher rate.

Chairman VOLCKER. That is right. A problem that is inherent in this situation is that the discount rate is set at a certain level for monetary policy reasons. Their rates are set using different crite-

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ria, and there are discrepancies between the two. But our basic posture toward the discount window—not just toward the thrifts but anybody—and it's been the basic policy for many decades—since the Federal Reserve was established—is that you come to the Federal Reserve for assistance when money isn't reasonably available elsewhere, and that will continue to be our policy.

The CHAIRMAN. Do you have any idea roughly how many thrifts have applied for loans at the discount window and how many have received them?

Chairman VOLCKER. Very few have applied for an actual loan. For some 270 thrift institutions, the basic lending framework has been put in place, and there are many more that, as a precaution, have had this kind of discussion with us. But there have been only a handful of thrift institutions that have borrowed for very short periods of time in recent months, which basically reflects two facts: one, that the home loan banks have been ready and willing to lend; and, two, that the industry has very great problems but there's not been any general liquidity problem in the industry. By and large, their liquidity position, while coming down a bit this year, has been historically higher than normal. They have an earnings problem at this stage, not a liquidity problem.

[The following newspaper article was received for the record:]

[From the Wall Street Journal, July 17, 1981]

FDIC, BANK BOARD SAY INSURANCE FUNDS ARE SUFFICIENT TO AID FAILING BANKS, S. & L.'S

WASHINGTON.—The chairmen of the Federal Deposit Insurance Corp. and the Federal Home Loan Bank Board asserted that their agencies have enough money available to aid failing banks and savings and loan associations for the rest of 1981.

Richard Pratt, chairman of the Bank Board, which oversees the Federal Savings and Loan Insurance Corp., told a House subcommittee yesterday that the FSLIC's $6.5 billion in insurance funds will be enough to handle any failing thrift institutions this year. He said he expects the Bank Board's list of problem S&Ls to show 363 troubled institutions at the end of June, up from 263 in May.

FDIC Chairman Irvine Sprague, testifying with Mr. Pratt, stated that the agency has more than $11.5 billion available and expects "as a rule of thumb" 10 bank failures in 1981. Four banks have failed this year, and 10 banks failed in each of the proceding two years. Mr. Sprague said 210 banks are considered "supervisory problems" this year, down from 217 in 1980.

The FDIC's funds "are more than sufficient for any problems we may have in the next year," Mr. Sprague said. But he said banks aren't immune to the thrift industry's problems. He noted that 42 mutual savings banks sustained operating losses during 1980. During the first five months of this year, 65 mutual savings banks operated at a loss, he said.

Benjamin Rosenthal (D., N.Y.), chairman of the House Commerce, Consumer and Monetary Affairs Subcommittee, asked Mr. Pratt if a new Bank Board ruling that allows S&Ls to participate in interest-rate future markets would be a risky venture. Rep. Rosenthal noted the failure of Economy Savings & Loan Association of Chicago earlier this year. That thrift's failure was caused in part by futures speculation that went sour when rates went up instead of down.

Mr. Pratt replied that the ruling would "authorize risk reduction because the regulation won't allow speculation."

Under the new rule, the S&Ls will be allowed to trade in Treasury securities futures and bank certificate of deposit futures. Previously, only Government National Mortgage Association futures could be traded.

The rule allows S&L to hedge all their assets by using profits on interest-rate futures to offset losses on assets.

Rep. Rosenthal cited New York & Suburban Savings & Loan Association as an example of how futures trading could be unenforceable. That thrift institution was warned repeatedly by the Bank Board to stop investing in Ginnie Mae futures as early as 1976. The S&Ls refused and began incurring considerable losses. The FSLIC

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finally forced the thrift to merge with Anchor Savings & Loan in New York last May.

Separately, Mr. Pratt asked Paul Volcker, Chairman of the Federal Reserve Board, to increase the access of ailing S&Ls to credit from the Fed.

In a letter to Mr. Volcker, Mr. Pratt said short-term and longer-term credit from the Fed would be a "useful complement" to lending by the Federal Home Loan Bank system for troubled thrift institutions. He also suggested that the Fed provide a direct line of credit to the Home Loan Bank system, which in turn could pass the loans on the S&Ls.

Currently, all depository institutions that are subject to Fed reserve requirements—including many thrift institutions—have the right to seek short-term loans from the Fed's "discount windown." But S&Ls must first exhaust all possibilities of receiving aid from the Federal Home Loan Bank system. Mr. Pratt's letter suggested eliminating that requirement and raised the possibility that the Fed could also provide longer-term credit to troubled S&Ls.

A Fed spokesman said the board hasn't yet considered Mr. Pratt's proposals.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I guess the concern many of us have is at a point the earnings problem can turn into a liquidation problem if the confidence caves in. There's a risk at some point that might happen. I might just mention how we could squeeze down defense spending. I might say to my friend, the Chairman, one way to get the Federal Reserve Chairman, Senator Garn, Senator Sarbanes and myself together is maybe we could decide not to spend quite so much on the MX missile. That might be one way to do that, and I say that with tongue in cheek.

The CHAIRMAN. Well, it might be less costly to put it on barges in Lake Michigan.

Senator RIEGLE. That may be where it ends up. I have a feeling it may not end up where it was originally intended to go.

I'd like to come back, Mr. Chairman, to our earlier discussion. First, let me thank you for your patience today and for your responses to us.

UNEVEN MONEY SUPPLY DISTRIBUTION

The problem that I see with the continuing high interest rates and the tight policy regarding the growth in the money supply, is that we're seeing an effect of that in this very uneven distribution. The consequences of this in some sectors is severe damage while other sectors ride this out relatively easily. I think this is a historic situation. I don't know of any parallel quite like it in contemporary times that has lasted this long or is this severe through this number of sectors, and it may go on for some number of months. We just don't know.

You hope that rates may come down by the end of the year, but that may not happen. I guess what concerns me most is that even though this isn't your stated intention you're doing a kind of credit allocation. You're rationing by price. Normally, that would fight the notion of free markets, but I think when you've got an extraordinary situation where the interest rate is rising to unprecedented high levels, you have a different kind of problem the normal one. You just can't assume the normal mechanics of the free flow of credit will meet the needs of the country or have any kind of equity to it.

I'd like to make this suggestion and I hope the Chairman would agree with this. I can think of at least four sectors that are being

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punished in the extreme, let's say unintentionally, but they are taking tremendous damage. I think this will have long-term consequences for the country.

One is agriculture and another is construction and real estate. A third would be autos and related industries, and a fourth would be the small businesses I think they're being priced out of the credit market. They're being squeezed relentlessly by a host of forces and I think it would be appropriate for us to ask the Fed to do a special study—and by that I mean something that could be done quickly within the next 30 days—as to what the consequences are to what is taking place in these four sectors. This pattern of very high and continuing interest rates and tight money supply and the degree to which these sectors are not getting the sufficient flow of capital and money, under what we might consider historic norms the shortage of that is literally killing off or crippling major portions of these sectors.

The reason that I think it's worth asking for, and spending some real effort to get, is that I think there's some very profound policy implications here. I don't think that we can escape the consequences of our actions, whether we intend certain consequences or not. I think that material, long-term, permanent damage is beginning to take place in the four sectors that I mentioned. I think it's important that we try to measure that to the degree which high interest rates and inadequate flow of credit is affecting these sectors, and to the extent you can document this problem would be helpful to the Fed itself. In other words, you may or may not decide that there are certain steps that you want to think about. You may want to modify your own policies in certain ways if you find that the burden of this policy is crushing some areas and basically not affecting certain sectors in the same degree.

I think here on the congressional legislative side, we need to know this as well. It may well be that we have to take some additional steps. We may want to try to provide some policy guidance or even some specific legislative initiatives to deal with this problem. The reason that I'm concerned about it is that I think our economic infrastructure in this country is complex enough. There has been enough drawn into the world economic picture that there are a whole new set of problems and implications that bear in on us and I don't think we can be indifferent or casual about a level of damage that we are taking in critical sectors that may end up haunting us for years to come. If we're going to do it, let's measure what is happening. Let's not basically turn away and say, well, that's just the breaks of the game or that's the way it works out in terms of how the credit resources make their way out into the economy.

I have a feeling that even in some of the high growth areas in distant places across the country the stories I read from Iowa for example—I don't know what the situation would be in Utah—I certainly have a keen sense for it in Michigan—but I have the feeling that there are a number of areas in the country that are really feeling the effects of this and are being damaged materially in these sectors that I speak about.

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REQUEST FOR FED TO SUPPLY A STUDY

So my request would be, Mr. Chairman, that the committee, or if you think it best that I request it on my own initiative I will do so, but I think it would be useful for the committee as a whole to ask the Federal Reserve over the next 30 days to do a study on the effect of the high interest rates and the tight money policies in at least these four sectors to try to give us an idea of where we stand, how much damage has been done, and what's the prospect in terms of failure rates and other problems that are arising so we know what's happening. At least we would have the knowledge and the information from which to try to draw some judgments as to what might be appropriate responses to the level of whatever we find these problems to be. I don't know how the Chairman feels about this but I would hope that he would feel this would be a useful thing to do for the committee and, if not, then I would ask for it in my own right.

The CHAIRMAN. Obviously, I can't speak for the Committee. There's only two of us here. I would ask the Chairman what he would be able to do in gathering this sort of information. I would not be in favor of asking for any extensive study that would take a lot of resources, money, to do that. I don't know what his capability is to gather that. It would seem to me that the problem is pretty generally known. If it were a matter of collecting information from various groups and how they are affected, we have had bits and pieces from various sectors on how it is affecting them. If you haven't been receiving that, I'll send you copies of what comes into me in wheelbarrels every day, but I don't know what his problem is in that amount of time, and I suppose, more practical, what data is available. So I would ask you that question.

Chairman VOLCKER. In that period of time, obviously, we haven't any capability to initiate new and original research. In the small business area, for instance, this problem has been recurrent. The Board has made or sponsored studies in the past. The ones that were most elaborate are outdated and took years to do, because it's a very difficult statistical problem—particularly in that area.

What we can do in a month is bring together material that's already available with some analysis about these particular areas, and we would be glad to do that. It may be useful to the committee or to Senator Riegle to have what we do know presented in an orderly way.

Senator RIEGLE. Well, if I could make that suggestion because I think you may find it would be helpful to the Fed as well, I may sound like I'm butting into your business here, but I think it would be useful for both of us to find out exactly what is happening in a consolidated way, at least in these four sectors. I would hope that maybe somebody in a reasonably high position in which you have confidence, could perhaps have the responsibility to pull this together and within 30 days have someone come back and meet with us in whatever kind of session is appropriate to go through what the figures show us, what is happening in the agricultural sector across the country, what is happening in construction, and what's happening in autos and related industries, and what's happening in small business so as we can tie it to the credit situation.

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Chairman VOLCKER. Of course, that's the problem. It's fairly easy to show what's going on in those sectors. Relating that directly to the credit situation is the difficulty. Just to amplify a little bit your own comments, I do not think that you can trace the difficulties of these sectors to the availability of credit, if I can make the distinction between "availability" and "price." There's a somewhat different situation than we have had in the past. There's no question that some of these sectors are more vulnerable to pressures in the credit market, generally interpreted. I think I could anticipate a conclusion of the study to be that it's not the case that the farmers or the car buyers or the auto dealers or the home buyers can not buy credit if they're willing to pay the interest rate, but rather that today they are not as willing to pay the interest rate as Gulf Oil Co. or Seagrams, and that's important.

Senator RIEGLE. That's exactly my point. In other words, finally at a point the differentiation between the two, the price and the supply, start to lose their meaning because what you have done is you have taken somebody out of the market in terms of their capacity.

Chairman VOLCKER. I don't disagree with your basic point.

Senator RIEGLE. Let me take it away from autos and just take agriculture. If it's true in agriculture most farming entities can't function if they've got to pay, say, a going interest rate of 17 percent, this violates their historic norms of what they can do and still operate in a profit situation and stay above water. It may well be that if the interest rates are going to stay at that level for a long enough period of time we will have to craft some special response, because agriculture, as a chunk in the economy, has some very important strategic implications to the country and we will want to face and deal with that problem. We may want to do this in the auto and steel industries and related industries. We may want to do this in small business, when you recognize that 95 percent of the new jobs in this country are created by small business and not by big business. What I'm saying is that I think we might have shifted through the old circumstance into a new circumstance where the implication and effect of high interest rates at these levels over a period of time are causing the level of damage that we have not had to consider before. It is a new problem. It's a whole new scale of problem that's hitting certain sectors and I don't think they have a way of organizing themselves very effectively to come in and make their case. The real estate people and the construction people have come in on behalf of the special savings certificate for which an effort has been made to try to craft into the tax bill. I just cite that as an example to the kind of ad hoc response to the emergency we're seeing. It may well be that we craft a more orderly response if we really know what the scale of the problem is that's taking place. That's why this is not an exercise in futility. I'm not trying to cause people to go out and do extra work or what have you, and my suggestion of 30 days is we not try to do a perfect job. We try to get a quick sense of what the magnitude of the problem is and discuss it back and forth to see if we can find some way to deal with this problem constructively.

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I would like to work in a cooperative way. I think the Chairman knows that and I know this Chairman knows that, but I don't think we can keep flying blind in pulling these aggregates together in these sectors that are so desperately in trouble.

Chairman VOLCKER. Clearly, all we can do in 30 days is bring together all the information that's available. It may be useful to us and it may be useful to you, and we would be glad to do that.

The CHAIRMAN. I would join Senator Riegle in that request as long as we understand the parameters of what you're capable of doing in that period of time. In that time you're not going to go out and do original research. As long as we understand the framework of what you can produce in that 30-day period, I certainly join the Senator in that request.

