FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1985

HEARING

BEFORE THE

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

NINETY-NINTH CONGRESS

FIRST SESSION

ON

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

FEBRUARY 20, 1985

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

99th Congress—January 3, 1985

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

99th Congress—February 21, 1985

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Kenneth A. McLean, *Minority Staff Director*
W. Lamar Smith, *Economist*

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FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1985

WEDNESDAY, FEBRUARY 20, 1985

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

The committee met at 8:35 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Mattingly, Hecht, Gramm, Proxmire, Cranston, Riegle, Dodd, Dixon, Sasser, and Stennis.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Mr. Chairman, we appreciate you changing the schedule from 9:30 to 8:30, 8:30 hearings in the Senate are not the normal thing that we do. But we can blame the British. I'm sure everyone knows that Prime Minister Thatcher, whom I have great admiration for, is speaking to a joint session in Congress at 11 o'clock, and the Senate is to form in the Senate at 10:30. That was the reason for the request. At the time we set the hearing, we certainly did not know that Mrs. Thatcher would be speaking. Clearly she is a great world leader, and it is necessary for us to be there.

I would hope that we would be able to conclude in 2 hours. If we have not, I have reserved time at 2 o'clock to return. I would hope that is not necessary, but if my colleagues on the committee wish to question longer than a 2-hour period, we will return at 2 o'clock.

The Full Employment Balanced Growth Act of 1978 requires the Federal Reserve to come before the Banking Committees of Congress twice each year to testify on monetary policy. These biannual hearings are important because Congress must understand the central bank's monetary policy in order to fulfill Congress' constitutional responsibilities in this area.

Public hearings on monetary policy are also important because of the Federal Reserve's intentions with regard to monetary policy must be understood by the private sector in order to make intelligent economic decisions.

As part of the biannual hearings, the Fed is required by the 1978 act to announce specific target ranges for growth in the monetary aggregates. While these target ranges provide important information to Congress and to the private sector, they are not sufficient to provide an adequate understanding of the Fed's intentions regarding monetary policy.

Questions which are outstanding today include the following:

Which monetary aggregate currently is the primary focus of monetary policy?

Is the Federal Reserve continuing to target interest rates?

To what extent does the Federal Reserve feel its freedom of action in setting monetary policy is limited by agricultural, energy, and international loan problems facing the banking system?

To what extent do foreign exchange considerations, like the rising value of the dollar, affect monetary policy?

Enhancement of the public's needed understanding of these aspects of monetary policy is a primary purpose of this morning's hearings.

I would also say, Mr. Chairman, that I have been keeping up with what's been going on while I have been in other parts of the country doing other things. And I have seen considerable criticism of your speaking out against budget deficits. Well, we have had that conversation many times over the last several years—the relationship of monetary and fiscal policy—and I see no reason why you should not continue to speak out on the actions of Congress and the need to reduce the deficit. There has certainly been no hesitancy on the part of my colleagues in this body and the House of Representatives to speak out on monetary policy. There should be no double standard here.

We make comments about how you conduct monetary policy, and you should feel free to talk about how we conduct fiscal policy and keep the pressure on Congress. Maybe if you and others do, we will do something about the deficits and make your job of managing monetary policy easier.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Mr. Chairman, first, it's good to welcome you back from the brink of outer space and back here in an area which certainly reminds us of the fact that we have problems here as well as in space. And also the columns of Doonesbury.

The CHAIRMAN. The only thing that bothers me, Bill, is the number of people who were happy to see me go into space, but they don't want me to come back. [Laughter.]

Senator PROXMIRE. Chairman Volcker, when you were appointed to a 4-year term as Chairman of the Federal Reserve Board in July 1983, you filed a statement with this committee, as we require of all Presidential nominees. One of the questions was, and I quote:

"Do you expect to serve the full term for which you have been appointed?"

Here is how you answered that question. You said: "I do not feel committed to do so."

Now, your statement at the time was widely interpreted as a signal that you would step down as Fed Chairman, shortly after the next Presidential election, probably a year after or so.

However, a careful reading of the transcript of your nomination hearing reveals that at no time did you say that you would step down, or reach an understanding that you would do so. You were simply indicating to the committee and to the Congress that you did not feel yourself committed to serving a full 4-year term.

I recall this history because I now urge you to abandon whatever plans you may have had for an early resignation, and that you serve out the balance of your 4-year term. The country clearly needs your continued leadership of the Fed. I do not know what private understanding you may have reached with President Reagan concerning your reappointment, but serving out the remainder of your term would be entirely consistent with your representations to this committee and the Congress. And I hope you will stay the course, and here's why.

First, none of your potential successors enjoys anywhere near the degree of confidence and respect that you have built up with the business and financial community. Your policies at the Fed have been credited, and rightfully so, with breaking the back of inflation. But, inflation is still a threat and it is not time to be changing leadership at the Fed until we have squeezed out most of the residual inflationary expectations which are responsible for keeping real interest rates far above their historic levels.

Second, we have a brand new economic team at the Treasury. Secretary Baker is a brilliant and able lawyer but he has practically no experience in financial matters, especially on the international level. More than ever, we need the sure hand of the Fed under your experienced leadership to help the new Treasury team meet its difficult responsibilities.

Third, there still has been no satisfactory progress in closing our enormous budget deficit. Indeed, this year, it will be bigger than it's ever been in our history by far. It's expected to be $222 billion. It will probably be substantially bigger than that.

President Reagan's budget proposal is clearly inadequate. The Republican leadership in the Senate, despite high hopes, has been unable to develop their own package. The Democrats in the House have not presented their alternative. We need the forceful leadership of someone like yourself to keep us on target. You have managed to maintain independence from both the administration and the Congress, and your voice is listened to with respect. I don't know of anyone else who could carry that role as successfully as you.

Now, finally, and most important of all, Mr. Chairman, during the next 2½ years, we can expect immense pressure on the Federal Reserve Board, probably more than ever before in its history, to ease up on monetary restraint. That's a nice way of saying to monetize the debt.

This year, we will have a deficit of $222 billion, as I say, according to the optimistic estimate of the administration. It could be higher, much higher. We may or may not reduce that deficit significantly next year, in 1986; even if we vote to do so, any number of unforeseen economic developments could frustrate our intentions and skyrocket the deficit to $300 billion or more.

Also, foreign countries could cool, maybe suddenly and dramatically, their willingness to loan capital to this country. The pressure for the Federal Reserve Board to step into the breach to ease credit in a big way could be swift and powerful. This country urgently needs a chairman who, under those conditions, would not only have the will to say no but would have the support of the business and banking community necessary to make that no stand up.

Mr. Chairman, I realize that I am asking for you to make a painful sacrifice. As you may recall, when you were before this committee in 1983 for your confirmation, I stressed the massive difficulties you face with an, alas, poor Volcker warning.

So I hope you will consider this plea and decide to stay on for your full 4 years. In my judgment, the country needs you more than they need any other public official in this country today. We need your calm, sane voice.

As the chairman of the committee has just reminded us, a remarkable British Prime Minister is going to address the Congress in a couple of hours. And I hope that if you have a thought to whirl around in that fine mind of yours while you're deciding whether to stay or go that you will strike a blow for mental health and remember the words of a previous distinguished British Prime Minister, the Earl of Beaconsfield, Benjamin Disraeli, who observed the only thing that has driven more men mad than love is the currency question. [Laughter.]

And with you gone, the currency question will, as Disraeli foresaw, make a bumper crop of blithering idiots on this committee, in the Congress, in the business community, and throughout the country.

So I hope you will, as I say, strike a blow for mental health and stay where you are.

The CHAIRMAN. I'm not sure there's any mental health in Washington. I made the comment the other day when somebody asked me what I'd been doing lately. And I said, well, I'd been down in Houston, where everybody knows what they're doing. And that's a very unique experience after 10 years in the Senate. [Laughter.]

Before I turn to Senator Heinz, I would like to welcome Senator Gramm to the committee. We have not yet officially organized because the Senate has not yet been able to come to an agreement on the size of committees or the ratios. But it appears that the Senate Banking Committee, and I use the term "appears," will be reduced in number from 18 to 15, which is what I've been trying to do since it grew from 15 to 18 a few years ago. I think that is the way it will stay. Senator Gramm, we are pleased to have you as a member of the committee. I know you will be a valuable addition.

Senator GRAMM. Thank you.

The CHAIRMAN. Senator Heinz.

OPENING REMARKS OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you. First, I'd ask unanimous consent that my prepared remarks be placed in the record in their entirety.

The CHAIRMAN. Without objection.

Senator HEINZ. Second, I would like to commend you, Senator Garn, on the very special effort you made to make sure that while you are engaged in your training, which we know is long and onerous that, nonetheless, you are here fulfilling in their entirety your responsibilities as a U.S. Senator this week.

I think it needs to be pointed out that we all do read Doonesbury. [Laughter.]