Senator RIEGLE. I appreciate that.

Chairman VOLCKER. I would note that even if you find these differential impacts—and there certainly are differential impacts—that doesn't point toward the magic solution as credit allocation. If I may make just one comment about Senator Sarbanes' line of questioning which I think is relevant, all these sectors would be better off if you didn't have such a big budget deficit that's preempting a large part of the credit availability in the economy. From that point of view, from the point of view very directly of the Federal Reserve and our responsibilities, anything you do with the defense program or any other spending area is a help to us in some narrow sense. I don't think that tells you very much in the end. It's the Congress that has to make the decision about priorities between the buildup in the defense program or in another area, based upon this knowledge, which I think you should have: the bigger the deficit is, the more pressure you put on the markets and, therefore, the more problems you've got with those particular sectors of the economy. But that does not mean that the automatic answer is to cut the defense program—that's what you have to judge, how important that is.

NEW ECONOMIC CIRCUMSTANCES

Senator RIEGLE. Well, I guess my thought to you would be this, I worry very much that we have come into a new economic circumstance, taking everything together in this country and internationally. Where we are today all the cross connected pressures that are bearing in on us are fundamentally different and have a different meaning and impact to us than what was true 5 or 7 or 10 years ago. I think now as we tighten down on the monetary side, which seems to be the principal inflation fighting device now, we have voted for a spending ceiling and I supported that. We have tax cuts and I intend to support those as an effort to break out of this. But we are having very tight monetary policy and that's one of the main reasons why the interest rates are so high. The thing that troubles me here is what is happening is that you're getting a pileup of wreckage in different sectors of the economy that goes beyond anything we've seen in contemporary experience because things have changed. I don't think we're accustomed to dealing with that problem or even thinking about it. It falls outside the framework of what the normal patterns have been. We are now seeing abnormal patterns and therefore a level of damage that goes

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beyond anything we have experienced before, at least in contemporary history. In light of the fact that all the evidence shows us that now we'd better broaden the way we think about this problem, to try to get our hands around some new things that are now taking place, and maybe the adverse consequences that go beyond anything we really want to put upon ourselves so that we may have to devise other ways. We may have to devise some modifications to our policies that will still keep us on track to our central objective without causing other permanent damage of a size and scale that will haunt us for many, many years to come. If this is a problem of that size—and I think more and more people of both parties are beginning to fear it might be—I agree with the Chairman, Senator Garn, that there's a certain amount of propagandizing that goes on about high interest rates. Privately I hear many of my colleagues in both parties are deeply concerned about the unevenness of the damage that's taking place and how severe and lasting its consequences may be.

So my appeal to you is to say let's work together to see if we do have something new that's happening to us and that we'd better get under the magnifying glass because it may well require us to invent a modification of our response which will keep us on track in our inflation fighting goal yet doesn't buy for ourselves a whole set of unintended side effects that may even end up canceling out the other benefits that we get. That's as clearly as I can state what I'm concerned about.

The CHAIRMAN. Mr. Chairman, I appreciate your testimony today and your patience in responding to our questions. I would say that being chairman of this committee, I would prefer not to be chairman of it when the prime rate was 21.5 percent, which happened about the same time I became chairman. Some people undoubtedly said it was my fault. Having struggled with this for 6 or 7 months and being plagued with it from all segments of the economy, maybe the only thing we can do is what I do if I can't find any solutions here, I modify what I do in my prayers. The first thing I pray for every day is low interest rates before anything else. I've even put my wife and children secondary to getting low interest rates. But in any event, we do appreciate you being here.

Tomorrow's followup hearing on monetary policy has been rescheduled for Wednesday, July 29, at 9:30 a.m. The conference on the reconciliation bill, at least our part of it as members of the Banking, Housing, and Urban Affairs Committee, will reconvene this afternoon at 3:30 p.m. here in room 5302 of the Dirksen Building, and this hearing will stand adjourned.

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

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1981

WEDNESDAY, JULY 29, 1981

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

The committee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator Alfonse M. D'Amato, presiding.

Present: Senators D'Amato, Proxmire, and Dixon.

Senator D'AMATO. The committee will come to order.

We have as our first witness the distinguished Chairman of the Council of Economic Advisers, Murray Weidenbaum.

Murray, I'd like to offer the apologies of the committee and particularly the chairman, Senator Garn, and Senator Lugar, who are both at the intelligence hearing today. Senator Garn asked me to convey to you his sincere regrets that he would not be able to be here and he looks forward to having an opportunity to be with you again and hear you again. He's submitted some questions that I'll pose to you and some that I will give you in writing, but I make his apologies along with Senator Lugar's for their inability to be here at this hearing.

I note you have a statement and why don't we get into that?

STATEMENT OF MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. WEIDENBAUM. Fine. Thank you, Mr. Chairman. I'm delighted to testify with the distinguished Senator from New York in the chair and I'd like to submit my full statement for the record and just read the highlights.

Senator D'AMATO. Certainly.

[The complete statement follows:]

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THE ECONOMY AT MIDYEAR

Statement

of

The Honorable Murray L. Weidenbaum
Chairman, The President's Council of Economic Advisers

Mr. Chairman and Members of the Committee:

Since I last appeared before you in early March to discuss the economic situation and the Administration's program for economic recovery, there has been encouraging progress. We have made significant advances in laying the foundations for a strengthened U. S. economy for the rest of the 1980s. The essential features of the President's budget and tax programs have met with acceptance by the Congress and are well on the way to implementation; the Administration has taken more than 100 significant steps on the road to regulatory reform for business, state and local governments, and nonprofit institutions; and the Federal Reserve has been following a policy of monetary restraint which is consistent with our mutual objective of bringing inflation down permanently.

In other words, in cooperation with the Congress and the Federal Reserve System, all four elements in the President's Program for Economic Recovery have been advanced significantly during the past four months.

At the same time, the economy, by and large, has been performing as anticipated. The pace of economic activity has slowed as the year has progressed, after an unsustainably rapid start early in the first quarter. In March, I noted that real economic activity would soften in the months ahead, and that the possibility of at least one quarter of negative growth could not be ruled out. That possibility has now been realized in the preliminary results for the second quarter. I will elaborate on the reasons for this pattern in a moment.

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At the present time, we are experiencing a pronounced slowing in the performance of such key indicators as industrial production, auto sales, and homebuilding and related activity. In a word, I would describe the economy as "spongy"; that is, temporarily soft, but with the inherent ability to resume expanding rather smartly, especially with the economic policies that the Administration is pursuing.

Perhaps the most heartening development over the past several months has been a moderation in inflationary pressures. In May, for the first time in 27 months, the increase in the Consumer Price Index, when measured over a 12 month period, dropped below double digits, and June repeated the pattern. Increases in most other price indices have shown comparable moderation. Although month-to-month variations in these volatile indicators can be quite large, we now expect, that for 1981 as a whole, the CPI will rise slightly less than 10 percent over 1980.

While oil prices frequently have been emphasized as an important factor in this moderating trend of inflation, monetary and fiscal restraint is the critical element underlying any sustained deceleration of inflation. The maintenance of restraint is absolutely necessary if this trend is to continue in the months and years ahead. I believe that further progress in bringing down the rate of inflation will begin to dampen inflationary expectations, and lead to a healthy readjustment in the saving, spending, and investment patterns of individuals and businesses alike. These expectations can be reinforced further through prompt action by the Congress on those aspects of the Administration's tax and budget proposals that have yet to be resolved.

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Some observers have drawn attention to the continuing double digit rate of increase in wage and salary costs. It has been suggested that more attention be paid to this factor as an element in underlying inflationary pressures. Let me simply observe that these trends reflect private sector decisions, and are heavily influenced by recent inflation - through formal and informal cost-of-living adjustments - and by expectations of future inflation.

We intend to avoid any jaw-boning of what are essentially private sector matters. Instead, our basic policy thrust is to create an environment characterized by a substantially lower rate of inflation, an environment in which both labor and management can negotiate without continuing concern about inflationary pressures and their impact on real wages and nominal profits.

But the need for hard and realistic bargaining on both sides of the labor-management negotiating table should be appreciated. Firms which incur unrealistically high wage bills which cannot be passed on in the form of higher product prices will see their profitability erode. And they should not look to this Administration for help in such a situation. In other words, since inflation is moderating, current wage negotiations should take that fact into account. Of course, at times when productivity gains are high -- and we anticipate this will be the case in the future -- it would be natural to expect wage costs to reflect such a positive factor.

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Monetary Policy and the Economy

One of the purposes of these Congressional oversight hearings is to ascertain whether the monetary policy objectives of the Federal Reserve are consistent with the economic objectives of the Administration and the budgetary and tax actions of the Congress. As you know, this Administration, from the beginning, has stressed the great importance of a steady, persistent anti-inflationary monetary policy. Achievement of our economic growth and employment objectives during the next several years depends on a significant reduction of inflation, inflationary expectations, and the inflation premiums in nominal interest rates.

The monetary growth objectives the Federal Reserve has set for itself during the next several years are consistent with what the Administration believes to be necessary to reinforce the other parts of our economic program. At oversight hearings before Congress in 1980 and earlier this year, Chairman Volcker described the Federal Reserve's policy as being one of a persistent reduction in the trend rate of monetary growth. We have confidence that the consistent implementation of that policy by our central bank will make a significant contribution to the restoration of credibility of the government's determination to end inflation.

Chairman Volcker has reaffirmed the Federal Reserve's target growth rates for the various monetary aggregates in 1981, as originally specified earlier this year. The target for the more commonly used of these measures -- M1B -- is growth in the range of 6 to 8-1/2 percent from the fourth quarter of 1980 to the fourth quarter of 1981. That is the

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target range for this measure before adjustment for NOW accounts. During the first half of 1981 -- from the fourth quarter of 1980 to the second quarter of 1981 -- M1B grew at a rate slightly below 7 percent. In his testimony last week, Chairman Volcker indicated that the M1B measure of the money supply may grow in the lower half of its target range for the balance of this year. That growth pattern of money this year is consistent with our expectations about economic growth for the remainder of this year. We expect that the Federal Reserve will continue its policy of gradual, sustained reduction in the growth of monetary and credit aggregates during the next several years. The Administration endorses the Fed's long-run, as well as short-run, policy objectives.

A few comments on our view of the economy in 1981 might be appropriate. The statistical highlights are contained in the accompanying Table. I will not repeat the detail of the midyear Review that was issued earlier this month, but our interpretation of some changes in economic assumptions may be informative. In the first quarter of this year, total spending in the economy -- nominal GNP -- grew at almost a 20 percent annual rate while real output grew at an 8-1/2 percent rate. Those exceptionally high growth rates were the lagged response of the economy to the highly stimulative monetary growth and government spending that occurred in 1980.

The growth of the money supply in the first half of 1981 about than one-half the growth rate that occurred in the second half of 1980.

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ADMINISTRATION PROJECTIONS OF ECONOMIC ACTIVITY.

	1980 actual	1981 estimate	1982 estimate
Gross National Product (in billions)	$2,626	$2,951	$3,296
Real Growth	-0.2%	+2.6%	+3.4%
Inflation:			
GNP deflator	+9.0%	+9.6%	+8.0%
CPI	+13.5%	+9.9%	+7.0%
Unemployment Rate	7.2%	7.5%	7.3%
Interest Rate, 91-day Treasury bills	11.5%	13.6%	10.5%

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Furthermore, the growth of government spending has been cut substantially compared to last year. As a consequence, we expect the growth of nominal GNP in the balance of 1981 to be at only one-half the rate that occurred in the first quarter.

For 1982, we expect the growth of nominal income to be somewhat less than for the average of the full year of 1981, but we expect real output to be higher while the rate of inflation is lower. In other words, we expect that the "mix" of total spending in the economy will shift towards more output and less inflation as the effects of the personal tax rate reduction and business tax incentives start to induce greater real investment spending in the economy.

The policy framework within which we are operating is based on four critical relationships:

Reduction of government spending as a share of GNP constitutes a major shift of resource utilization out of the public sector and into the private sector;

Sustained reduction in the increase of the monetary aggregates reduces the growth of nominal GNP and thus reduces the inflationary momentum in the economy;

Reduced inflation results in lower nominal interest rates;

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> Accelerated depreciation, together with continuation of investment tax credits and regulatory relief, will result in a major increase in real investment spending and employment in the private sector, especially in a less inflationary environment.

These elements of the President's economic program are interdependent and mutually reinforcing. The policy objective of reducing the trend growth of the money supply is as important as the reduction in the growth of government spending and the reduction in personal and business taxation.

Turning to the important question of interest rates, I have to acknowledge that progress here has been slow. Although most short-term rates, at present, are down somewhat from their highs of mid-May, we have not yet seen the major downward movement that would ordinarily be expected to follow clear-cut evidence of a moderation in inflationary pressures and business activity. Even though many sectors of the economy have shown an impressive ability to adapt to a high interest rate environment, it is clear that some areas, such as autos, homebuilding, and the thrifts are being adversely affected.

However, there is little doubt in my mind that we should begin to see, in the near future, a substantial unwinding of the large inflationary premium that has been built into both short- and long-term interest rates over the past several years.

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If participants in financial markets have been slow to adapt to the changed environment, I believe they have some basis for being cautious. After all, in recent years they have been burned on a number of occasions by false starts in getting inflation under control. However, as the evidence continues to accumulate that the Administration and the Congress are determined to stay the course, our policies of fiscal and monetary restraint can be expected to lead to the favorable trend of interest rates that we show in our mid-year forecast for the period through 1982 and beyond.