That, in fact, this is the first official business of the committee. This is our semiannual meeting where we hear from the Chairman of the Federal Reserve on monetary policy. We've been tasked with that responsibility by the Congress.

There have been no recorded votes, although one is likely today. And we know that you plan both the Meese nomination vote and this particular hearing, so that there would be absolutely no question that you were performing your duties in space and your duties in Congress 100 percent.

By the way, anybody who can do two jobs at one time is probably going to be accused of moonlighting. [Laughter.]

The CHAIRMAN. I'll think about it. [Laughter.]

Senator HEINZ. The only other comment, and this I direct to Chairman Volcker, which I hope he will touch on in his remarks, we are faced with a most unusual situation. We have a trade deficit that is $127 billion and going up. We have interest rates that appear to be going down. And we have the Treasury Department, breaking with earlier precedent, intervening in the exchange markets to hold the value of the dollar down.

In spite of these three factors which would normally, each of them, bring the dollar down, the dollar has risen on the international exchange markets. That causes me to ask whether or not it is now true that such things as trade flows are indeed what we have traditionally thought to be a major significant determinant of the strength of a nation's currencies, have not been outflanked to a considerable degree, indeed, to the point of significance, by capital flows.

In 1983, the Treasury Department estimated that there were $2 trillion of trade worldwide. But that there are $20–$30 trillion of capital flows. That is, a factor 10 to 15 times larger than trade flows.

I would be interested if we can touch on that in your commentary or in the questions because it seems to me the inevitable question that is posed to you is whether the Federal Reserve must now consider the demand for capital. And, if you will, from your point of view, the foreign demand for dollars, or the foreign demand to invest in the United States as a very vital and appropriate factor in determining the appropriate monetary growth rate.

I would only agree that having asked that question, Disraeli was right on the mark. I hope that I have asked the right question and I hope there is, if I have asked the right question, an answer to it that will not drive men mad.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz.

[The complete prepared statement of Senator Heinz follows:]

OPENING STATEMENT OF SENATOR HEINZ

As we meet here this morning, many of the overall measures of the performance of our domestic economy look relatively good. For all of 1984, real GNP was 6.8 percent higher than in 1983. This constituted the largest 1-year expansion of output since 1951.

Last year nonfarm productivity grew 3.1 percent. This compares with an 0.8 percent average annual growth rate during the previous decade.

On the inflation front, performance remains far superior to that of a few years ago. Consumer prices rose 4 percent in 1984, about the same rate of increase as in 1982 and 1983.

While the unemployment rate in January edged up 0.2 to 7.4 percent, this reflected a surge in the number of people seeking employment, not a decline in the number of jobs.

Finally, since our last monetary policy hearing in July 1984, the prime rate has declined from 13 to 10½ percent.

Of course, we all know that the budget and trade deficit numbers are not as rosy. The President's budget foresees a deficit of $180 billion in fiscal year 1986, even if Congress were to adopt all of the administration's proposed expenditure reductions.

Last year the United States ran a $123 billion trade deficit, and the deficit for 1985 appears certain to be even higher.

A major contributor to that trade deficit is the soaring value of the dollar. On an index weighted according to the amount of U.S. trade with individual countries, since mid-1980 the dollar has risen more than 50 percent in value.

Equally troubling is the fact that old conceptions about economic policy are being subjected to increasing challenge. Our domestic economy does not appear to be operating as it once did, and the explanation appears to lie in the growing importance of international economic developments.

Until recently, macroeconomic policy here at home could be based on the assumption that the success or failure of an industry would be determined by its ability to meet the competition in terms of quality of product and cost of production.

Under such a concept of how our economy operates, exchange rates were determined by trade flows. A rise in our exchange rate would reflect an increase in the demand for our country's exports, and the rise in the exchange rate would tend to equalize trade flows.

Today, exchange rates clearly are not driven by trade flows, and the prospects for U.S. industries that depend on exports clearly do not reflect their ability to control costs and compete in quality.

As a second example of the growing challenges to old conceptions about economic policy, I point to the presumed inevitable tie between an acceleration in money growth and an acceleration in inflation. Statistical analysis of the past performance of our economy had pointed to the conclusion that an acceleration in monetary expansion would lead to an inevitable upward jump in the inflation rate after a lag of about 2 years.

Given this historical statistical relationship and given the acceleration of money growth after mid-1982, many economists predicted that inflation in the U.S. economy would accelerate during 1984. But, as I have already noted, this did not occur. A primary reason appears to be an international influence on our domestic economy: the rising value of the dollar lowered the cost of imports and prevented domestic producers from raising their prices.

As yet another example of the growing challenges to old conceptions about economic policy, I point to factors presumed to determine the demand for money. Statistical analysis of historical data had pointed to the conclusion that the demand for dollars was a function of economic growth here in the United States and domestic interest rates.

Prof. Ronald I. McKinnon, however, has argued persuasively that foreign demand for dollars has become a major determinant of the overall demand. As a result, Dr. McKinnon has argued that the Federal Reserve must now consider the foreign demand for dollars in determining the appropriate monetary growth rate.

In conclusion, I believe that the growing importance to our economy of international economic developments is posing a serious challenge to old conceptions about economic policy. This morning I intend to focus on the appropriate policy responses to these new international economic realities.

The CHAIRMAN. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I'm delighted to see a person I regard so highly in public service, Chairman Volcker, here this morning. As I mentioned to the Chair, I have to go over to the House side to testify at 9 o'clock on Congressman Annunzio's Statue of Liberty's coin bill. I'll be back here, I assure you, by 9:30 for the question period.

I ask consent to put this statement in the record at this time in the interest of our time constraints, and I'll return about 9:30.

The CHAIRMAN. Without objection. Thank you, Senator.

[The complete statement follows:]

PREPARED STATEMENT OF SENATOR DIXON

According to the President's proposed budget for fiscal 1986, I should be very optimistic about the future prospects for the U.S. economy. The statistics the President cites are very impressive: Economic growth of 6.8 percent in 1984; corporate profits up 90 percent since the recession; 7.2 million new jobs created in the last 25 months; and inflation of only 4 percent.

These numbers paint a rosy picture of the prospects for a bright economic future. Unfortunately, however, this is not the total picture. Other numbers show: A national debt that will soon exceed $1.8 trillion; an all-time record budget deficit of $223 billion for fiscal year 1985; interest expense that will exceed $140 billion next year; a dollar that is 40 percent overvalued; and a trade deficit of more than $123 billion for 1984.

The real question is how long the first set of numbers can coexist with the second? How long can low inflation and high GNP growth last when we are forced to borrow $100 billion a year or more overseas to meet Government borrowing requirement, when the export sectors of our economy are literally being destroyed by the impact of the too-strong dollar? In short, how long can we go on like this before we have to pay the bill?

I raise these questions not because I have some simple answers but rather because it is long past time to take a hard look at where our failure to address the Federal budget problems is taking us.

Illinois is a major agricultural State. Right now, conditions in the agricultural economy in my State are worse than any time since the Great Depression. Illinois farmers depended on export markets to sell a large part of their crop, but those export markets are drying up because of the rise in the dollar.

Caterpillar tractor, one of Illinois' preeminant manufacturing firms, is similarly affected. It is literally being beaten down by the dollar. The company is being forced to move an increasing amount of its operations offshore, and those jobs, once lost, will not likely return to Illinois.

The Chairman of the Federal Reserve Board is with us this morning to discuss monetary policy and the outlook for the economy. His statement and his announcement of the monetary targets for this year are, as always, matters of great interest, if the crowd in this hearing room is any indication.

I have an enormous amount of respect for Chairman Volcker and I am always delighted to have the benefit of his counsel and advice. However, I am increasingly uneasy about the burdens we are putting on the Chairman, and I wonder how long the Federal Reserve Board will be able to successfully conduct monetary policy without better cooperation from Federal fiscal policy.

I think that the Federal Reserve has, by and large, done a good job of managing monetary policy. But I do not believe that monetary policy can, by itself, ensure long-term steady, noninflationary economic growth for our economy. I do not believe that monetary policy can by itself, correct the imbalances in our economy being created by the continuing rise of the dollar. I am not even convinced that monetary policy can, by itself, bring down our current too-high interest rates. I know that rates have come down somewhat in the past year, but I would note that the premium over inflation still seems to be at record levels and that the Congressional Budget Office is forecasting higher rates by 1986.

I know that Chairman Volcker will be the first to acknowledge that he cannot go it alone. So what's really at issue here this morning is whether we are willing to begin taking the steps to create a more balanced approach to managing the economy, reducing the degree of stress past actions by the President and Congress have put on the conduct of monetary policy.

Simply put, I think our economic future depends less and less on the monetary targets and more and more on our ability to restrain the growth of Federal spending and our ability to reduce evergrowing Federal deficits.

I look forward to hearing from the Chairman this morning, and having his comments about what we can do to keep the healthy segments of our economy healthy and also about what we can do to restore economic health to the parts of our economy that aren't in such good shape, particularly the export sectors in both manufacturing and agriculture.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No statement. Just a welcome, sir.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Mr. Chairman, please proceed.