In closing, I would like to re-emphasize the importance of "staying the course". From the very beginning, the Reagan Administration has emphasized that our program differs fundamentally from the stop-and-go practices of the past. We believe that the most constructive role for government policy in the economy is to provide a stable framework for the private sector's risk-bearing and entrepreneurship. Experience in previous years has taught us that trying to "fine tune" the economy is a fruitless, not to say counter productive, activity. The U. S. economy is far too intricate and Americans are far too independent to be susceptible to closely calibrated and detailed orchestration by the Federal government.

It is with this knowledge, and in this spirit, that we intend to go forward in creating an environment in which the basic strengths of the U. S. economy will be allowed to provide the jobs and standards of living to which all Americans aspire.

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Senator D'AMATO. Thank you very much, Professor.

This past week the Senate has adopted a so-called all-savers certificate. I have my own doubts about who it's going to save. The premise upon which this legislation was passed, maybe coerced the Senate into voting for, was that it would do two things—act as a safety valve, so to speak, to give some relief for homebuilders as it was targeted 75 percent of the excess proceeds are derived from the institutions that avail themselves of it for homebuilding, home loans; and second, that it would indeed help the thrifts and the savings and loans.

My question is, do you believe this is the answer that is going to help the savings and loans or is it merely some propaganda?

Second, what about the fact that in 15 months it is destined to expire? Aren't we indeed encouraging the thrifts then to engage in a policy of short-term borrowing for long-term purposes. Doesn't that defeat the goal and are we really saying that we're going to make this all-savers certificate a less than temporary thing but will we now then be faced 15 months hence with the situation where the same institutions that call for the short-term solution will now say they need an extension because after all they have made hundreds of millions of dollars worth of loans predicated on these certificates.

IMPACT OF ALL-SAVERS PROVISION

Mr. WEIDENBAUM. Mr. Chairman, I think the all-savers provision will help homebuilders and the thrifts. The real question is how much, and I can't give you a specific answer.

I will be frank. I have never supported that provision, but at this stage it's part of a tax bill which I think, on balance, will do a great deal of good. That is, the bipartisan tax bill supported by the President. And I accept the various provisions of the bill because, on balance, I think that bill is a powerful bill, a very important bill, and it's basic to my forecast of a strong 1982. But the all-savers provision expires in 15 months— I won't shed tears when it expires, very frankly, but I will note that the version of Senator Schmitt's more generalized incentive to save will be phased in on a permanent basis. I think that's a very constructive provision.

Senator D'AMATO. Let me ask about this part of the all-savers provision. As you know, there is a $400 exemption for interest earned in effect for this year, $400 on a joint return.

Mr. WEIDENBAUM. Interest and dividends, yes.

Senator D'AMATO. Interest and dividends. That has been wiped out as far as interest is concerned and $200 has been retained in terms of dividends. Haven't we, in essence, as a result of the all-savers provision, taken away the ability of those people who are under the 30-percent tax bracket to have part of that interest income and to encourage interest savings, wipe that out and given it to those people who are over the 30-percent tax bracket?

Mr. WEIDENBAUM. It would appear that the Senator has described the general effect of that change.

Senator D'AMATO. So we have taken $900 million that would have gone in tax relief for people under the 30-percent tax bracket, a family of four—by the way, that's about $26,000 a year, an individual about $21,000—and the little help that someone in the

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25-percent tax bracket with $400 in interest income, that's $100 they would have not had to pay, they are now going to pay that $100 and someone in the 40-percent tax bracket is going to get this wonderful interest saver, that all-cash saver, and, of course, that is a $2.1 billion that we're talking about all savers, $900 million comes from who I might call the little guy—we have just taken that out and it seems to me that is one of the most insidious forms of transferring wealth—I have always complained about taking from the upper and then income distribution. Here's income distribution taken from the smaller segment and bringing it up to people over the 30-percent tax bracket. How do we justify that?

Mr. WEIDENBAUM. Here's how I justify it.

Senator D'AMATO. Maybe you shouldn't. How can you justify a political action that I can't believe in good conscience an economist like yourself would have made? I don't believe you would have made that recommendation.

Mr. WEIDENBAUM. As I said a moment ago, I have never supported that provision.

Senator D'AMATO. Not particularly all savers. Don't tell me you support that.

Mr. WEIDENBAUM. I've never supported that provision.

Senator D'AMATO. Thank God. Thank God.

Mr. WEIDENBAUM. However, Mr. Chairman, beginning with my years at the Treasury, I've learned that we rarely see from the Congress a simple major tax bill. In reality, when the inevitable legislative process is underway—what starts off as a simple tax bill inevitably becomes complicated. When I have to make a judgment, what I have to do is look at the total effect—because in my calculations more than four-fifths of the revenue effect of the tax bill are from the initial recommendations—that is, straight across-the-board reduction in personal tax rates and the 10-5-3—I did this for 1981-86. About one-fifth is for all of the additions after those two, and the bulk of that one-fifth is for dealing with marriage tax penalty and the indexing.

So that the various esoteric special provisions that have been added to the tax bill really represent in reality a very small portion of the total tax bill. That's why I'm such a strong supporter of the tax bill.

TAX PLAN CALLED DISCRIMINATORY

Senator D'AMATO. I support the President's basic tax plan, but I can't, for the life of me, understand the justification that says that because 80 percent is good, we're going to buy a part that is clearly discriminatory to those people who are under the 30-percent tax bracket—not only discriminatory, it is literally robbing them. It's taking from these people and giving to the people in the high-tax brackets. I'm saddened, absolutely saddened, by that. I don't think we understood what we were doing and I think it is a deplorable, shocking kind of income distribution of the worst kind.

There may be some arguments that could be utilized that we should take those that can afford to give to down below, but I can't buy the argument that we should take from somebody in the 20-percent bracket and make available his dollars to somebody in the 40-percent tax bracket. Excuse me for my depth of feeling that I

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express to you, but I'll tell you one thing, I'm introducing legislation—and we would have had it on the floor yesterday but the chairman of the Senate Finance Committee indicated to me he would work with us in attempting to adjust what I consider to be an absolutely deplorable piece of legislation in terms of this respect. If you want to keep all savers, keep it; but don't do it at the expense of people who don't know what happened or who didn't have lobbyists arguing for them, and when they find out, I would suggest to you that the Reagan administration and its policies are going to be in for a thrashing. People are going to say, "Why did you do this?" I just think it's wrong. It's counterproductive to all the good things needed to do the things we have achieved that I have supported and many Democrats have supported in addition. I just don't understand this kow-towing to something in that version. It doesn't make sense and it's counterproductive.

Senator Proxmire has some questions. I'd like to later on address one or two other things, but I understand Senator Proxmire has a list. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Weidenbaum, I'm glad to have you back before the committee. As I said informally to you up here when you were qualified as the Chairman of the Council of Economic Advisers, we have known of your very, very fine work over the years.

On page 2 of your prepared statement you say, "Perhaps the most heartening development over the past several months has been a moderation in inflationary pressures."

What contribution, if any, did governmental policies play to that moderation in inflationary pressures? Weren't most of them inflationary pressures that were eased that had nothing whatever to do with our policies? Two areas where you got the principal relief were: One, energy, because of a worldwide oil glut; and, two, food; and of course in the short term and even the long term governmental policies don't have much effect there. Weather has a far greater effect.

Mr. WEIDENBAUM. First of all, on energy, I think the early decontrol of gasoline prices by President Reagan had an important effect. Initially, as you recall, prices rose.

Senator PROXMIRE. That quickly? No lag?

Mr. WEIDENBAUM. There was no lag. Initially prices rose to world market conditions, but as we said at the time we announced decontrol, painful as those price increases would be, there would be a major spur to conservation and that has occurred. Our imports of oil have come down substantially. The soft economy, frankly, has been another supporting factor for the oil-price declines.

Senator PROXMIRE. But the long-term increase, the quadrupling and quintupling of oil prices, certainly overwhelmed that deregulation that President Reagan put into effect so recently as far as conservation is concerned.

Mr. WEIDENBAUM. I think both are genuine factors.

In terms of the good performance on food prices, I would say that the good Lord has smiled on the American people since Ronald Reagan took office. [Laughter.]

I really don't think we can claim special credit.

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Senator PROXMIRE. Well, he smiled on some of them. I'm not too sure he smiled on the home builders and the auto dealers and the auto workers and so many other people that are singing the blues now.

I have some marvelous statistics here today comparing 1950 with 1981, and the unemployment rate was about 30 percent less than it is now; the prime rate was 2.09 percent; the Treasury bill rate was 1.2 percent; the mortgage rate was 4.5 percent. I must say that the situation hasn't improved very much.

Then later on page 2 you say, "the maintenance of restraint is absolutely necessary if this trend is to continue in the months and years ahead."

I'm not sure what restraint you're talking about. We certainly don't have much in the way of fiscal restraint. We're going to have a budget deficit this year of almost $60 billion. The Congressional Budget Office, which is somewhat more objective than any administration is likely to be, projects a budget deficit next year of about the same and the following year about the same and in 1984 about the same. Furthermore, we are now indexing the income tax as of 1984-85 I guess it is, and we are going to have an enormous increase in defense spending over the years which is particularly going to be high in the outyears, and that, I submit, is the reason why interest rates are so high.

I think the people in Wall Street are very smart. I think they can see these things and they can see nothing in the future but steady deficits, at least at the rate we are suffering now. Where's the restraint?

Mr. WEIDENBAUM. First of all, the restraint is the monetary restraint that I have documented in my testimony. I point out that the rate of growth in the money supply has been cut by about one-half from the unsustainable rapid rate in the second half of 1980 and, of course, with the Congress and the administration working together in an unparalled effort to restrain Government spending, it is our expectation to steadily reduce the deficit.

Senator PROXMIRE. Haven't we just shifted that? Haven't we shifted the spending from the domestic to the military and then aggravated the situation as far as Federal borrowing is concerned in the enormous tax reduction?

Mr. WEIDENBAUM. No, sir. The cuts in civilian spending offset several times the increase in defense spending. In fact, allow me to lay to rest the concern about the lack of restraint in the budget. You might call the numbers I have here quoting the devil to prove scripture, but I have asked the staff of the Council of Economic Advisers to estimate the so-called high employment budget my Keynesian predecessors developed as a measure of fiscal restraint or fiscal stimulus.

Now I don't claim credit for this concept, but this is the standard conventional measure of fiscal restraint used by my distinguished Democratic and liberal predecessors.

Senator PROXMIRE. That doesn't make it right.

Mr. WEIDENBAUM. Well, perhaps it doesn't make it wrong.

Senator PROXMIRE. Maybe it does.

Mr. WEIDENBAUM. We'll see. Let me give you the numbers. In the calendar year 1980—and we cannot take either blame or credit for

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1980—the so-called high employment budget showed a deficit of $18.3 billion. In calendar 1981, on the basis of our program, we estimate a swing to a $22.8 billion high employment budget surplus, a larger surplus in 1982; but between 1980 and 1981, we have a $40 billion swing in the so-called high-employment budget from an $18 billion deficit to almost a $23 billion surplus.

Senator PROXMIRE. You know, we haven't heard very much about that high employment theory. We had it for a long time. People have dropped it, and certainly when you're talking about interest rates and you're talking about monetary policy, we could have surpluses forever and you would still have actual deficits in which the Federal Government is out in the credit market with a national debt that's rushing toward a trillion dollars, and an average maturity of less than a year borrowing that trillion dollars over and over again, and driving interest rates right up through the roof, no matter what you say about a theory that if we had full employment we would have a surplus.

Mr. WEIDENBAUM. Of course, I do not subscribe to the Keynesian heresy, so I don't endorse these things, but I call it to your attention. I do say this administration is committed in the most serious, conscientious way to steadily reduce the budget deficit. That's our determination.

INCREASING WAGES PUSH PRICES UP

Senator PROXMIRE. Now the administration has walked away from any jawboning of wages and prices and you led the cry on that and you indicate that you think that what many people feel is the underlying inflation force—that is the increasing wages and pushing up prices—that that's going to be taken care of, as you say on page 3 in the third paragraph, you say, "Firms which incur unrealistically high wage bills which cannot be passed on in the form of higher product prices will see their profitability erode."

That doesn't have much to do with the real world as far as coal is concerned, and oil and steel and the construction industry. What happens, as you know, as you have very powerful unions, you have unions that are industrywide, and they increase their wages and it's passed on. The automobile industry is continuing to increase the price of their automobiles. The steel industry is doing the same thing and the same thing is true in construction. Housing prices are up.

Mr. WEIDENBAUM. To answer the first part of your question, Senator, it's my understanding that wrong monetary and fiscal policy are the basic source of inflation, not private wage and price decisions.

I did point out in the statement that in this kind of environment those companies and those unions who don't make wage and price decisions in accord with market forces are going to feel the effects of those market forces. It isn't surprising to me that some of those industries where cost structures are way out of line have shown losses of sales and have had to lay off a lot of their workers.

Senator PROXMIRE. What are they doing? Automobile prices aren't coming down. They're going up. The same thing is true in these other areas. Housing prices aren't dropping. Housing prices are continuing to accelerate.

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Mr. WEIDENBAUM. I think you will find that as companies see there's a new economic environment, a less inflationary economic environment, in which it will be harder to pass on those price increases, that the market pressures will induce them to make more realistic decisions, both on the bargaining table and in their own cost decisionmaking.

Senator PROXMIRE. Mr. Chairman, you come up here and you make very logical and impressive arguments.

Mr. WEIDENBAUM. Thank you.