The CHAIRMAN. Chairman Volcker, please proceed.

Mr. VOLCKER. Well, Mr. Chairman, let me say first of all that I particularly appreciate your presence here this morning for these hearings, recognizing your other preoccupations. I thought for a moment Senator Heinz was going to suggest the dollar was in orbit. [Laughter.]

The CHAIRMAN. I'm not sure, Mr. Chairman, that I'll be able to see the top of the national debt when I'm up there. [Laughter.]

Mr. VOLCKER. I do appreciate, too, the comments that Senator Proxmire made. I appreciate them very much. I haven't got any commitments one way or the other, except to maybe my own mental health at some point.

Also, of course, I appreciate the opportunity to be here to present our objectives for next year. We have distributed the regular Humphrey-Hawkins report this morning, and I'll just comment more generally on our decisions, the outlook for the economy in the context of some important, unfinished business that we all face.

Thank you, Mr. Chairman.

[The complete prepared statement and the monetary policy report to Congress follows:]

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

I appreciate this opportunity to appear before you to present the Federal Reserve's monetary policy objectives for 1985. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve was transmitted to you this morning. That report reviews in detail economic developments and monetary policy in 1984, and sets forth for 1985 the plans for policy by the Federal Open Market Committee. This morning I would like to discuss the Committee's decisions and the outlook for the economy in the context of some important unfinished business facing all of us responsible for economic policy.

The Economic Setting

The familiar objective of monetary policy is to foster sustained economic growth and employment in a context of reasonable price stability. Stated so generally, that objective can hardly be challenged; it indeed encompasses the broad goals of economic stabilization policy generally.

Measured in those terms, there is clear reason for satisfaction in the performance of the economy last year. In summary, with real gross national product up by 5-1/2 percent over the year, and by about 12 percent in two years, we have enjoyed the strongest expansion since the Korean War period. On top of the gains in jobs in 1983, employment increased by over 3 million last year. The unemployment rate fell one full percentage point to 7.2 percent at year-end. Real incomes for the average American are up.

Prospects for sustained growth and productivity over time rest importantly on success in achieving and maintaining an environment of greater stability of prices and financial markets. In that light, it is encouraging that, contrary to widespread earlier expectations, the strong growth of 1984 took place without inflation increasing appreciably from the sharply reduced levels of 1982 and 1983. Specifically, the consumer price index increased around 4 percent last year, little changed from the previous two years, and prices of most goods (in contrast to services) at the wholesale and retail levels rose by less than that. While the evidence is less tangible, there are also encouraging signs that chronic expectations of future inflation have been damped.

The behavior of actual prices and nominal wages, which by some measures rose more slowly in 1984 than in 1983 despite expanding demands for labor, may in some part reflect those changes in attitude. Businessmen and workers no longer seem so preoccupied with a need to anticipate inflation in their pricing and wage decisions. And declines in bond yields after midyear seemed to reflect, to some degree, less fear of future inflation.

To be sure, a number of factors that may not be lasting have helped to hold price increases down. The continuing appreciation of the dollar and strong competition from imports have placed strong pressures on prices and wages in some manufacturing and mining industries. Widespread declines in commodity prices cannot persist indefinitely. Unemployment is still higher than we would like to see. But it is also true that progress against inflation, as it is prolonged, can potentially feed on itself by encouraging restrained price and wage behavior.

As we start 1985, the immediate economic outlook appears reasonably favorable in these respects. Projections of Federal Open Market Committee members that I will be reviewing later in my testimony broadly parallel those of the Administration, the Congressional Budget Office, and many other observers; economic growth is expected to remain strong enough in 1985 to produce some further decline in unemployment, with little if any pickup in inflation.

But we must not be beguiled by those tranquil forecasts into any false sense of comfort that all is well. If the enormous potential of the American economy for growth and stability -- not just for 1985 but for the years beyond -- is to become reality, we need a sense of urgency, not of relaxation.

For one thing, with the general price level still rising in the neighborhood of 4 percent a year -- and with prices of services that today account for so much of the economy rising more rapidly than that -- we should not confuse evidence of progress against inflation with ultimate success. Indeed, the more favorable price expectations I noted a few moments ago could prove fragile -- highly vulnerable to any indications that public policy is prepared to accept and accommodate to inflationary forces. That must be of particular concern in the conduct of monetary policy.

Perhaps more immediately, despite the strength of the overall expansion, some important areas of the economy are under strain and there have been recurrent international and domestic credit problems. Those strains and pressures are aggravated by underlying imbalances that, unless dealt with effectively, will undercut the long-term outlook.

One of those imbalances was highlighted by the slowdown in GNP growth we experienced in the third quarter. Such a "pause" is not an unusual feature of an expansion period. Demand does not grow smoothly, and occasional inventory imbalances will develop that require production adjustments. What was unusual last summer was that the slowing of demand growth was accompanied by a surge in imports, magnifying the effects on domestic producers. That summer import surge was reversed by year-end, but the underlying trend toward higher imports is clear. Our trade deficit increased to about $110 billion in 1984, far higher than ever before, and the entire external current account deficit -- counting both goods and services -- has deteriorated by about $100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

The rising trade deficit helps account for the failure of a number of important sectors to participate at all fully in the expansion. Agriculture, heavy capital equipment producers, and the metals industry, all of which face difficult structural problems in any event, are examples. They are further pressed by interest rates that, as you know, remain historically high, both in nominal terms and relative to recent inflation.

Looking abroad, growth in many industrial countries remains sluggish amid continuing high levels of unemployment, and depreciation of their currencies vis-a-vis the dollar seems to be one factor inhibiting more expansionary policies. Important developing countries are still struggling to restore stability and maintain growth while laboring under heavy debt burdens. In this interdependent world, these difficulties feed back on our own prospects.

It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits -- deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

Government deficits can be relatively benign and even useful in boosting incomes and purchasing power in the slough of recession and when private investment and credit demands are weak. It is also true that our growing volume of imports over the last two years has provided an impetus for growth in other countries when other expansionary forces were weak. Moreover, the kind of obvious squeeze on, or "crowding out" of, domestic housing and investment that many anticipated as the expansion has developed has not been apparent.

We have been able to reconcile high deficits, sharply rising imports, and strong investment mainly for one reason: we have been able to attract an enormous amount of savings from abroad to supplement our own. The net capital inflow approached $100 billion last year, and it will probably need to be still larger this year. Domestic net savings -- by individuals, businesses, and state and local governments -- are running at about $325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

That same inflow of funds has encouraged a very strong dollar. The strong dollar, in turn, contributes importantly to the huge and growing trade deficit. Our policy dilemma is simple but perhaps not fully understood. We cannot logically welcome the capital inflow from abroad in one breath and complain about the trade deficit in the next. They are two sides of the same coin.

We are managing to finance the deficit and maintain housing and investment expenditures with the help of imported capital. At the same time, the exporter, those competing with imports, and the farmer are being "crowded out."

Looking ahead, the stability of our capital and money markets is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets. So far, they have been not only willing but eager to do so. But we are in a real sense living on borrowed money and time.

It is up to all of us to make constructive use of both the money and the time. In essence, that is the challenge for all of us -- for monetary and fiscal policy, and for all the other policies that can contribute to a productive, growing economy.

Monetary Policy in 1984

As you will recall, the economy was expanding particularly rapidly during the early part of 1984, and demands for money and credit -- and for bank reserves to support monetary growth -- were also strong. By early spring, data available at the time showed M1 increasing at rates well into the upper portion of its range for the year, which targeted growth at 4-8 percent.* At the same time, driven by the financing needs generated by rising levels of private spending and by the Federal Government, M3 and non-financial credit were expanding around or above the upper end of their long-term ranges.

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*The data in this testimony for the monetary aggregates reflect recent seasonal and benchmark revisions. While the changes for the year as a whole were small, the revised data for M1 for the first half of the year are lower, and the second half higher, than reported earlier.

The strong expansionary forces in the economy were reflected in some limited upward movements in interest rates in February and March, and early in the spring the Federal Reserve began to exert some additional restraint on reserves being supplied through open market operations. Consequently, depository institutions were forced to rely increasingly on borrowing at the discount window to satisfy demands for reserves. With credit demands and the economy continuing to expand strongly, and with markets concerned about the possibility that inflationary forces might reassert themselves as the period of strong expansion lengthened, interest rates moved noticeably higher in the spring. In April the Federal Reserve increased its discount rate 1/2 of a percentage point to 9 percent to bring this rate into better alignment with market rates and to discourage reserve adjustment at the discount window.

In May, a liquidity crisis developed in one of the largest commercial banks in the country, growing out of continuing concerns over weaknesses in its loan portfolio. The Federal Reserve, the FDIC, and the primary supervisor of the bank, the Comptroller of the Currency, worked closely together to support the orderly functioning of the institution while more permanent recapitalization and other elements of a long-term solution could be developed. Nonetheless, that incident, together with continuing concerns about international debt problems, for a time contributed to uneasiness in banking markets, and interest rates on short-term private credit instruments rose appreciably above those on government securities.*

Demands for money slackened after midyear as the economic expansion slowed. Long-term interest rates began to drop from the higher levels reached in the spring as inflation concerns moderated. With the problems of the Continental Illinois Bank contained and progress made toward restructuring the debts of some important developing countries, the abnormal interest

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*Attachments I & II summarize these and related developments, and the Federal Reserve response, more fully.

rate spreads began to narrow, but the money markets as a whole remained under some pressure. By late August and September, with M1 growth moving toward the midpoint of its range and M3 expansion slowing toward the upper end of its range, and with some evidence that economic growth had slowed, the Federal Reserve began to ease pressures on reserve positions.

That process continued through the fall, and borrowing at the discount window fell steadily from September through January. Late in the year, total and nonborrowed reserves began to grow rapidly. Short-term interest rates declined between 2-1/2 and 3-1/2 percentage points over the last four months of the year. Reacting to these declines, and to an extent facilitating them, the Federal Reserve in two half-point steps reduced the discount rate to 8 percent, the lowest level since 1978.

Several additional factors influenced judgments about the appropriate degree of easing of reserve positions during the fall. The dollar remained exceptionally strong in foreign exchange markets, potentially increasing pressures on some sectors of the American economy and a source of growing concern among some of our trading partners experiencing depreciating currencies vis-a-vis the dollar. At the same time, relatively favorable incoming data about prices and wages tended to allay concerns about actual and potential inflationary pressures. In fact, prices of many sensitive commodities were falling appreciably. In these circumstances, reserves could be provided more liberally, and growth in the money supply more actively supported without providing a basis for a destructive rise in inflation expectations.

The fall in interest rates and the more generous provision of reserves in the context of some increases in economic activity led to a rather strong revival of M1 and M2 growth around year-end, bringing both aggregates relatively close to the mid-points of their respective ranges. As monetary and credit growth continued at a relatively rapid pace into January, the easing process came to an end.

Unlike the pattern during much of 1982 and 1983, when M1 grew more rapidly than nominal GNP (that is "velocity" slowed), the income velocity of M1 rose 4 percent last year. That is broadly in line with cyclical experience in the past, taking into account both the pattern of interest rate movements and income growth. M2 velocity also increased, rising around 1-1/2 percent following two yearly declines.

These developments provide some support for the view that velocity trends over time, as well as cyclical changes for these aggregates, may be returning to patterns more along the lines of earlier experience. In contrast, in 1982 and 1983, during a period of rapid transition to deregulation of deposit interest rates and substantial economic uncertainty, those earlier patterns had been disrupted and velocity had declined appreciably.

The rise in M3 and credit during 1984 exceeded expectations at the start of the year, and both measures exceeded by a considerable margin the upper limits of their ranges over the year as a whole. In fact, credit increased at its most rapid pace over the entire post-World War II period, both in absolute terms and relative to nominal GNP. Debt growth of this magnitude would appear to be much faster than consistent with the long-run health of our economy and financial system. It reflects to some degree the imbalances in our economy I emphasized earlier.

For example, the budget deficit led to expansion of federal debt of 16 percent, an unprecedented rate of growth in the second year of a business cycle. The growth of the debt of non-federal sectors, at nearly 13 percent, also was high relative to past experience. A portion of this growth in private debt -- perhaps around 1-1/2 percentage points -- can be attributed to a huge volume of mergers, leveraged buyouts, and stock repurchases by businesses which had the effect of substituting debt for equity. Despite some sizable sales of new stock, non-financial corporations on balance retired about $70 billion of stock last year.

Whatever the circumstances and justification for the particular companies involved, a financial structure that tends toward more debt (and shorter debt) relative to equity becomes more vulnerable over time. More cash flow must be dedicated to debt servicing, exposure to short-run increases in interest rates is magnified, and cushions against adverse economic or financial developments are reduced. These are factors that prudent lending institutions should take into account in evaluating new credits, and reports suggest that some banks did in fact review their policies toward mergers and leveraged buyout financing as the year wore on.

While the effect cannot be isolated, the rapid growth of debt relative to GNP may also reflect the fact that domestic spending increased appreciably faster than domestic production, which is what the GNP measures. A new machine, for instance, will require financing, whether purchased at home or abroad, and sharply increasing amounts of capital equipment have in fact been imported. As I indicated earlier, directly or indirectly, that financing may be supplied from abroad, alleviating the pressures on our market. But the debt burden inevitably rests with the borrower.

Monetary Policy in 1985

At its meeting last week the FOMC agreed to some small changes in some of the ranges for the monetary and debt aggregates tentatively set out last July. The modifications are in response to analysis of information now available and do not represent any change in policy intentions. As shown on the attached table, for M1, the Committee reaffirmed the lower tentative range it adopted last July of 4 to 7 percent growth from the fourth quarter of 1984 to the fourth quarter of 1985. M2 is targeted to grow between 6 and 9 percent, the same range as used in 1984. The upper end of that range was increased by 1/2 percent from the tentative range for 1985 set in July. That small adjustment reflects a technical judgment -- based on assessment of recent developments -- that M2 could expand more in line with income growth this year, in keeping with the historic record of little trend growth in its velocity.

The upper end of the new M3 range of 6 - 9 1/2 percent was also set 1/2 percent higher than tentatively agreed in July. The associated monitoring range for credit was set at 9 to 12 percent, a percentage point above the 1984 range. Adjustments in both target ranges still contemplate a considerable slowing in these two aggregates from what actually occurred in 1984. Even so, credit growth, fueled in part by the budget deficit, is expected to be quite strong, significantly exceeding the rate of expansion of GNP for the third consecutive year.

The Committee does not anticipate that growth of debt within the targeted range would necessarily pose significant new risks for the economy or the financial system in the year immediately ahead. However, a healthy financial structure will in time require more restraint on borrowing relative to the economic growth that, in the last analysis, provides the wherewithal to service the debt. One continuing problem in that respect is the extent to which the current tax structure tends to favor debt rather than equity financing, a point addressed in the Administration's reform proposals.

The ranges for growth in money and credit are expected by FOMC members and non-voting Reserve Bank Presidents to support another year of satisfactory economic expansion without an acceleration of inflation. Forecasts of real GNP growth centered around rates of 3-1/2 to 4 percent from the fourth quarter of 1984 to the fourth quarter of 1985 -- rates anticipated to be sufficient to reduce the unemployment rate to around 6-3/4 to 7 percent by year-end. Inflation, as measured by the GNP deflator, was expected most frequently to be in a range of 3-1/2 to 4 percent over the year, about the same rate as prevailed in 1984.*

In view of the necessarily tenuous nature of any judgment about the outlook for exchange rates, FOMC members in preparing their projections assumed that the dollar would fluctuate in a range encompassing its level of recent months. They also assumed that the federal budget deficit would be reduced significantly in fiscal 1986 relative to base line projections, a development that would help damp both interest rate and inflationary expectations. Obviously, those assumptions suggest some of the important risks inherent in the outlook.

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*These projections, now regularly set out in our Humphrey-Hawkins Reports, should not be interpreted as indicating "targets" for real growth or inflation in the short or longer run. As discussed in Attachment III, the Committee does not target a specific long-range growth path for the economy.

As I indicated in discussing 1984 developments, we entered 1985 with the various monetary aggregates growing relatively rapidly. The targets for this year take, as usual, the actual average for the fourth quarter of the previous year as a starting point (or "base"). Consequently, we are starting the year with the levels of the aggregates above the target ranges as they have been conventionally illustrated -- that is by so-called "cones" starting at a point late the previous year and widening through the current year. (See Charts I to IV.)

That conventional and widely used "picture" is essentially arbitrary. Interpreted rigidly (and wrongly), the narrowness of a cone in the early part of the year -- literally narrower than some weekly fluctuations in the money supply -- would attach policy importance to levels or movements in the various aggregates that in fact have no significance.

We have sometimes considered, and others have suggested, a better "pictorial" approach would be to illustrate the targets by a different (but also necessarily arbitrary) convention -- parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period, as shown in the charts attached. The target range is then portrayed as maintaining the same width throughout the year. The current levels of the aggregates, as you can see on the charts, are within such parallel lines.*

As a matter of economics and policy, rather than graphics, the Committee is not disturbed by the present level of M1 and M2 relative to its intentions for the year. It contemplates that, as the year progresses, growth will slow consistent with the target ranges.

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*Attachment IV addresses the different but related questions of the appropriate "base" used in setting and illustrating targeted growth ranges.

Consistent with that approach, as I indicated earlier, the progressive process of easing reserve positions undertaken in the latter part of 1984 ended. The provision of reserves through open market operations is currently being conducted a bit more cautiously to guard against inadvertent "overshoots" in supplying reserves. Any further change in approach will, as always, depend upon assessments of the trend of monetary growth in the period ahead, evaluated in the context of the flow of information on the economy, on prices, and on domestic credit and exchange markets.