Senator PROXMIRE. And fine statements. And yet the Congress of the United States, the Senate of the United States, passes by 100 to nothing a resolution which I showed you earlier which reflects the kind of pressures we get when we go home and we talk to our auto dealers and our homebuilders and our families that want to go and buy a home and can't afford them because interest rates are so cruelly high, and we passed this resolution, as I say, 100 to nothing. It was a Chiles resolution passed yesterday and it says, in part:

The President should adopt policies to assure the continued financial health of credit to small business, thrift institutions, small farms, residential construction and not-for-profit institutions.

As the principal economic adviser to the President, how would you comply with that overwhelming unanimous 100 to nothing sense of the Senate resolution?

Mr. WEIDENBAUM. I take the concern of the Senate very seriously, and surely it reflects the concern that we all share about the high interest rates that are truly hurting so much of our economy. The serious question—and I only glanced at the statement so I can't say I read it all—the serious question may not have been addressed in that statement and that is, how can you responsibly, effectively get down those interest rates without stirring up another round of double digit inflation which would only get us back to even higher interest rates? That's the serious question.

Senator PROXMIRE. Well, my time is up, Mr. Chairman, but you're absolutely 100-percent right on that, but I think that's the problem we have to face. How are we going to meet the very, very real terrible problems of our constituents who say, "Give us all the theory you want to about how you can't get it down unless you continue a tough monetary policy, but that's going to kill us. We're going to be dead in a year or two, out of business."

Mr. WEIDENBAUM. If the high interest rates stay high—and, very frankly, it's my understanding that the financial markets don't yet believe that the Congress and the President and the Federal Reserve are going to stay on course——

Senator D'AMATO. Why should they believe that, Mr. Chairman?

Mr. WEIDENBAUM. Well, in the past, there was good reason for skepticism because in the past administrations did lose their nerve. This administration is determined to follow the policies we have laid out so carefully because we think it is the only way of getting inflation and interest rates down in the way that they will stay down.

I assure you that it took not years but decades for this economy to get into the mess that it now is in, and quite clearly there's no way of curing the economic ills in a matter of months. We do have to speak realistically to the American people. I'll do the best I can.

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Senator D'AMATO. Senator Dixon.

Senator DIXON. Thank you, Mr. Chairman, and may I share my colleague's, Senator Proxmire's, delight in seeing you again, Mr. Chairman. Your appearances here before have been greatly appreciated. We share a love for Washington University, Mr. Chairman, in St. Louis.

Mr. WEIDENBAUM. The Senator is a distinguished alumnus of the Washington University Law School, I'm proud to note.

Senator DIXON. Thank you.

May I pursue with you a moment the things that Senator Proxmire was talking about in connection with these high interest rates that persist, and I note in your statement on page 8 that you have little doubt that we should begin to see in the near future a substantial reduction in those rates.

Don't you think that there is a probability that the financial community continues to be concerned about the outyears so far as the reduction of budget deficit is concerned and so far as bringing all of the things into line that the President has suggested will begin to take place beginning about 1983?

Mr. WEIDENBAUM. Yes, Senator Dixon. I think that's a very legitimate concern and my response to them and to the committee is that the President, from his first week in office, has set in motion the most comprehensive, continuing effort at budget restraint. It's an ongoing effort. The recommendations of the budget cuts, slowing down growth in and spending that the President has submitted to Congress are only the start. We continue to devote a major share of our time and effort and energy to developing further economies and efficiencies in government.

ADMINISTRATION'S PROJECTIONS FOR 1983

Senator DIXON. I wonder if you would share with us once again what the administration's own projections for targets are in 1983 with respect to inflation, interest rates, and the budgetary deficit.

Mr. WEIDENBAUM. In 1981, we estimate a current year real growth of 2.6 percent. In 1982, real growth of 3.4 percent. By the way, I made a calculation last night comparing these numbers with the Blue Chip Economic Indicators, which is a monthly report of what experienced, outstanding private forecasters are telling their managements.

Compared to our 2.6-percent real growth for 1981, blue chip indicators shows precisely 2.6-percent growth for 1981. In 1982, we estimate 3.4 percent. They estimate 3.2 percent, quite close. For the GNP deflator, our most comprehensive measure of inflation, we say 9.6 percent in 1981. They think it will be a little better, 9.3 percent. In 1982, we say 8 percent. They say 8.2 percent. Unemployment rate, our estimate is 7.5 percent for this year, down in 1982 to 7.3 percent.

In terms of the budget, our estimates of the deficit, our current estimate is for fiscal 1981 $55.6 billion. We have it going down next year, fiscal 1982, to $42.5.

Senator DIXON. What is the deficit for 1983?

Mr. WEIDENBAUM. In 1983, $22.9.

Senator DIXON. $23 billion. That's what I understood it to be.

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Mr. WEIDENBAUM. And a balanced budget in 1984 and surpluses in 1985 and 1986.

Senator DIXON. What was the inflation rate anticipated to be in 1983 in the President's figures?

Mr. WEIDENBAUM. The inflation rate, the GNP deflator in 1983, 7 percent, but the CPI, 5.7 percent. It will fall.

Senator DIXON. In the interest rate, what do you anticipate it to be in 1983?

Mr. WEIDENBAUM. The 91-day Treasury bill, 7.5 percent.

Senator DIXON. And is it your firm opinion, to the best of your ability to prognisticate on matters of that kind, Mr. Chairman, that will be the approximate figures in that year?

Mr. WEIDENBAUM. Very frankly, Senator Dixon, nobody can guarantee it. These are our best judgments providing that the policies we recommend are enacted.

FINANCIAL COMMUNITY SKEPTICAL

Senator DIXON. Isn't it a fact that the financial community has some serious doubts about those figures and that some of the underlying conditions that are contributing to these high interest rates that persist against what we have all seen as a market drop in the inflation rate is the fact that there's a lack of confidence in the financial community about those figures?

Mr. WEIDENBAUM. Well, it's several things. First of all, there is skepticism, as I sense it, that we will continue with these policies. Frankly, there's no amount of eloquence that I can provide to convince the markets. I think the act of continuing the policies, of staying on course, is what will convince the markets as inflation continues to come down. That is what is going to turn around and improve inflationary expectations, not any number of lectures from any economist.

In terms of getting those budget deficits down, that will take a joint effort of the Congress and the administration, but I have been spending a bit of time overseas dealing with our foreign friends and allies. The thing that impressed me there is some of the countries like West Germany that have a much slower inflation rate than we do have a much larger deficit in relation to their GNP than we do. So deficits are important, but I wouldn't focus exclusively on the deficit as the factor in inflation or high interest rates. I think you're back to monetary policy as a very key determinant there, but it's not an either/or. You have to look at both.

Senator DIXON. I think I share your views in that respect. I think it might be a little contrary to the teachings of the administration during the last campaign, some of those things you said about the deficits, but certainly in the case of Japan and Germany they are cases in point in that regard.

Hasn't it been suggested, Mr. Chairman, that the administration feels we should have another round of budget cuts after these budget cuts are in place and the tax bill has been passed?

Mr. WEIDENBAUM. Oh, yes, indeed. In fact, we have lines in the budget for future savings and, as I say, it isn't a question of one round or two rounds. The efforts to come up with budget savings and economies and efficiencies in Government is an ongoing mandate from the President for the entire administration.

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Senator DIXON. Well, someone suggested figures in the area of $40 billion. Is that a possibility that those figures are entertained by the administration?

Mr. WEIDENBAUM. Well, I really wouldn't focus on any one number for a very basic simple reason. We need more savings even should we accomplish $40 billion. I, for one, won't sit back on any laurels. I think we still have more to accomplish. I think the inflationary pressures, the pressures for new and increased Government programs, are always with us and the only way—this has been my observation in many years of working in Government budgeting—the only way to keep the budget under control after you get it under control is to have an ongoing program of budget restraint. You just can't stop at any one number.

Senator DIXON. Given, No. 1, the cuts which have occurred totaling approximately $35 billion now that the reconciliation process is pretty well complete, given the commitment of the administration to the improvement of our military posture and our defense system in the country, given the revenue excesses of the tax bill which both parties are guilty of—nobody here is directing the blame entirely at the administration, but I think you and I would agree there are some excesses in that bill unanticipated by the administration initially in what occurred. Wouldn't you say that right now Wall Street has some reason to be concerned and the financial community has some reason to be concerned about meeting those commitments that are suggested in the administration's plan for the next several years?

Mr. WEIDENBAUM. On that score, frankly, I think not. If there's anything this administration has shown, it's its ability to translate rhetoric into action. We took office promising large budget cuts and we have delivered, with the help of the Congress. It's been a true bipartisan effort. But if there's anything we have shown—and the financial markets I believe eventually will come to appreciate—it's that this administration is succeeding in slowing down and fundamentally altering the path of Government spending.

Senator DIXON. Could you quickly suggest two or three things, if you're at liberty to do so, that the administration has talked about with respect to anticipated further cuts that have been discussed within the administration?

Mr. WEIDENBAUM. Well, to give a good picture, let me say that in the deliberations I have participated in, no program has been off limits. So I don't want to finger or target any one part of the budget for fear that you will think that other parts are sacrosanct. We are continually reviewing every aspect of the budget to see how we can accomplish the objectives given by the Congress and the executive branch. This review takes place across the board, including the military.

Senator DIXON. Thank you, Mr. Chairman.

PROBLEMS OF THRIFT INSTITUTIONS

Senator D'AMATO. Mr. Chairman, one of the areas of deep concern to I think the financial community and to this administration should be the problems that many of the thrifts face, particularly in my State. In our State, New York, we talk about the administration dealing with these problems up front. I don't believe that we

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have even begun to look at the consequences to the savings and loans, the thrift industry, and the unraveling that may take place if we continue a policy of laissez faire or what will be will be. I think we call it the que sera theory, monetary theory, as being evidenced.

Now the Federal Home Loan Bank Board has asked for various regulatory authority and we haven't seen the administration support that. Is it the policy of this administration to say let those thrifts fail that can't make it in today's economic situation? Because it seems to be that we are taking a deliberate attitude and policy that says just that.

Mr. WEIDENBAUM. We have in the administration spent many days over a long period of time closely monitoring and considering policies toward the thrift institutions. We are working with the regulatory agencies in developing legislation to strengthen the financial safety net, so to speak, for our thrift institutions. It is important we have a financial safety net, the FDIC, the Federal Home Loan Bank System, as well as the counterpart for the Federal credit unions, to guarantee the safety of insured deposits as well as the strength of these institutions.

We do not take an unsympathetic attitude toward the thrift industry—I'm an individual who still has substantial accounts in his local savings and loan association.

Senator D'AMATO. Let me suggest that a major institution turns in its charter. Let me suggest that you may be aware of some of them who are contemplating that action. I'm talking about a substantial group. Why? The board of directors of that institution, while it's in a position where it still has some capital, says, why should we risk our net worth as individuals; why should we take on this responsibility; and therefore, it tenders back or gives back its charter to the Feds and says, "Here, you run the bank."

What do you think the effect will be on those institutions who are solvent, who may be having some problems? Don't you anticipate a run on those banks as well when they hear one bank begin to do that and when they hear some of the smaller banks begin to do that?

Mr. WEIDENBAUM. No, sir. I think the financial institutions, commercial banks, savings and loans, and mutual savings banks are fundamentally sound. It has been my experience that in every industry in this country, including the thrift industry, you have some companies, some institutions, that do very well and some that do very poorly; and, yes, it's true that in every industry from time to time companies, institutions, do go out of business, do merge, but the overall——

Senator D'AMATO. Who's going to take over a Dime Savings Bank, a Westside Federal, a $2.5 billion institution that has maybe $30 million in losses now? Who's going to take them over?

Mr. WEIDENBAUM. First of all, despite some of the cries of alarm, I notice that in June federally insured savings and loan associations had a net deposit gain.

Senator D'AMATO. Where is that?

Mr. WEIDENBAUM. Total S. & L.'s.

Senator D'AMATO. What about in New York?

Mr. WEIDENBAUM. I don't have a breakdown by State.

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Senator D'AMATO. If you took a breakdown in New York and just looked at New York, you would have more banks that had a net revenue loss than a gain; isn't that correct?

Mr. WEIDENBAUM. I just don't know.

Senator D'AMATO. If one of those banks loses capital, that's also the ability to earn. If it loses $30 million, that's also $30 million it can't put out in the market, can it?

Mr. WEIDENBAUM. It's my expectation that the decline in interest rates will do more to strengthen the thrift institutions than any other combination of measures.

Senator D'AMATO. We don't see that on the horizon.

Mr. WEIDENBAUM. It's our projection in our midyear review which we released and which I summarized in my statement, but as I said, I think we need to understand there is an important financial safety net and that the administration has been in touch with the regulators who, to my knowledge, are developing legislation which will be——

Senator D'AMATO. FSLIC has about how much in assets, $6 billion?

Mr. WEIDENBAUM. That is approximate, I believe.

Senator D'AMATO. And if it were to attempt to back up—if you had some failures that had to liquidate, what would it have in ready assets?

Mr. WEIDENBAUM. It would have, first of all, that financial safety net, of course, which also includes pipelines to the Treasury and the Federal Reserve System which is why I say I do not see a cumulative——

Senator D'AMATO. Why not buy out some of the lower interest rate mortgages for those banks, for the banks who have done a good job and now face capital losses and come down to a point where we would consider it to be dangerously low, and give them an opportunity so when interest rates do come down they can perform their function? If we don't do that, what's the alternative going to be?

Mr. WEIDENBAUM. Well, I'll call a spade a spade and a subsidy a subsidy, and buying those low-interest mortgages at anything like book asset value is a subsidy because the market asset value is often a small fraction of the book asset value. What worries me is that——

Senator D'AMATO. You know what worries me? What worries me is we have become so doctrinaire and we believe that maybe it's rhetoric that as people are drowning we're saying, "Oh, you'll come up for the third time. You've got the strength to make it. We know you do." And I believe that there are many of those thrifts in New York who don't have—I can't speak for other areas of the country—who don't have that kind of strength, and I'm wondering whether or not we're going to be engaged in a much more costly process and what the effects may be overall, not only to the thrifts but to our economy, to the economic system, if they begin to take place—the kind of things that some people—they may be crying wolf, but I certainly don't think we address the problem of the thrifts correctly by passing what I consider to be just an absolutely abhorring bill, the all-savers bill, and I just can't, for the life of me, when we gave $2.1 billion away, see a more politically expedient

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pap and nonsense that this administration has succumbed to, and I'm upset about that and I'm upset on the other hand by our lack of any definitive program to deal with the problems of the thrifts. It's not enough to simply say when interest rates come down they will be in better shape. Interest rates aren't moving down and will not move down quickly enough to put some of these institutions in a position where they can carry on. If they can't, where are we going to be then?

Mr. WEIDENBAUM. We have been monitoring the thrifts since we took office and, very frankly, the concerns are real, but I can't honestly say that the forecasts of the thrifts going down the tube have been any more accurate than other economic forecasts. I'm pleased to note that the great bulk of the thrift industry is weathering these difficult times. That's why I call the chairman's attention to this report for the month of June. The deposits are still rising.

Senator D'AMATO. We're going to take a brief 5-minute recess so we can make a rollcall vote and then we will resume.

[Recess.]

Senator PROXMIRE. The committee will come to order.

A TRILLION DOLLAR DEFICIT

Mr. Chairman, last year the budget deficit absorbed 17 cents of every new dollar saved. The off-budget borrowing absorbed another 17 cents. So that almost more than one-third of all the new savings went to the Federal Government in one way or another.

Obviously, there was some crowding out and obviously that's one of the reasons for the high rate of interest.

Would the Reagan administration oppose increasing the debt ceiling to $1 trillion? We're at $985 billion under the present limitation. We may have to come in for another increase in a couple months. What do you expect the administration to do? Will they ask for $1 trillion or more?

Mr. WEIDENBAUM. We're not in a position at this point and certainly won't be in a position until after the tax bill to make the calculation which would lead us to making a proposal on the debt limit.

As we have discussed in that past, the debt ceiling reflects the past actions by the Congress on both the tax side and the expenditure side, but if the chairman is truly concerned about keeping the public debt low, I urge you to redouble your efforts to achieve economies in Government spending.

Senator PROXMIRE. What more can I do, Mr. Chairman? In 1979, I put in an amendment that would balance the budget in 1980. I got 26 votes for it. I put in the same amendment in 1980 for 1981 and I got 20 votes. I put in the same amendment in 1981 for 1982 and got 13 votes. Three Republicans supported that. The administration walked away from it.

Let me just point this out. The administration says that we are not going to balance the budget in 1982 or 1983, not until 1984. It reminds me of a man who's suffering from alcholism. He goes in and sees the doctor. The doctor says, "You're ruining your life. You're ruining your health. You're ruining your family. You're going to lose your job." And the man looks up at him and says,

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"Doc, I'm convinced I'm never going to have another drink after 1984."

You wouldn't believe a fellow like that, and after the experience we had with the Carter administration—they said the same thing in 1980 they were going to balance the budget. They didn't do it.

Mr. WEIDENBAUM. It really reminds me of a man with a temperature of 104 who's looking at the doctor who will give him the pill that will get him back to normal in 24 hours. I think the pill would kill the patient, rather than cure him. It would take time to reduce the temperature, the fever, and that's precisely the situation we face.

SACRED COWS

Senator PROXMIRE. Well, let me give you an example of what the administration could do. The CQ this last issue has a list of sacred cows, the main invincible programs again spared the budget axe. I submit after this cut——

Mr. WEIDENBAUM. Are dairy price supports there?

Senator PROXMIRE. No, no. They are no longer a sacred cow. They should have been but they weren't.

Mr. WEIDENBAUM. I'm glad to hear the Senator from Wisconsin saying that.

Senator PROXMIRE. Of course, the administration really got the poor dairy farmer in our State. It may be politically good for some of us, but it's bad medicine for our farmers.

Let me tell you what are sacred cows here—Clinch River breeder reactor, Export-Import Bank——

Mr. WEIDENBAUM. We tried to cut that one.

Senator PROXMIRE. Some of these you were for cutting, but you couldn't win.

Mr. WEIDENBAUM. In the Congress.

Senator PROXMIRE. A substantial majority of the Republicans as well as Democrats opposed you on these things, 87A attack airplane, Public Health Service hospitals, Amtrak passenger trains, Head Start program, peanut allotment. You have a majority in the Senate and you couldn't make any progress on those. So the notion that you're going to make further cuts—that reads well and that's nice rhetoric, but it's hard to believe in view of the fact that you couldn't make these cuts that you recommended this year because, as this article points out so well, you ran into certain awfully tough lobbying, and I think you have the soft touches already.

Mr. WEIDENBAUM. It's our expectation that the battle to restrain Government spending is in high gear and will stay in high gear. I think the most convincing explanation I can give you is the reality. We have recommended, and the Congress is in the process of carrying out, the largest program of budget cuts in modern times.

Senator PROXMIRE. You certainly have, and I respect you for it. I have supported every one of those cuts. I've tried to go deeper on them. You're right in doing it, but it just isn't enough.

Mr. WEIDENBAUM. And we will do more in 1982. We will do even more in 1983 and 1984.

Senator PROXMIRE. When you put together the fact that you do have substantial cuts, $37 or $38 billion, in domestic cuts, but you have substantial increases in military programs and big tax reduc-

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tions so that the net effect—the net result, according to a dispassionate observer like the Congressional Budget Office, is that you're going to have continued deficits of just about the present level for the next 4 years, including 1984.

Mr. WEIDENBAUM. Dispassionate is in the eyes of the beholder, I assume.

Senator PROXMIRE. But they're both Republican and Democrat.

Mr. WEIDENBAUM. I say the budget cuts match the tax cuts. The net budget cuts match the tax cuts.

Senator PROXMIRE. Well, then, you have made no progress at all, if that's all you do.

Mr. WEIDENBAUM. And the economic growth brings in the added revenues which will get us toward a balanced budget.

Senator PROXMIRE. Well, you make awfully cheery assumptions on the economic growth.

Mr. WEIDENBAUM. No, sir. As I demonstrate in my testimony, our forecasts for 1981 and 1982 are very similar to the prevailing forecasts of the private sector.

Senator PROXMIRE. Would you give me the arithmetic that shows that the net budget cuts, including the increase in military spending, match the tax cuts for 1982, 1983 and 1984 and afterward?

Mr. WEIDENBAUM. I'll be pleased to supply that for the record, including the off-budget reductions which, of course, count dollar for dollar in Treasury-financed——

Senator PROXMIRE. Including the indexing of the income tax which is going to be in the hundreds of billions of dollars over the years?

Mr. WEIDENBAUM. I'll be pleased to submit all that for the record.

[The information referred to follows:]

RESPONSE TO SENATOR PROXMIRE'S REQUEST FOR INFORMATION

The accompanying table provides a comparison of estimated budget cuts, including the proposed increase in military spending, and tax cuts that you requested when I testified before the Senate Banking Committee on July 29, 1981.

The budget cuts include on- and off-budget spending. The on-budget figures represent the difference between the outlay projections in the Mid-Session Review and the February 18 current policy base line, updated for changes in economic assumptions between the March budget and the Mid-Session Review. (The February 18 base line assumes current services levels for nondefense programs and Carter budget amounts for defense purchases and foreign aid.) The off-budget cuts reflect policy changes between the January and March budgets. The reductions in revenues include the tax cuts enacted in the Economic Recovery Tax Act of 1981 as well as other minor changes in receipts proposed by the Administration in its budget.

The figures in the table indicate that in the two budgets where the Administration has actually submitted proposals to Congress—budgets for fiscal years 1981 and 1982—the net spending reductions offset the tax cuts—$40 billion to $38 billion. In addition, reductions in the credit budget will further reduce the Federal government's claim on economic resources. (The credit budget overlaps to some extent with budget outlays so savings in the credit budget cannot simply be added onto the outlay savings.) Therefore, in fiscal years 1981 and 1982, the Administration's economic program represents a reduction in the demands that the Federal government makes on the Nation's financial markets.

For 1983 and future years, the Administration is currently in the process of developing budget cut proposals in addition to those contained in the budget reports on March 10 and July 15. Under the circumstances I am not in a position to provide you with complete details. However, the President has repeated his intent to steadily reduct the budget deficit and to achieve a balance budget in the fiscal year 1984.

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REDUCTIONS IN OUTLAYS, BUDGET RECEIPTS AND CREDIT BUDGET TOTALS

[In billions of dollars]

	Fiscal year—	
	1981	1982
Outlays—Total	2	38
On-budget [1]	2	34
Off-budget [2]	(*)	5
Receipts—Total	2	36
Tax Act of 1981 [3]	2	37
Other changes (increases) [4]	0	−1
Credit budget totals [5]	7	10

[1] Reductions in on-budget outlays are the difference between the Administration's outlay estimates reported in the Mid-Session Review and the February 18 current policy base, adjusted for changes in economic assumptions between the March budget and the Mid-Session Review. The February 18 base assumes current services levels for non-defense programs and Carter budget amounts for defense purchases ands foreign aid.
[2] Off-budget outlay reductions resulting from policy changes, reported in the March Budget Revisions.
[3] Revenue impact estimated by Treasury, Office of Tax Analysis.
[4] Mid-Session Review.
[5] Mid-Session Review versus January budget levels.

*NOTE: Components may not add to totals because of rounding.

ECONOMIC RECOVERY PROGRAM

Senator PROXMIRE. Now, as I said earlier, I think the policies followed by Mr. Volcker are certainly logical. They have the lovely beauty of arithmetic on our side where we can see that if you hold down the rate of increase in the supply of money there will be less money and money will increase in value, which is another way of saying prices will have to fall.

On the other hand, that's in the long run. In the short run, you have people out there—homebuilders and auto dealers—who are dying. High interest rates are killing housing and autos. Isn't there anything we can do to help industries like this, who through no fault of their own, are suffering so tragically?

Mr. WEIDENBAUM. Yes, sir; and precisely, the Reagan economic recovery program is designed to achieve that economic growth in a less inflationary environment which will provide the basic economic environment for the expansion of homebuilding and of autos and other industries, but in a competitive environment without guaranteeing any of them a share of the national income. They will have to compete for it.

Senator PROXMIRE. Well, in other words, you're not really going to do anything for them. You're just going to let them go.

Mr. WEIDENBAUM. No, sir. It's our expectation that our program will strengthen the American economy.

Senator PROXMIRE. Sure. Well, I think in the long run that may well be true. As I say, I think it's a logical plan. I'm just wondering if there's anything we can do in the meantime.

Mr. WEIDENBAUM. There are a lot of things that I think Congress can avoid doing. The most important is trying to avoid bailing out and avoid signaling the willingness to bail out industries that don't meet the marketplace.

Senator PROXMIRE. That's what the Chiles resolution which passed 100 to nothing really meant.

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Mr. WEIDENBAUM. The Chiles resolution?

Senator PROXMIRE. The one I showed you. The one that says the President should adopt policies to assure the continued financial health of credit to small business, thrift institutions, small farms, residential construction, and so forth.

Mr. WEIDENBAUM. Senator, I think we both have learned over the years that ambitions preambles do not get us far in terms of achieving serious objectives.

Senator PROXMIRE. I'm not talking about ambitious preambles. I'm talking about a resolution that passed the Senate unanimously and called on the President to adopt particular policies.

Mr. WEIDENBAUM. If it's in terms of credit allocation, it's counterproductive, in my judgment.

Senator PROXMIRE. Well, nevertheless, it is an action of the Senate unanimously. Every one of the 53 Republicans voted for it, as well as all the Democrats.

ANTITRUST POLICY

The final question is this—final area that I want to ask maybe one or two questions about. You and I have discussed antitrust policy. Since you were last here, the Antitrust Division seems to have sent a strong signal to big business that the megamergers and concentrations would be looked at favorably by the Reagan administration. Add to this the attempt to gut antitrust by the FTC and the most recent revelation in the paper this morning, the Post, which reads as follows:

> In a letter signed by Acting FTC Chairman David Clanton, a Republican, and endorsed by the entire commission, the commission charged that the Justice Department's Antitrust Division is seeking to use the *Conoco* case as a means to provide signals to the public about the Reagan administration's merger policy.

Then it goes on to say:

> After the department withdrew its grant of clearance, and during discussions concerning which agency should review DuPont's proposed acquisition of Conoco, the commission's representatives consistently emphasized the agency's very considerable expertise with respect to the companies involved and the markets about which antitrust issues might arise.

Mr. Clanton went on to say

> The initial and principal in the department's presentation was a different consideration—namely, the department's desire to use this matter as a means to articulate certain of its general enforcement intentions for large mergers.

The question is, the FTC is expert, particularly in this case. They are familiar with this case. They know this case. They are highly competent in the antitrust area. And yet the Justice Department would take away from them the opportunity to act with respect to Conoco.

Mr. WEIDENBAUM. I have no judgment on the specific case. I will tell you my general concern on the antitrust matters, and that is, we are witnessing a period in which American corporations are losing their position in world markets and increasingly American corporations are competing against foreign companies both at home and abroad. I think the traditional and now outworn way of looking at market concentration—just looking at American companies and American sales without looking at foreign companies and foreign markets—is just outmoded. And I'm concerned that we

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have been witnessing and may continue to witness a period where American companies are losing their position in the markets of this world.