The annual target ranges for M1 and M2 assume that trends in velocity are returning to a more normal and predictable pattern. However, there is some analysis that suggests the trend of velocity over time may be a little lower than the trend of 3 percent or so characteristic of much of the postwar period when interest rates were trending higher. Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee anticipates that those aggregates might end the year in the upper part of their ranges. The lower part of the M1 range would be consistent with greater cyclical growth in velocity than now thought likely. As usual, these ranges will be reviewed at mid-year, in accordance with Humphrey-Hawkins Act procedures.

The Challenge Ahead

The approach toward monetary policy that I have outlined for 1985 is designed to promote, as best we can, our common objectives of sustained growth and stability. We can build on the strong progress of 1983 and 1984. There is forward momentum in the economy. The public at large seems to sense a greater degree of control over inflation than for many a year -- and I sense some chance of further progress toward price stability this year even as the economy grows.

Happily, despite the strength of the economic advance and the financing of a huge deficit, interest rates are today little above those of two years ago. The threats of financial dislocation growing out of the debt problems of much of the developing world, or from more purely domestic financial pressures, have been well contained. Points of strain will, without doubt, require continuing attention this year. But, in the context of a healthy economy, they are capable of resolution.

By encouraging appropriate growth in money and credit, in discharging our supervisory responsibilities, in performing when necessary the essential functions of lender of last resort, and in our general surveillance of the financial system, the Federal Reserve can help build on that progress. We aim to do so.

But it is equally important to understand clearly what monetary policy and the Federal Reserve cannot do.

The progress against inflation, the strength of the dollar and the competition from abroad, and some margins (if diminishing) of capacity and manpower have provided a certain degree of flexibility in the conduct of monetary policy. But that limited flexibility would be abused at our collective peril. Credibility in the effort to deal with inflation is a precious thing. The lesson here and abroad, now and through history, is that, once a sense of price stability is lost, it can be restored only with pain and suffering.

The Federal Reserve can theoretically run the modern equivalent of the printing press -- we can create more money. But more money is not the same as correcting the gross imbalance between our ability to generate real savings and the demands for those savings posed by housing, by investment and by the federal deficit.

To create money beyond that needed to sustain orderly growth would be to invite renewed inflation -- damaging incentives to save in the process. In contrast, *to encourage savings from income* would be to provide more of the <u>real</u> resources we need for future growth -- and it would help spur productivity and reduce price pressures in the process.

If that route isn't open to us -- and as a practical matter we probably can't do much right now to change ingrained savings behavior -- then the only constructive alternative is to attack the problem from the other side of the ledger by reducing the federal deficit.

For the time being, capital from abroad has been readily available to close the growing gap between our domestic savings and the demands upon them, moderating pressures on interest rates. Indeed, the money attracted partly by perceptions of our strength has come so freely we have an exceptionally strong dollar. But that same strong dollar contributes to a massive trade deficit that strains key sectors of industry and our agriculture, aggravating structural problems.

No doubt <u>bad</u> monetary policy could drive the dollar down -- a monetary policy that aroused inflationary expectations, undermined confidence, and drove away foreign capital. But then, how would we finance our investment and our budget deficit?

Nor is the process of money creation adapted to relieving particular sectoral strains within our economy. We can and will, in our administration of the discount window and in our actions as lender of last resort, protect the essential financial fabric by supporting credit-worthy depository institutions faced with extraordinary needs.

But the evident problems of particular sectors, in the last analysis, will yield only to measures that support their efficiency and broaden their markets. That in itself is a large agenda, for government and those involved alike. And the process will be much easier if we at the same time address the basic imbalance between our capacity to save and our need to invest and to finance the government that I have emphasized today.

Conclusion

I fully appreciate the difficulties of the decisions before you as you collectively approach those excruciating budgetary choices. As you do so, I know that you are aware of the priority that progressive reduction of the deficit deserves. That, indeed, would provide the most fundamental kind of reassurance that growth can be sustained in an environment of greater stability.

For our part, in the conduct of monetary policy, we in the Federal Reserve will be sensitive to both the opportunities and the dangers before us. We believe the approach I have outlined with respect to the monetary targets and our implementation of policy sensibly reflects and balances the concerns I am sure we share.

Growth Ranges for the Aggregates for 1984
in Comparison with Actual Growth
(QIV to QIV)

	Percent Increases	
	Ranges	Actual Growth
M1	4 to 8	5.2
M2	6 to 9	7.7
M3	6 to 9	10.5
Domestic Nonfinancial Debt	8 to 11	13.4

Growth Ranges for the Aggregates Adopted for 1985
in Comparison with Tentative Ranges and Those for 1984
(QIV to QIV)

	Percent Increases		
	Adopted Ranges for 1985	Tentative Ranges for 1985 Set in Mid-1984	Ranges for 1984
M1	4 to 7	4 to 7	4 to 8
M2	6 to 9	6 to 8-1/2	6 to 9
M3	6 to 9-1/2	6 to 9	6 to 9
Domestic Nonfinancial Debt	9 to 12	8 to 11	8 to 11

Chart 1

M1 Target Ranges and Actual

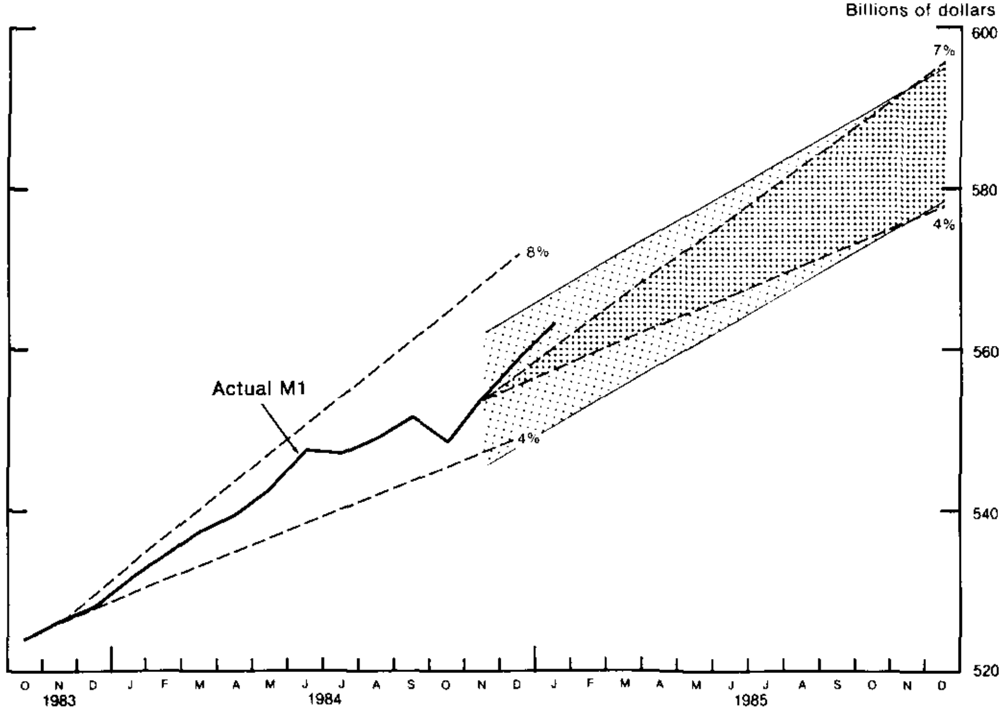


Chart 2

M2 Target Ranges and Actual

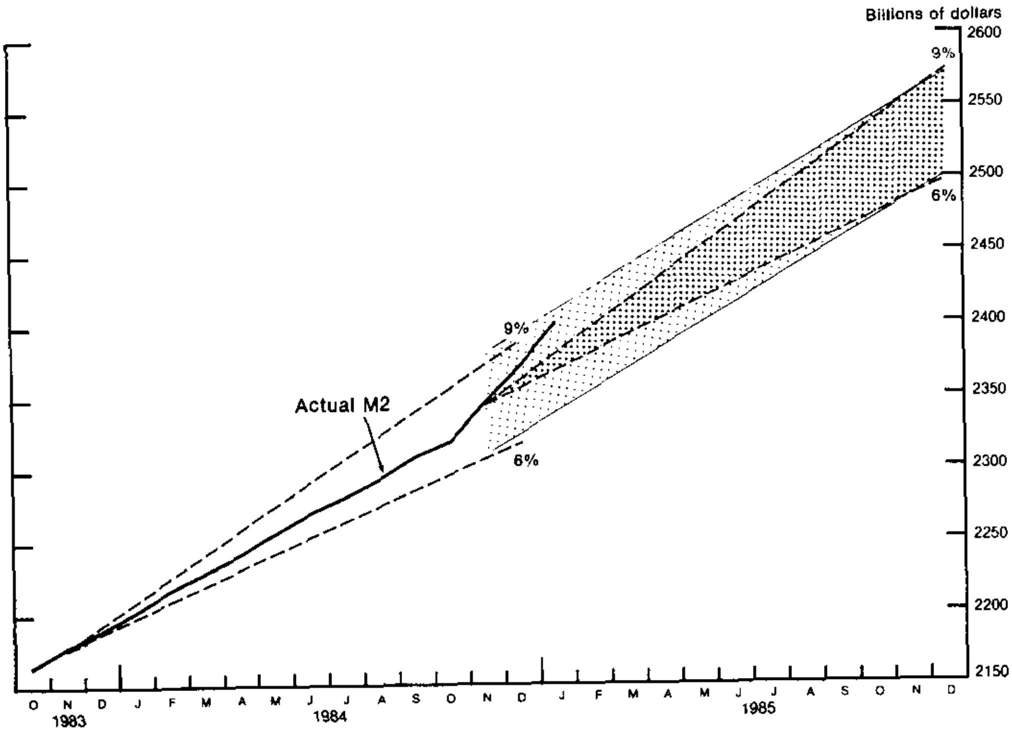
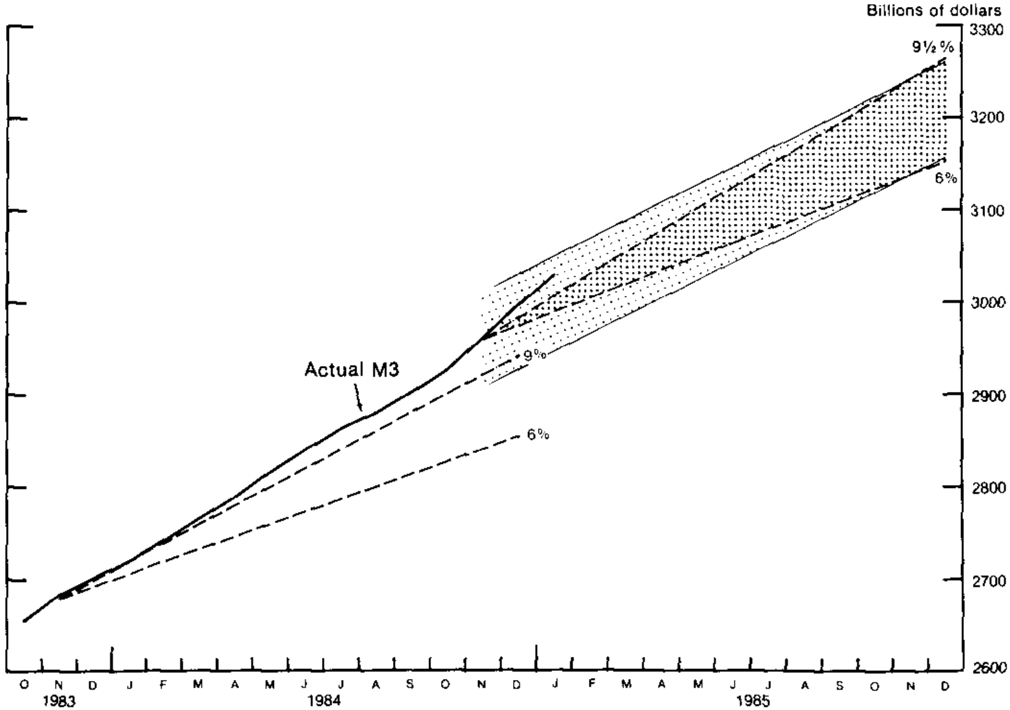


Chart 3

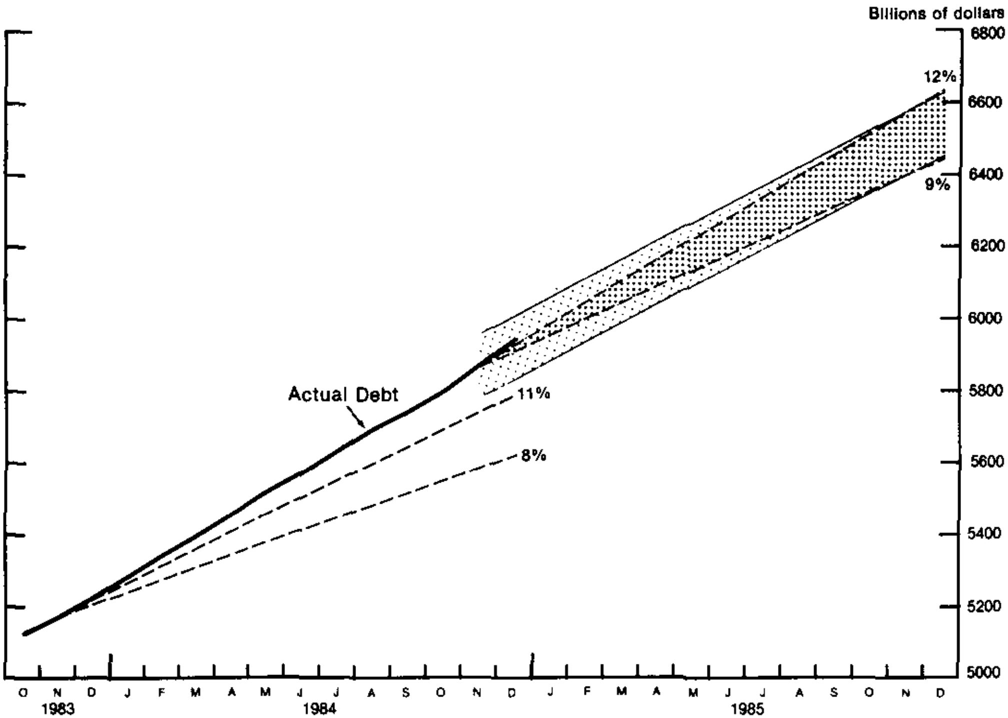
M3 Target Ranges and Actual



43

Chart 4

Debt Monitoring Ranges and Actual



Attachment I

The Implications for Monetary Policy of the Near Failure of the Continental Illinois Bank

The condition of the Continental Illinois Bank -- the seventh largest in the United States at the beginning of 1984 -- had been a matter of concern to regulatory authorities and market participants for some time, particularly after the failure of the Penn Square Bank in the middle of 1982 brought to light large loan losses and weaknesses in credit policy. Continuing profit and loan problems culminated in rumors of possible impending failure and a liquidity crisis in May 1984, involving withdrawal or failure to renew billions of dollars of deposits in the bank over a few days.

The FDIC, the Federal Reserve, and the Comptroller of the Currency, with the cooperation of a group of major banks, developed arrangements to provide temporary capital and liquidity support pending more permanent solutions and reorganization. The Federal Reserve -- acting as lender of last resort -- provided large amounts of funds through the discount window to maintain the bank's liquidity. That lending rose irregularly from around $3 billion during most of May to a peak of more than $7 billion in August. During the autumn the amount of outstanding loans declined to much reduced levels.

Provision of funds through the discount window has the effect of expanding total bank reserves, and unless otherwise offset, the lending to the bank would have had the effect of expanding the money supply well beyond targeted ranges. To maintain consistency of reserve provision with FOMC intentions, essentially equivalent amounts of reserves were absorbed by open market operations. While the large borrowings necessarily involved some added technical difficulties and uncertainties in the conduct of open market operations, the Committee was able to achieve its reserve objectives.

At the same time, however, the liquidity crisis of Continental Illinois Bank, particularly in an environment in which international debt and other credit problems were attracting attention, generated concern about possible threats to the stability of other financial institutions. As a result, interest rates on banking liabilities rose appreciably relative to interest rates on Treasury securities during the spring. More cautious funding and lending policies by a number of banks appeared to have some effect on maintaining short-term interest rates at higher levels than might otherwise have been the case.

The extraordinary concerns in the marketplace dissipated as the year wore on, reflecting some sense of progress in dealing with both the international debt situation and points of domestic financial strain. Strong liquidity pressures at one of the largest savings and loan organizations during the late summer and fall, requiring sizable liquidity support by the Federal Home Loan Bank System, had lesser effects on market attitudes.

The experience of 1984, together with supervisory efforts and the strong continuing pressures on some sectors of the economy have underscored for depository institutions the importance of adequate capital and prudent lending policies, and other means of assessing and controlling risk. Substantial efforts have been made by many of the larger banking organizations to increase capital ratios and to review credit standards. In time, in the environment of a growing economy, these efforts should be reflected in stronger institutions and a reinforced banking system.

Attachment II

The International Debt Situation in 1984

At times during 1984, concerns about the external debt problems of key borrowing countries continued to be an important factor affecting attitudes in financial markets. As the year began, markets had substantial doubts about the viability of the Brazilian adjustment program, the programs of the new Venezuelan and Argentine governments were unknown, and there was some sense of weariness among the borrowing countries and their creditors. Tensions were aggravated by increases in dollar interest rates in the spring and early summer.