Sure, you see large numbers if you look at the annual sales or annual assets of large corporations, but if you look at these corporations in relation to the size of the world markets and in relation to the size of their competitors, I think you get a very different viewpoint.

Senator PROXMIRE. Mr. Chairman, my time is up, but let me just point out that I don't know how anybody can argue that Mobil acquiring Conoco—Mobil is certainly one of the suitors—or DuPont acquiring Conoco, another leading suitor, or any of the oil companies acquiring the second biggest oil company—how in the world can you make an argument that's necessary for them to compete with foreign concerns? It's beyond making that argument.

Mr. WEIDENBAUM. The argument I'm making is that American industry, including the petroleum industry, is competitive. There certainly is not a concentrated structure in the American petroleum market and if you look at world petroleum markets it is an even less concentrated and more competitive structure than the public realizes. The reason companies are large is those markets are large.

Senator D'AMATO. Well, I might mention, with reference to the point my distinguished colleague, Senator Proxmire, raised, in terms of I think public reaction as well as reaction here in Congress in terms of Mobil and DuPont moving to obtain Conoco, I don't share that reaction, only because of one consideration; and that is, better Mobil or DuPont than Seagram's or NuWest or some venture that is sponsored by a foreign corporation under the guise of the free enterprise system where it finances or helps obtain the financing for this kind of acquisition. I would like to see the Reagan administration support reasonable margin requirements. It doesn't make sense to require American investors to have certain requirements so that we don't endanger the markets and, by the same token, those same requirements are not required of foreign investors, particularly to facilitate corporate takeovers, as we have seen NuWest moving in on Cities Service. That has got to be an absolutely incredible kind of thing and we sit back and acquiesce and it's laissez faire again. We talk about creating a climate to aid the American consumer and businessman, et cetera, and we do nothing when we see these kinds of situations. Then we refer to the free marketplace. Something is inconsistent, Murray.

Senator PROXMIRE. If the Senator would yield, Senator Heinz and I have led the fight against foreign takeovers by foreign banks and there seems to be a moratorium here on the takeover of Conoco.

Mr. WEIDENBAUM. The administration again has set in motion a detailed study of foreign investment in the United States. As a general proposition, I will give you my personal view, and that is that we need to take a hardnosed but clearheaded attitude. Why? In so many cases, American firms have invested so much more in those foreign countries.

Yes, I'm aware, for example, of Canadian firms who are investing in the United States, but I'm also aware of the fact that U.S. firms hold absolutely far larger investments in Canadian firms,

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and in terms of the portion of the Canadian economy, quite clearly, American firms have a tremendously larger portion of holdings of the Canadian economy than Canadian firms have in our economy, and we always told these foreign countries——

Senator D'AMATO. Are you going to defend the Canadian Government's program of almost expropriation—isn't that basically what they have set about to do?

INVESTMENTS ON EQUAL BASIS

Mr. WEIDENBAUM. I do not defend it. I do not justify it in any way, but what I'm justifying is the two-way flow of bona fide——

Senator D'AMATO. Two-way flow on equal footing, and if you don't have equal footing and you have a government, I don't care whether it's the Canadian or anybody else, who is deliberately attempting to drive out our capital investments with unfair, arbitrary laws, what do we do? And then encouraging acquisitions in this country so they can trade stock and switch up in Canada and literally attempting to take over the mineral corporations and oil corporations—do we sit by and acquiesce? Where is this tough American we're talking about?

Mr. WEIDENBAUM. Those are legitimate concerns and those are the kinds of foreign investment practices and foreign country investment practices that we are giving our full attention to.

Senator D'AMATO. It seems to me we have swept it under the rug for political expedience, swept it under the rug. We are not focusing and I haven't heard—I've heard Bill Brock's representative or assistant come in here and we talked about moratorium and margin requirements and, my gosh, you ought to have seen some fancy-dan dancing. When we came to the moratorium, absolutely no. When we came to equalizing the ability to do certain things, there wasn't any support. And I just think that it's outrageous when we have unfair, unequal kinds of trading aspects, that something has to be done, and we have an obligation to the citizens of this Nation to see to it that it is done. I didn't think we were so strong that we could just say, "You can do what you want and we're so big that we know we can weather it."

Mr. WEIDENBAUM. I would add, Mr. Chairman, that we need to do it in a way that doesn't discourage bona fide foreign investment in this country or our companies investing overseas.

Senator D'AMATO. I don't think Senator Proxmire or I would suggest barring any bona fide investing here in this country and taking American capital and investing it in foreign countries. But bona fide investment on equal footing, on an equal basis is something to be encouraged, but I don't think that's the kind of thing that Senator Proxmire and I have been talking about and the kind of thing we have seen recently with this rash of attempted acquisitions, particularly in the area of the mineral companies and the oil companies.

Mr. WEIDENBAUM. We have that situation under close surveillance. Quite clearly, it's such a newly developing situation and involves such a variety of economic, financial, and foreign policy factors, that we are very carefully developing our response.

Senator D'AMATO. I'd like to offer my thanks to the distinguished Chairman of the President's Council of Economic Advisers for your

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lucid testimony and your graciousness, the graciousness of yourself and your time, and again, I reiterate Senator Garn's apologies for not being able to be here with you.

Mr. WEIDENBAUM. I'll be glad to answer Senator Garn's questions at a later date and I thank the chairman and Senator Proxmire for their courtesy and the opportunity to testify this morning.

Senator D'AMATO. Thank you, Mr. Chairman.

The next panel of witnesses will be Dr. Gilbert Heebner, chief economist of the Philadelphia National Bank; and Dr. Daniel Ahearn, chief economist of the Wellington Management Co., Boston, Mass.

STATEMENT OF A. GILBERT HEEBNER, EXECUTIVE VICE PRESIDENT AND ECONOMIST, PHILADELPHIA NATIONAL BANK

Dr. HEEBNER. I consider it a privilege, of course, to present my assessment of the conduct of monetary policy in the first half of 1981 and to offer certain recommendations regarding policy directions in the period ahead. I'm going to summarize my statement by just excerpting from it.

Senator D'AMATO. I will ask, Dr. Heebner, that all of your testimony be placed in the record.

Dr. HEEBNER. Thank you.

[The complete statement follows:]

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STATEMENT BY A. GILBERT HEEBNER
EXECUTIVE VICE PRESIDENT AND ECONOMIST
THE PHILADELPHIA NATIONAL BANK

Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

July 29, 1981

MONETARY POLICY: AN ASSESSMENT AND RECOMMENDATIONS

I consider it a privilege to present my assessment of the conduct of monetary policy in the first half of 1981 and to offer recommendations regarding policy directions in the period ahead. It is a wholesome feature of the democratic process that members of the private sector, along with those from the public sector, are given the opportunity to express their opinions on these important issues.

Monetary Aggregates and Reserves

To make clear my basic approach, I should say that I applaud the change in monetary techniques announced in October 1979 under which the Federal Reserve emphasizes controlling reserves and the money supply, rather than containing fluctuations in interest rates. Trying to control interest rates usually means trying to prevent them from rising, thereby resulting in excessive growth of money, and in turn, both higher inflation and interest rates. I am convinced that over time inflation can only rise if it is accommodated by money growth, and conversely, that the key element in bringing down inflation is a sustained slowing of money growth.

In keeping with this approach to monetary policy, I heartily concur with the policy objectives of the Administration and the Federal

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Reserve to steadily reduce the targets for money growth in the years ahead. Moreover, I believe that quantified targets are a useful discipline. Without them, it is too great a temptation to rationalize policy behavior with such subjective terms as "judgment," "flexibility," "discretion," and similar words that mean different things to different people.

I would give good grades to the Federal Reserve for monetary policy during the first half of 1981, especially compared with the second half of 1980. From the fourth quarter of 1980 to the second quarter of 1981, M_1B, adjusted to remove shifts from savings accounts to NOW and ATS accounts, grew at an annual rate of 2.2 percent. That was below the lower end of the target range of 3½-6 percent for the year 1981. (Without adjusting the actual data for shifts out of savings, the growth rate was 6.9 percent, slightly below the mid-point of the target range announced in February of 6-8½ percent, reflecting tentative assumptions regarding shifts into NOW and ATS accounts.) The large increase in the week ended July 8 interrupted a declining trend in the weekly figures that had been seen since early May.

M_2, on the other hand, grew at an annual rate of 9.5 percent from the fourth quarter of 1980 to the second quarter of 1981, above the upper end of the Fed's target range of 6-9 percent for this year. Bearing in mind the difficulties of aiming at and hitting two targets with one instrument, reserves, I think that the Fed did rather well in the first half.

In the second half of last year, in contrast, growth of M_1B and M_2 exceeded the upper ends of the target ranges by wide margins, causing growth for 1980 to exceed the upper ends in both cases. Looking at bank reserves, the contrast between the second half of 1980 and

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the first half of 1981 is dramatic. In the 1980 period, the monetary base, total reserves, and nonborrowed reserves were pumped up rapidly, as the Fed overcorrected for slow growth of the monetary aggregates in the first half. Thus far this year, the reserve measures have been held under firm control. That is particularly encouraging in assessing Federal Reserve policy, because it is reserves, not the monetary aggregates, that the central bank can affect directly.

Interest Rate Behavior

Policy makers and the public would probably be pleased with the recent performance of monetary policy if only it were accompanied by lower and more stable interest rates. To be sure, there are other problems, but from a number of standpoints economic activity has been rather favorable this year. The rate of inflation has come down. Unemployment, while relatively high, has not risen on balance. Growth of real gross national product dipped in the second quarter, but that followed the unsustainably high growth of the first quarter.

Interest rates, however, remain high, with real rates (i.e., after subtracting inflation) at historically high levels. And the increased volatility of the past two years has continued. The commercial paper rate, for example, went from an average of 18.07 percent in December to 13.94 percent in March and then back up to 17.16 percent last week. Aa corporate bond yields averaged 14.79 percent last week, above December's level of 13.78 percent from which they had dipped only moderately in the early part of the year.

That interest rates remained stubbornly high in recent months is puzzling since a number of economic factors suggested that rates should come down. (Indeed, we seem to have come to the point where

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explaining past interest rate behavior is very difficult, let alone forecasting where rates will go.) Factors suggesting lower rates included a slackening in business activity, a slowing in the increase of broad measures of inflation, decreases in oil and other commodity prices, a strong dollar, and a decline in the narrowly-defined money supply after early May.

Why, then have interest rates remained high and indeed risen in recent months? A principal factor has been credit demand spurred by an illiquid corporate sector and the involuntary building of business inventories. From the four weeks ended April 8 to the four weeks ended July 8, business loans of large commercial banks rose at a seasonally adjusted annual rate of 24 percent. Adding in loans to finance companies and nonbank commercial paper to get a broader total of short-term credit, the annual growth rate over that period rose to 35 percent (not seasonally adjusted).

In the long-term sector, new issues of corporate and municipal bonds swelled to almost $9 billion in June, well above the average of slightly over $6 billion during the previous five months. Any tendency for long-term rates to decline is likely to bring a flood of new bond issues as corporations seek to repair the liquidity eroded in recent years of high inflation and interest rates. The pent-up demand for long-term money may be expected to limit any decline in bond rates in the months ahead.

The strained liquidity of nonfinancial corporations can be seen in their ratio of short-term debt to total debt. That ratio reached 39.1 percent in the first quarter, compared with the previous cyclical low of 33.2 percent in the third quarter of 1976. Some improvement had been accomplished in the lower rate environment of last year's

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recession. However, that opportunity was short-lived, and by the first quarter of this year the ratio was back to the high seen in the corresponding period of 1980.

Another factor that has contributed to high and volatile interest rates is market psychology and expectations. This is more difficult to discuss in statistical terms since we are essentially talking about the state of mind of market participants. But it is nonetheless real. To some extent, market rates of interest reflect what lenders and borrowers think they will be.

That expectations may be contributing to high interest rates is understandably frustrating to the Administration and the Federal Reserve. They have announced a policy of steadily slowing the growth of the money supply in the years ahead and of reducing the budget deficit in successive years to achieve a balanced budget by 1984. According to the theory of efficient markets, this information regarding future monetary and fiscal policy, and a resulting expected decline in inflation, should be reflected in current interest rates. The fact that it is not suggests that market participants do not believe, or at least are skeptical, that the announced policies will be carried out.

On the monetary side, I believe that the Federal Reserve is gradually gaining credibility. The fact that it did not repeat last year's mistake and pump in reserves to try to prevent interest rates from rising this spring helped to gain credibility. However, the Fed did exceed its money growth targets for 1980, and the jury is still out for 1981. Also, even short-term movements above targets, as occurred in April and early May, disturb market psychology and, with a short lag, send interest rates upward.

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One of the conclusions of the Fed's special study of the operating techniques adopted in October 1979 was that efforts to "severely limit" deviations in the growth of monetary aggregates from their target paths would entail even larger fluctuations in short-term interest rates. At the same time, the deviations themselves affect interest rates, and I believe that some of the pressure on rates from a quick return to path would be relieved by the reassurance to the market that the Fed was indeed going to stay within its longer-term target ranges.

I suspect that fiscal policy may be encountering a greater credibility problem in the credit markets than monetary policy. To be sure, the deficit for the 1981 fiscal year was estimated at $55.6 billion in the Administration's midyear economic review (after postponement of the tax cut), close to the level estimated in February. Also, important strides have been made in cutting budgeted expenditures in fiscal 1982. However, I believe that investors are nervous that not only may this year's deficit be somewhat higher, but that next year's may be significantly above the $42.5 billion officially estimated. One thing that scares credit markets is the prospect of large deficits in a rising economy (which is forecasted for late 1981 and 1982) while the Fed is maintaining a firm hold on the monetary reins.

Finally, in regard to high and volatile interest rates, we should recognize the impact of a structural change that has taken place in our economy over the last ten years or so. That is the de-regulation of interest rates and changes in financial markets that have enabled funds to move more freely in quest of more attractive returns. Since the late 1960s, interest rate ceilings have been removed on large negotiable certificates of deposit. More recently,

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various steps have been taken to raise ceilings on consumer savings instruments and Regulation Q is to be phased out by 1985. In addition to statutory and regulatory actions, innovations in the market have facilitated the mobility of funds. Money market mutual funds, mortgage pass-through certificates, and further development of the Eurodollar market are cases in point.

It should be understood that in such an environment, inflationary forces and other pressures will be more quickly translated into market rates of interest. The supply of and demand for funds will be equalized, i.e., markets will be cleared, by increases in interest rates. Under the earlier structure with rate ceilings and impediments to funds mobility, there was more non-price rationing -- to a greater extent credit was rationed by limited availability than by price. From time to time we will see higher rates under the new evolving structure than we would have seen under the old. I strongly believe, however, that the evolution to freer financial markets represents progress; price rationing is more economically efficient than non-price rationing. The way to deal with high interest rates is to reduce inflation and inflationary expectations, not to impose price controls and barriers to the movement of funds.

Recommendations

The most important recommendation regarding monetary policy that I or anyone could make is that the Federal Reserve should adhere to a long-term course of steadily reducing money growth. That is an essential condition of bringing down the rate of inflation, and it is essential that inflation be reduced if we are to achieve stable economic growth and deal with other economic problems, including unemployment.

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It cannot be emphasized too strongly that over the longer-run you cannot get lower unemployment by accepting higher inflation. If the trend rate of inflation rises in the years ahead, so will unemployment.

Furthermore, I do not believe that deceleration of money growth need be associated with higher interest rates. Fundamentally, of course, that is because reduced money growth will bring reduced inflation, and over time, interest rates reflect inflation. There has been quite a debate over the interest rate implications of the Administration's projections of nominal gross national product and money growth for the years 1982 to 1986. The slower money growth that is projected, together with high GNP growth, represents a rapidly rising velocity of money (GNP/money supply), and it is said that high velocity means high interest rates.

I think this may turn out to be a non-issue. For one thing, we may not get as high a growth of nominal GNP as projected, which may not be all bad, especially if the reason is lower inflation. Secondly, the relationship between the level of short-term interest rates and velocity appears to have changed. In 1977 through 1980, for example, the annual percentage changes in M_1B velocity either decreased or were unchanged, while short-term interest rates rose each year. Structural changes in the payments mechanism may in part account for this pattern. Also, perhaps the relatively large increases in M_1B, which tended to hold down the increases in velocity, contributed to inflationary expectations and higher interest rates. The main point is that the Federal Reserve should not refrain from slowing money growth in fear that that will push up interest rates.

Nor should the Federal Reserve back away from an anti-inflationary monetary course in response to foreign dissatisfaction with our

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high interest rates. Not surprisingly, such dissatisfaction was heard at the Ottawa summit meeting last week. The attitudes of our foreign friends are understandable. High and volatile U.S. interest rates and their impact on exchange rates create problems for foreign countries, e.g., capital outflows, higher import costs, and difficulties in conducting their domestic economic policies. If the Fed steadily slows money growth, however, our rates may be expected to come down. If that doesn't happen, the answer is not for the Fed to ease up, but to consider other anti-inflationary efforts. The most effective, and admittedly the most difficult, would be further expenditure cuts to reduce the Federal budget deficit.

Turning to specifics for the near-term, it is urgent that the Fed stay within the target ranges of 3½ to 6 percent for M_1B and 6 to 9 percent for M_2 that it has established for 1981. I concur with the decision, reported by Chairman Volcker last week, to aim for the lower end of the M_1B range for the year as a whole. The reduced M_1B range that was announced for 1982 is welcome; I would also like to see a reduction in the target range for M_2.

Moreover, in my opinion, movements outside the ranges, especially above them, should be corrected promptly. I fear that delaying return to the target path in an effort to smooth out interest rates courts the risk of creating reserves excessively. It is too easy to cross over the line between limiting interest rate fluctuations and loss of monetary control.

Emphasis on staying within target ranges may seem harsh and unrealistic in view of the difficulties of controlling something as unruly as the monetary aggregates. Admittedly, it is difficult to control the supply of money when the demand for it is often unstable.

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There is a good reason, however, for maximum efforts to reach quantified targets, in addition to the impact of money growth on inflation. That reason is credibility. Policy will only become credible when it is seen adhering to the course announced by the policy makers, when words are matched by actions.

I would like to see the Federal Reserve give serious consideration to using total reserves or the monetary base as an intermediate target of policy, instead of the monetary aggregates. A reserves target would offer several potential advantages. Since it is reserves, not money, that the Federal Reserve affects directly, it could come closer to its targets. That would enhance its credibility. Also, the reserves target would avoid the dilemma that the Fed faces when, as in the first half of this year, growth of one monetary aggregate is below its target range and growth of another is above it. It may be argued that a total reserves or monetary base target would be inefficient because the money multiplier (money/reserves or base) is too unstable and because money is more closely related to the behavior of the economy than is reserves. In my judgment, however, the issue deserves re-examination.

On a matter related to the control of reserves, I submit that the time is long overdue to adopt a flexible discount rate policy. The discount rate should be allowed to float with other money market rates. By holding it below market rates, the Federal Reserve creates an incentive for banks to borrow at the discount window. When the provision of nonborrowed reserves is reduced, the restrictive effect on total reserves is delayed by increased bank borrowing. Then the Fed has to deter borrowing by signaling to banks that they are less welcome at the window. Control of reserves would be more timely and

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effective if the discount rate were a market-sensitive rate.

Another change in monetary technique that seems appropriate is the adoption of contemporaneous reserve accounting. The present lagged system, under which reserve requirements are based on the deposit levels of two weeks earlier, means that the amount of reserves that the banking system will require is a given fact at the beginning of a settlement week. The Fed, in effect, has less discretion in making a quick adjustment of reserve levels. The lagged system would appear to limit the promptness of policy actions, especially since the Fed has shifted to an emphasis on controlling reserves and monetary aggregates rather than interest rates.

The $64 question, however, is to what extent monetary control is impeded by lagged reserve requirements. It would be useful for the Fed to provide an answer to that question. Banks will find it more difficult to operate under a contemporaneous system that would require them to estimate and hold reserves in relation to deposit levels of the current week. I believe that their resistance to the proposed change would be lowered if they were convinced that contemporaneous reserve requirements would significantly improve monetary policy. Also, bankers would react more favorably if allowances for carrying forward reserve deficiencies or excesses were increased.

Finally, I recommend that reserve requirements be imposed on money market funds that offer checking privileges, which the overwhelming number do. On a list of 93 funds, I counted 88 that offered checking. There is some appeal to the position of those bankers who say, "don't regulate them, de-regulate us." Reserve requirements on transaction accounts, however, are a permanent instrument of monetary control. The ratios are being lowered over time under the Monetary

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Control Act, but they are not being phased out, as is Regulation Q. Thus I believe that the money funds should be subject to this instrument.

Conclusion

The Federal Reserve should continue to give top priority to adhering to a long-term course of steadily reducing money growth. Policy must be persistent and credible, not subject to erratic changes in quest of ostensible short-run benefits. It is important that the Fed not be deflected from its course by distress with high interest rates. They can be expected to come down as inflation and inflationary expectations subside. Toward that end, monetary restraint must be accompanied by continued pruning of Federal expenditures and shrinking deficits.

Not all our economic problems can be corrected by monetary policy. But if the Federal Reserve succeeds in reducing money growth in the years ahead, it will have made an invaluable contribution toward our goals of low inflation, stable growth, and high employment.

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Senator D'AMATO. Thank you very much.
Dr. Ahearn.

STATEMENT OF DANIEL S. AHEARN, CHIEF ECONOMIST, WELLINGTON MANAGEMENT CO., BOSTON, MASS.

Mr. AHEARN. Mr. Chairman, it's a privilege to be here with you and I'm here to testify on Federal Reserve monetary policy and its probable effect on the economy.

[The complete statement follows:]

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Statement before the Senate Committee on Banking and Urban Affairs
Daniel S. Ahearn, Senior Vice President and Director
Wellington Management Co./TDP&L
July 29, 1981

Gentlemen:

I appear before you to testify on Federal Reserve monetary policy and its probable effect on the economy.

The Federal Reserve has been in existence for about 68 years. It has often been surrounded by controversy, as it is today. Yet it has been a very constructive contributor to our nation. Prior to its founding, the U.S. had a record of dramatic financial panics and long periods of recession which in fact led to the establishment of the Federal Reserve. Controversy about the Federal Reserve usually develops when its policies interfere with people's desires to spend and borrow. As former Fed Chairman William McChesney Martin once said, the Federal Reserve is like the person who has to take the punch bowl away when the party begins to get out of hand; in other words, an unpopular spoilsport.

The Federal Reserve is important because its job is to control money and credit, and we live in a money and credit economy. People and firms are motivated to work and to produce by the prospect of money rewards. To be attractive as a motivator money must be reasonably scarce in relation to the goods people want and it must be able to retain its value over time. Otherwise, people would not work for it. If too much money exists, prices tend to rise, money loses its scarcity value and inflation develops. If too little money exists, prices tend to decline and the economy may slow down, even turn down.

The Federal Reserve, like any other human institution, is far from perfect. It makes mistakes. Maintaining the right monetary balance is

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difficult. First, the relationships between the amount of money in the economy and economic activity may change, even over short periods. There are a number of reasons for this. Changes in people's confidence levels may change the amount of money they want to hold. Changes occur in the efficiency with which our economy uses money, reflecting better check collection procedures, for example. And, perhaps most important, the private market system is continuously developing new money substitutes or "near monies". This latter point highlights one of the great problems for monetary policy: the changing nature of money.

Financial market innovations constantly create new ways to pay for things: credit cards and checkable money market funds used by individuals; negotiable CD's issued domestically and internationally by banks; commercial paper and short-term negotiable notes issued by corporations. These are only a few of the devices that have enabled economic entities to acquire spending power beyond their immediate cash resources. And new ways of mobilizing additional spending power are constantly being developed. The most significant new product is the cash management account developed by a major brokerage firm in combination with a large bank and the VISA credit card system and now being imitated by other firms. The cash management account is an ingenious product which permits a customer to write checks, use a VISA credit card or borrow automatically against his total resources of cash, money market fund assets, and stocks and bonds. The individual can thus treat as cash a large percentage of his or her stock or bond holdings. This approach, though still in its infancy, could ultimately liquify hundreds of billions, even trillions, of dollars of otherwise relatively illiquid financial assets. Such a potentially enormous addition to the supply of spending power could swamp the M-1A and M-1B monetary aggregates on which the Federal Reserve focuses.

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The Federal Reserve is, of course, aware of the problem. Its staff continuously endeavors to identify new forms of "money". Necessarily, however, there is a lag in catching up with such developments. The reality is that the Federal Reserve is always trying to control last year's definition of money while the financial markets and the economy operate on this year's definition and are hard at work on developing next year's version.

While this is not illegitimate (indeed the resourcefulness of our innovative financial system is the envy of the world), it does complicate the task of the Federal Reserve. What it means for the Federal Reserve is that it will not have as immediate an impact as it once had in influencing the supply of the means of payment. And whatever influence eventually is gained will probably require interest rates to rise to higher levels than were needed in the past. Taken together these considerations suggest that Federal Reserve influence on the economy will come more slowly and be accompanied by higher interest rates than we might expect. Patience and a willingness to endure some discomfort are going to be required traits for Federal Reserve officials, for the governmental observers who look over their shoulders, and for the public which monetary policy seeks to influence.

Both Government and the private sector are also innovating in other ways which tend to weaken the influence of monetary policy and interest rates. The entire concept of indexing, for example, in wage contracts, in social security benefit payments, in private construction contracts, lessens the pain of inflation, because it pays compensatory rewards when inflation rises. This reduces concern about inflation for those indexed and lessens their willingness to accept restraints aimed at stopping inflation. Indeed, it is not only that indexing reduces the anti-inflation constituency. In some cases, those indexed

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see inflation as a source of income and end up with a stake in continuing inflation. It deserves notice, too, that inflation adjustment payments add to current buying power and are biggest precisely when inflation is worst, thus adding to inflation pressures at just the wrong time. The justification for indexing is equity, to redress the wrong done by inflation. Indexing, however, is not equitable. In fact, it can work only if some people are not indexed and are left to be exploited by inflation. The problem of inflation is an excess of dollar buying relative to real goods, not a shortfall of money. Adding to dollar incomes by indexing worsens the inflation problem and hurts even more those not indexed. If everyone were indexed, relative positions would not improve but inflation would be worsened by the additional spending. To use a simple analogy, if you index some of the people it is like giving out a few peach baskets to stand on to some of the crowd watching a football game. Those given baskets will be able to see better, at the expense of those who did not get a basket. If everyone gets a peach basket, relative positions are unchanged and no one sees better even though the height of the crowd has been raised. In a similar way, if everyone's income was indexed equally, everyone would have more money but the end result would be everyone paying higher prices. Real incomes would still deteriorate and the real value of savings deposits and other fixed money assets would decline even faster. Unfortunately, the indexing process is spreading and may soon be applied to tax rates, further reducing the pain of inflation and pari passu the anti-inflation constituency.