Subsequently, concerns in financial markets receded somewhat as interest rates moved lower, clear progress was recorded in narrowing some countries' external imbalances, and plans for long-term debt restructuring were developed for some of the largest borrowers.

The improvements in external accounts in Mexico and Venezuela in Latin America, and in Yugoslavia and Hungary in Eastern Europe, produced current account surpluses last year. Brazil's current account deficit was essentially eliminated, and a number of other countries had reduced deficits.

This progress was faciliated in many cases by significant increases in exports, particularly to the United States, and in most cases was accompanied by a recovery -- or at least a slower rate of decline -- of imports. Such developments, coupled with continued moderate capital inflows, contributed to sizable increases in the international reserves of many of these countries and to the prospects of reduced demands for extraordinary external financing in the future. At the same time, most of those countries managed to achieve domestic growth.

Against this background, several of the major borrowing countries were able to move on to a second phase in their adjustment and financing programs. One important iniative, when warranted by progress in adjustment, has been planning for longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico and Venezuela; serious negotiations have begun with Brazil and Yugoslavia; and the financing package prepared for Argentina contains some longer-term elements.

However, it is also evident from developments in 1984 and the first months of 1985 that the process of adjustment which began in 1982 is far from complete, particularly on the internal side. Financial markets will remain sensitive to indications of progress or the lack thereof. Cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required. The need for imaginative and constructive solutions to the problems faced by individual countries is not over.

Attachment III
Targeting Real Growth

Questions sometimes arise as to whether the Committee's forecasts for real GNP growth or prices are in the nature of short-run targets toward which the Federal Reserve "fine tunes" policy, or whether the Committee has preconceptions about just how rapidly the economy can and should grow over the medium or longer run.

The answer to those questions is no. Monetary policy is, of course, broadly directed toward sustaining the growth process in a non-inflationary environment. But the Committee as a group has no preconceived notion as to just how rapid growth can or should be over a particular period of time, without straining our resources or giving rise to price pressures and imbalances that would make it ultimately unsustainable.

Our capacity for growth over time depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence. There are other policies, public and private, quite outside the purview of monetary policy that will influence both our growth potential and actual growth paths over time. There are debates in and outside the Federal Reserve as to some of these factors that affect economic growth, but annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run.

For instance, the Committee would presumably welcome faster growth than predicted for 1985 if that proved consistent with moderating inflationary forces, and indeed, less inflation than anticipated would tend to encourage greater growth, consistent with our monetary targets. Indeed, the relationship between money and economic growth at any point in time is sufficiently loose that many other factors bear upon actual performance.

In sum, policies are periodically reassessed in light of incoming information about prices, output, exchange rates and other variables bearing on our growth potential and prospects for inflation. In practice there is sufficient flexibility in our targeting procedures to accommodate information that might suggest greater or lesser growth potential over time.

Attachment IV
The Base for Monetary Target Ranges

Some questions have been raised concerning the "base" used by the Open Market Committee in deciding on targets for the monetary and credit aggregates for the calendar year. Consistent with the Humphrey-Hawkins Act procedures, the Committee's target ranges are specified each February as a range of growth from the fourth quarter of the previous calendar year to the fourth quarter of the current calendar year.

The convention that is usually used, is that the beginning point -- or "base" from which growth is measured -- is taken to be the fourth quarter average growth of a particular monetary or credit aggregate. Other "bases" could be used -- and occasionally have been used -- if the conventional base period is seriously distorted, by institutional change or otherwise.

During its recent meeting the Committee, as it has from time to time, discussed the issue of the desirability of choosing a base for 1985 for one or more of the aggregates other than the conventional one. It concluded that none of the fourth quarter averages for the targeted aggregates were distorted in a manner that strongly suggested the desirability of departing from the usual convention, and that such a departure might indeed confuse communication of the Committee's intentions. It also noted that the average level of both M1 and M2 during the fourth quarter of 1984 was reasonably close to the mid-point of the previous year's range, an alternative base suggested by some. M3 and credit ran significantly above the 1984 ranges. Rebasing those aggregates at the mid-point of the 1984 ranges would thus have implied a wrenching adjustment in the levels of those aggregates, a result that would be contrary to the Committee's intentions. Essentially, such a change would have implied a substantial tightening to bring the growth of those aggregates into the new ranges, or, alternatively, a specification of ranges of growth for 1985 that would have been extraordinarily high and quite out of keeping with longer range intentions.

More broadly, a decision to regularly target growth from the mid-point of a previous year's range would seem to imply the continuing validity of a judgment made a year earlier that the mid-point of a previous range is in some sense a uniquely "correct" level of a monetary aggregate. The Committee does not share such a conviction. Instead, it believes that the appropriate trend of each aggregate needs to be judged in the light of evidence as to velocity changes and other factors as they emerge over time.

In setting targets for any year, the Committee is, of course, aware of the base level of the aggregate. Adjustments in the new target ranges themselves, or in the conduct of policy within those ranges, can take account of any modest distortions in the base. Such considerations are reflected in the discussion of policy in the testimony.

Board of Governors of the Federal Reserve System

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

February 20, 1985

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 20, 1985

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

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

Sincerely,
Paul A. Volcker, Chairman

Section 1: The Outlook for the Economy in 1985

Nineteen eighty-four was another year of substantial economic growth in the United States. Production and employment gains were large, making the expansion of the past two years--with growth in real gross national product averaging 6 percent per annum--the strongest cyclical upswing since the early 1950s. Moreover, continued vigor of the economy was accompanied by signs of some further lowering of inflationary expectations. Aggregate price measures rose around 4 percent last year, about the same as during the two preceding years. While prices of services continued to rise by 5 to 6 percent, prices of many goods were relatively flat, and underlying wage trends seemed to be moderating.

Economic growth had been extraordinarily rapid in the first half of 1984, and then slowed abruptly around midyear. Although some slowing in growth was widely anticipated, the abruptness of the change raised some question about the continuing strength of expansionary forces. However, during the last few months of the year, output and employment were clearly rising, though at a more moderate pace than earlier in the year.

The strong gains in overall activity during the year drew attention away from a number of continuing problems, but those problems are nonetheless real and serious. The overall rate of unemployment is still uncomfortably high and the joblessness among certain groups--for example, teenagers and blacks--remains well above the average. Sectors of the economy facing intense competition from abroad, such as agriculture and certain mining and manufacturing industries, have not participated in the rapid economic expansion overall, and have been under strong financial stress. Strains also remain evident among financial institutions: a number of depository institutions have experienced a deterioration of the quality of their loan portfolios, and the earnings of thrift institutions remain constrained by low-yielding assets accumulated in earlier years.

While it has not been an impediment to economic expansion to date, growth in credit has been exceptionally rapid and many households and businesses have accumulated substantial indebtedness, often in short-term or variable-rate forms that make them especially vulnerable to unexpected economic developments. Also, despite the impetus from strong U.S. demand, growth in economic activity has been limited in a number of important industrialized countries, and many developing countries, in Latin America and elsewhere, are still struggling to restore satisfactory growth. While progress was made in stabilizing the external finances of some of the largest of those countries, that progress can only be secure in the context of greater stability in their own economies and of sustained growth in the industrialized world.

Many of the problems afflicting particular industries have causes and complications that at least in part must be dealt with in direct and specific ways. But it is also evident that the enormous imbalances in our federal fiscal posture and in our trade and current account position have aggravated the problems and made constructive solutions much more difficult. In an expanding economy requiring more private credit, the need to finance the large federal deficits has contributed to the pressures that have held real interest rates at historically high levels. The failure to deal with budgetary deficits also has sustained doubts in the minds of the public about the ability of the government to continue to curb inflation over the long run.

The large federal deficits are mirrored in our external imbalance. Many foreign investors have been attracted to the comparatively high real rates of return offered on dollar-denominated assets, and U.S. lending abroad has been reduced. Other forces stimulating capital inflows have been at work as well, including political and economic uncertainties in other countries and the relative stability and vigor of our economy. The shift in capital flows has supplemented domestic saving and helped finance the federal government deficit and private investment. But, at the same time, the strong demand for the dollar has driven its value on foreign exchange markets to extremely high levels. As the dollar has appreciated, the demand for our exports has suffered and our purchases of imported goods have increased dramatically, resulting in strong competitive pressures on the manufacturing, mining, and agriculture sectors and leading to calls for protectionist measures. Moreover, the capital inflows lead to mounting financial claims of foreigners that the nation must be prepared to deal with in future years, through reduced imports or increased exports, in either case lowering domestic consumption.

The Economic Projections of the FOMC

Notwithstanding the risks associated with the domestic and international problems just outlined, the weight of the evidence points to reasonably favorable near-term prospects for aggregate economic performance. In recent months, personal income growth has been strong, reflecting continuing substantial gains in employment and helping to support consumer spending. Overbuilding of multifamily residential units and offices in some parts of the country may pose questions about the outlook in these areas, but the lower interest rates that developed over recent months suggest that single-family homebuilding may strengthen. Surveys of businesses indicate plans for continued growth in plant and equipment spending in the coming months, though at a slower pace than last year; meanwhile, some imbalances in business inventories that developed during 1984 appear to be well along in the process of correction, and in some sectors inventories are quite lean relative to sales. Many states and localities are experiencing an improvement in their finances, which portends further support to the expansion from that sector. And, at the federal level, there continues to be a strongly stimulative thrust from fiscal policy.