The financial markets have gone towards indexing too. One of the earlier steps was the abandonment of fixed rate lending and the adoption by major banks of a variable or floating prime rate which rises or falls with the cost of

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short-term money to banks. From a borrower's standpoint this made an initially high loan interest rate the same as an initially low rate, since both would subsequently move up and down similarly and would average about the same over the life of a loan. Hence, a good deal of the deterrent effect of high bank interest rates was eliminated. Floating bank loan rates also made banks much less concerned about the impact of Federal Reserve policy on them since any increase in the cost of short-term money could be passed along to their borrowers. They henceforth worried only about the "spread" of their loan rates over their cost of funds and very little about the absolute level of interest rates. This approach is now spreading rapidly in the mortgage market and will have similar consequences of reducing the impact of any given interest rate level on economic activity.

More recently, the markets for fixed income securities have seen the development of a variety of notes and bonds whose interest rates fluctuate with short-term rates, usually Treasury bill rates. Treasury bill rates in turn correlate reasonably well with the rate of inflation. So far, however, there have been no bond issues in the United States whose coupon interest payments are directly related to the inflation rate (though the British Government has issued two index-related bonds this year with mixed success). To the extent the concept works, index-linked bonds should maintain their capital value better in inflationary periods than fixed coupon issues. And to the extent this occurs, the expenditure-inhibiting effect of losses in bond capital values during periods of inflation would be weakened.

<u>As the impact of interest rates is weakened by indexing, the impact of Federal Reserve monetary policies is similarly diluted. Thus, here, too, the</u>

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implication is that under current conditions Federal Reserve restraint would take longer and interest rates would have to go to higher levels than we have been accustomed to in the past.

My conclusion is that we should not lose patience and assume that Federal Reserve policies are either ineffective or wrong headed. Several decades of inflationary drift are not likely to be reversed in one or two years. The accomodations to inflation I have mentioned, new means of payment and various ways of indexing, are making the application of monetary policy more difficult and the achievement of results a more protracted process. In my view we should not encourage more indexing and the proliferation of novel payment mechanisms should be monitored carefully so as to insure that the external costs they may entail are fully recognized. But regardless of success in these endeavors, Federal Reserve monetary policy can and will work in time if we have both patience and a willingness to accept short-term discomforts as a price of a less inflationary, sounder long-term future. Unfortunately, the past record suggests that the public, the Congress and the Executive lose patience when monetary policy begins to bite. We can only hope that this time will be different.

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Senator PROXMIRE. Well, I want to thank both you gentlemen. I apologize—this is a very, very difficult time for the committee members to be present and it's a shame because these are two most thoughtful statements and, of course, our responsibility in monetary policy is very clear. We, as a committee, represent the U.S. Senate in monetary policy. The Federal Reserve is our creature. We can abolish it, recreate it, change it or modify it. They are independent of the executive but not independent of us. So that your testimony is of the greatest importance.

Now, in general, both you gentlemen approve the policies followed by the administration, particularly in the last 6 months—I should say by the Federal Reserve Board, particularly in the last 6 months; is that right?

Dr. HEEBNER. Yes, sir.

Mr. AHEARN. Yes, sir.

PATIENT WITH FED POLICIES

Senator PROXMIRE. Mr. Ahearn, you argue that we should be patient and recognize how these policies take a while to have their effect and to bring inflation under control. I indicated earlier some of the difficulties we have with our constituents if we follow your advice.

Mr. AHEARN. Right.

Senator PROXMIRE. And that difficulty continues to build up. Frankly, I'm amazed at how mild it's been, considering how high interest rates have been.

Mr. AHEARN. I think that's true, Senator.

Senator PROXMIRE. In the past, we have had people like Wright Patman, chairman of the House Banking Committee for many years, who conveyed vehemently against the Federal Reserve Board and many Senators and Congressmen did, including a very powerful majority under President Johnson, and President Johnson did the same thing, but there's been a lot more moderation on the part of Congress. I just wonder how long that can continue.

Mr. AHEARN. In my opinion, Senator, part of the explanation is that the public recognizes that inflation has necessitated high interest rates and another part of it is that the public sees U.S. industry as less competitive—take the automobile industry, for example. While high interest rates are clearly difficult for the automobile industry because the purchase of a car is a large expenditure for the average person, it's also quite clear to the average person out there, almost anybody, that the problems of the automobile industry go well beyond high interest rates.

Senator PROXMIRE. That's true, but then when you take the individual dealer, he can't—and he has to finance that inventory that's sitting on his sales floor and if he's going to sell cars he wants to have a car there so if somebody comes in and says they want a car today he won't have to wait 2 weeks for it; they'll go to a competitor and he may lose a sale. But we have had many dealers who simply can't afford to maintain an inventory. They can't afford to pay interest on it and that's inhibited car sales apparently very seriously.

I'm told by the head of American Motors, for example, which has their principal production facilities in Wisconsin, that this is very

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tough for them and high interest rates have had a serious effect on their sales for that reason.

Mr. AHEARN. I wouldn't deny that, Senator, but the Japanese cars, the imported cars, took 28 percent of the market in June. They were up in sales. They made a new high in terms of penetration of the market. I'm for the American car. My family owns American cars, but I think it's quite clear that the interest rates that are paid are paid by the dealer of imported cars as well as American dealers.

Senator PROXMIRE. The place where the interest rates really hit with savage effect is on the homebuilding industry.

Mr. AHEARN. Right.

Senator PROXMIRE. Where people will get a mortgage that will last 30 years or 35 years and at least 70 percent of their monthly payments are interest payments.

Mr. AHEARN. Right.

Senator PROXMIRE. And, of course, that knocks out literally hundreds of thousands of families. We're operating now at an annual rate of about 1 million starts a year. We have capacity for 2 million. And this is something that the end doesn't seem to be in sight.

Mr. AHEARN. Again here, the problem is that the people who for years were victimized by low interest rates on their savings by Government regulation, regulation Q and other such controls, so that they had to take 5 percent, have been given a way out. The money funds have developed. The money funds have grown from nothing to $135 billion because they gave the average man a reasonable return on his savings.

Now you can't expect the thrift institutions to lend to the home buyer at rates below what they have to pay the saver in order to get deposits. That's the big problem.

Senator PROXMIRE. You're absolutely right. That's a reflection of the underlying problem, but the underlying problem is the fact that credit is very dear and the interest rates are generally high and that mortgage rate— you're right, there was some subsidizing over the years, but when the mortgage rate was at 4.5 percent, interest rates generally were very low. As I indicated earlier, in 1950 the prime rate was 1.2 percent and the Treasury bill rate was even lower.

CHANNELING LOANS TO PREVENT TAKEOVERS

I'd like to ask you, Mr. Heebner, about a part of the resolution I didn't read earlier that the Senate passed unanimously, and it's directed at the Federal Reserve. This says that the Board of Governors of the Federal Reserve should exercise regulatory powers so that loans be made for productive economic purposes—exercise regulatory power, rather than to enable large firms to acquire smaller firms and to assure that sufficient credit is available to protect viability of thrift institutions without wholesale mergers or takeovers, and they are required to make a report to the Congress on February 1, 1982, relatively a few months from now, as to how they are carrying that out.

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How do you view that directive requiring the Federal Reserve to act to channel loans for productive purposes and to prevent loans for acquisition purposes?

Dr. HEEBNER. First, let me answer philosophically that this is a form of credit controls and I'm opposed to credit controls because I think that they are not efficient in allocating credit.

But more specifically, having chaired a committee in our bank which met every morning during the time that the credit controls were in effect in the second quarter of last year, I would say that identifying productive credit, especially as defined by administrators in Washington, is extremely difficult—indeed, I would say impossible.

Some mergers and takeovers might be a very productive use of credit. Others might not be. Some things that would qualify as productive credit in the way in which that would often be defined by administrators—let's say business inventories—might be unproductive and unwise. Maybe the firm is loading itself up on business inventories to an extent that would be detrimental to operations.

So my point is that defining what is productive versus unproductive is probably best left to the guy who is faced with the bottom line.

Senator PROXMIRE. Supposing we confine this to jawboning on the part of the Federal Reserve, which they have done in the past, to do their best to persuade the banks not to make loans for acquisition purposes. In other words, not to make loans for the purpose of acquiring a Conoco.

Dr. HEEBNER. I think one of the problems with jawboning is that it kind of rewards the bad guys who don't respond and penalizes the good guys who do.

The other thing is that jawboning almost always sets up expectations in the private sector that it is going to be followed by something mandatory. Often the jawboning is accompanied by something like, "Well, if we don't get cooperation, we'll have to consider other steps," and even if that isn't said, it is implied. Then there are sometimes perverse effects. The jawboning creates the very thing that it is trying to disallow.

I can tell you that in the days right before the credit controls were applied, in March of 1980, there was a tremendous amount of borrowing and setting up of credit facilities to get under the wire before the anticipated controls were imposed.

Senator PROXMIRE. I'm very much against the credit controls and I led the fight, along with Bill Armstrong, to try to get the basic law that would provide the Federal Reserve discretion abolished. On the other hand, I'm just wondering if there isn't something—are we just helpless? Can the banks funnel credit into the acquisition of a large firm like Conoco, billions and billions of dollars, while farmers and small businessmen and other productive enterprises can't get capital without paying this enormously painful price?

Dr. HEEBNER. I would repeat that the marketplace is the best test. With respect to the amount of funneling of credit into mergers and acquisitions, I am sure you are aware that if you just total up the aggregate amount of the facilities that are mentioned there is a fair amount of double counting. It is a little bit like multiple

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applications for college admission. If several companies have set up facilities to buy the same company, only one of them is going to succeed in being the buyer. So there can be some exaggeration.

Also, as one generalizes about small business, it should be recognized that there are small businesses and then there are small businesses. Some are making out quite well. Some are not. Believe me, I sympathize entirely with the intent of the resolution to get interest rates down. Nobody would want to see them come down more than an asset-liability manager in a bank, as I am. But I think that small businesses are better off in an environment where, as painfully high as interest rates are, they can get the money if they can use it profitably, rather than face a situation, as in the 1960's, where banks would just say, "Well, I am sorry, no more borrowers."

NOVEL PAYMENT MECHANISMS

Senator PROXMIRE. One question finally to you, Mr. Ahearn. In your prepared statement you argue that financial innovations such as money market funds will lead to higher interest rates and slow the economy's response to monetary policy. Then in your concluding paragraph you say the proliferation of novel payment mechanisms should be monitored carefully so as to assure that the external costs they entail are fully recognized.

The question is this, are you suggesting that the Government might need to prohibit innovations like money market funds to assure the efficacy of monetary policy?

Mr. AHEARN. No; what I'm saying, in conjunction with Dr. Heebner's comment, is that if an innovation involves a money market fund behaving like a bank—and I think we are in the early stages of that—we check against money market funds, we make payments with them, and among my acquaintances I find people who never wrote a money market fund check in their lives and last year they paid their taxes with one. This year they're writing 3 or 4 a month. Next year it will be 10 a month. These funds are being used like banks and they should be treated that way. That's what I mean.

Senator PROXMIRE. I'm not sure. I'll tell you, the sentiment against any such a treatment is very, very strong out there.

Mr. AHEARN. Well, the sentiment against doing anything that discommodes people is strong. The way we got into this inflationary plight is that we made it easy for everybody to spend.

Senator PROXMIRE. You said if they wrote—I don't think you could get rid of money market funds. They would just stop using it for check cashing.

Mr. AHEARN. No; I don't think you could get rid of money market funds and it may be that 10 years from now we will have $700 billion worth of money market funds and almost no savings institutions. I would not omit that potential at all. Things change.

RESERVE REQUIREMENTS

Dr. HEEBNER. Senator, could I just add to the point Dr. Ahearn is making. I suggested it in my statement that there be reserve requirements against money market funds. In addition to the rea-

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sons that have already been mentioned, I would submit that, from the standpoint of an institutional adjustment, it is easier to do this earlier in the game than later in the game. There are now $135 billion of money market funds. As Dr. Ahearn says, when there are $700 billion, it is going to be much harder and more wrenching to try to introduce reserve requirements.

I can see a parallel with respect to the introduction of reserve requirements on nonmember banks. I had the opportunity to testify before you and before this committee on behalf of the American Bankers Association when the Monetary Control Act was being considered.

One of the things that made it so difficult to introduce reserve requirements was that nonmember banks had gone so long without them. One of the things that facilitated the introduction with respect to thrifts was that it was not a big issue because their transaction accounts were not large. Had we waited 10 years and NOW accounts had reached huge proportions, I think it would have been much more difficult politically to have imposed reserve requirements.

Mr. AHEARN. You know, Senator, there is something that my professional colleagues—I do a lot of work in the bond market. One of the things that's led to the difficulties of the savings industry and the proliferation of money market funds is what we call the negative yield curve, the fact that short-term rates are considerably higher than long-term rates.

Savings institutions were built in an era when they borrowed short at a low interest rate and loaned long at a high interest rate. If we could get back to a positive interest rate curve—and that will come if we control the inflation because inflation is what created the negative yield curve—then the advantage that money market funds today have will diminish. Money market funds have a significant advantage because they are in there paying 16 and 17 percent to savers and earning it because they have portfolios full of contemporaneous inflation adjusted yields which continuously rise with the rate of inflation because they are short. In contrast, the savings institutions are stuck with long-term 7, 8, 9, 10, and 11 percent mortgages whose yields do not rise with inflation. If we get inflation under control, we'll get a positive yield curve and many of the things that you're worrying about—what kind of regulation would solve this or that problem—would be solved by the market itself. Savings institutions would again earn higher yields on mortgages than they would have to pay on savings deposits and they would be profitable again.

Senator PROXMIRE. Thank you, gentlemen, so much. I'm sorry I have to run. It was excellent testimony.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

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