The smallest increases in nominal wages and compensation in more than a decade have been accompanied by an improvement in productivity and downward pressures on energy and commodity prices. These developments help support the possibilities of continuing restraint in price increases. Also, in the context of an economy expanding at a sustainable rate, they are consistent with continuing growth in average real income.

Taking account of the above factors, the members of the Federal Open Market Committee (as well as Federal Reserve Bank Presidents who are not at present FOMC members) now foresee the probable continuation of the economic expansion through its third year, although at a more moderate pace than in the first two years. The central tendency of the members' forecasts indicates the probability of an increase in real GNP of between 3-1/2 and 4 percent this year. The unemployment rate is expected to decline in 1985 to a level of between 6-3/4 and 7 percent by the fourth quarter. At the same time, most members expect general measures of price inflation to remain close to recent trends.

Economic Projections for 1985

	FOMC Members and other FRB Presidents		Adminis-	
	Range	Central tendency	tration	CBO
Change, fourth quarter to fourth quarter (%)				
Nominal GNP	7 to 8-1/2	7-1/2 to 8	8.5	7.7
Real GNP	3-1/4 to 4-1/4	3-1/2 to 4	4.0	3.4
GNP deflator	3 to 4-3/4	3-1/2 to 4	4.3	4.2
Average unemployment rate in the fourth quarter (%)	6-1/2 to 7-1/4	6-3/4 to 7	6.9	7.0

When considering the general outlook for 1985, members of the FOMC recognized that persisting problems could become aggravated for particular sectors of the economy, and that there are risks for the economy as a whole. Clearly, there is growing distress in many farm communities. Incomes from farming have been low, land prices are falling, and many producers face heavy debt burdens. In the household and business sectors, higher levels of indebtedness are unlikely to forestall further gains in spending, but unless moderated, they would in time add to financial pressures.

Favorable price performance has been encouraged by the strength of the dollar in the exchange markets. A sharp and large reversal of that strength could be reflected in at least temporarily stronger inflationary pressures. Greater confidence in prospects for price stability is, of course, dependent over time on suitably restrained growth in the money supply, and that necessary approach, and more moderate real interest rates, would be facilitated by effective action to reduce substantially the size of federal budget deficits in the upcoming and subsequent fiscal years. Action to restore balance in the government's fiscal position is important to the achievement of an environment conducive to stable, strong economic growth. In their forecasts, the Committee members assumed that the exchange rate would remain within the range of recent months and that effective fiscal action is in prospect.

The "central tendency" forecast of the FOMC members is broadly consistent with that of the Administration, as indicated in the *Economic Report of the President*, and that of the Congressional Budget Office. The Administration's projections for both real GNP growth and inflation do fall, however, toward the upper part of the ranges of Committee members' forecasts, while the CBO's estimate of real growth is a bit lower than the FOMC central tendency range.

Section 2: The Federal Reserve's Obectives for Money and Credit in 1985

At its meeting of February 12-13, the FOMC set monetary and credit growth ranges for 1985 designed to be consistent with further sustainable economic growth and progress toward reasonable price stability over time. Specifically, the Committee (1) set a growth range for M1 of 4 to 7 percent from the fourth quarter of 1984 through the fourth quarter of 1985, the same as that tentatively selected last July; (2) established target ranges of 6 to 9 percent and 6 to 9-1/2 percent for M2 and M3, respectively, one-half percentage point higher at the upper end of the range than tentatively set in July; and (3) set an associated monitoring range of 9 to 12 percent for the debt of domestic nonfinancial sectors, one percentage point higher than tentatively indicated. The upper end of the range for M1 is one percentage point below that of 1984, and the range for M2 is the same as last year's. The upper end of the target range for M3 is slightly above that for last year. That increase, as well as the upward adjustment in the associated monitoring range for the debt of domestic nonfinancial sectors, reflects analysis of developments during 1984 suggesting that growth somewhat greater than anticipated earlier may be consistent with Committee objectives for the year. Expansion within these ranges would represent a significant deceleration in the actual growth of M3 and debt from the experience of last year when the target ranges were exceeded.

In formulating these objectives, the Committee assumed that no new statutory or regulatory developments would be enacted that would appreciably influence the behavior of the monetary and credit aggregates in 1985. Although at the beginning of the year the minimum denomination of super NOW and money market deposit accounts was reduced from $2,500 to $1,000, to date the promotional activity accompanying this change has been minor, and it appears that M1 and M2 have not been affected significantly.

On average, the behavior of M1 velocity--nominal GNP divided by the money stock--during 1984 was broadly consistent with previous cyclical patterns. Together with other evidence, this development suggests that the factors responsible for the highly unusual velocity behavior over 1982 and early 1983 have receded.

Nonetheless, a range of uncertainty inevitably remains about the trend of M1 relative to nominal GNP in light of recent deposit deregulation and other financial innovations that have affected the funding policies of banks and the cash management practices of the public. On balance, it appears likely that the process of deposit deregulation will lead to a trend rate of increase in the velocity of M1 that may be somewhat lower than in the post-World War II period as a whole. However, in view of the multiplicity of changes in financial instruments and practices that influence the behavior of all the monetary measures, interpretation of all the aggregates will continue to be made within the context of the outlook for economic activity, inflationary pressures, and conditions in domestic and international financial markets, including the strength of credit demands.

The new 4-to-7 percent target range for M1 encompasses growth in M1 consistent with velocity expansion over the coming year approximating that of last year, and also higher M1 growth that would be needed should velocity grow at a rate approximating the reduced trend suggested above. The movements in velocity during 1984 occurred in a context of moderate increases in interest rates over much of the year; however, velocity has slowed substantially in recent months in the context of an appreciable rise in money growth and following declines in interest rates. In all the circumstances, a somewhat higher rate of money growth than implied by straight line projections from the fourth quarter 1984 base to the targets for the fourth quarter of 1985 may be appropriate early in the year, but growth of M1 would be expected to slow, and velocity growth to rise, as the current adjustments are completed. Thus, as the year progresses, growth of M1 would be expected to move gradually toward and into the FOMC's target range. Depending upon developments with respect to velocity and price behavior, growth in M1 and the other monetary aggregates in the upper parts of their ranges may be appropriate over the year as a whole. Those developments will, of course, be closely monitored over the year.

Like M1, growth of M2 and M3 have been particularly strong in recent months, reflecting the unusually favorable yield spreads in favor of monetary assets that emerged temporarily toward the end of last year; open market interest rates dropped more swiftly than rates offered by depository institutions on retail deposits and returns on money market mutual funds. In addition, M3 growth has reflected substantial issuance of large CDs by thrift institutions to support their lending in mortgage and consumer loan markets.

Growth of the broader monetary aggregates is influenced, as well, by the pattern of international capital inflows associated with the huge current account deficit. Domestic banks may continue to borrow sizable amounts of Eurodollar funds from their foreign branches and unaffiliated foreign banks; such borrowings are not included in the measured monetary aggregates. By reducing the need for funding through other managed liabilities included in M2 and M3, these inflows tend to restrain measured monetary growth in relation to growth of bank credit and credit generally. Moreover, many domestic borrowers, including the federal government and private corporations, may continue to tap overseas securities markets directly, reducing the need for credit expansion by U.S. intermediaries.

Given the federal budget deficit as projected by the Administration for 1985--as well as a likely expansion of spending by domestic sectors in excess of nominal GNP growth, as part of that spending flows abroad--the Committee contemplates that domestic nonfinancial debt may continue to increase more rapidly than nominal GNP. Still, actual growth of debt in 1985 should be markedly less than in 1984, as nominal GNP growth and overall credit demands moderate. Growth within the debt range for 1985 assumes also a slowing in credit for mergers, leveraged buyouts, and other financial restructuring. Such credit led to some erosion in corporate equity cushions last year, and a more cautious approach is anticipated this year.

The outlook for financial conditions generally is again expected to be affected importantly by current and prospective federal budget deficits, which will remain enormous in comparison with experience in previous economic expansions. This massive federal borrowing will compete for available domestic savings with the strong private credit demands accompanying further growth of economic activity, keeping interest rates and exchange rates higher than they otherwise would be. Such relatively high interest rates and exchange rates limit expansion in those sectors that are most sensitive to the cost of credit and impair the competitive positions of domestic import-competing and export industries. Decisive and credible actions to reduce federal budget deficits would have favorable effects on investors' expectations and help to lower interest rates, especially longer-term rates, even before these reductions become fully effective. Such actions would work to relieve the imbalances and strains within the economy, contribute to further abatement of inflationary expectations, and so reinforce the prospects for continued growth and stability.

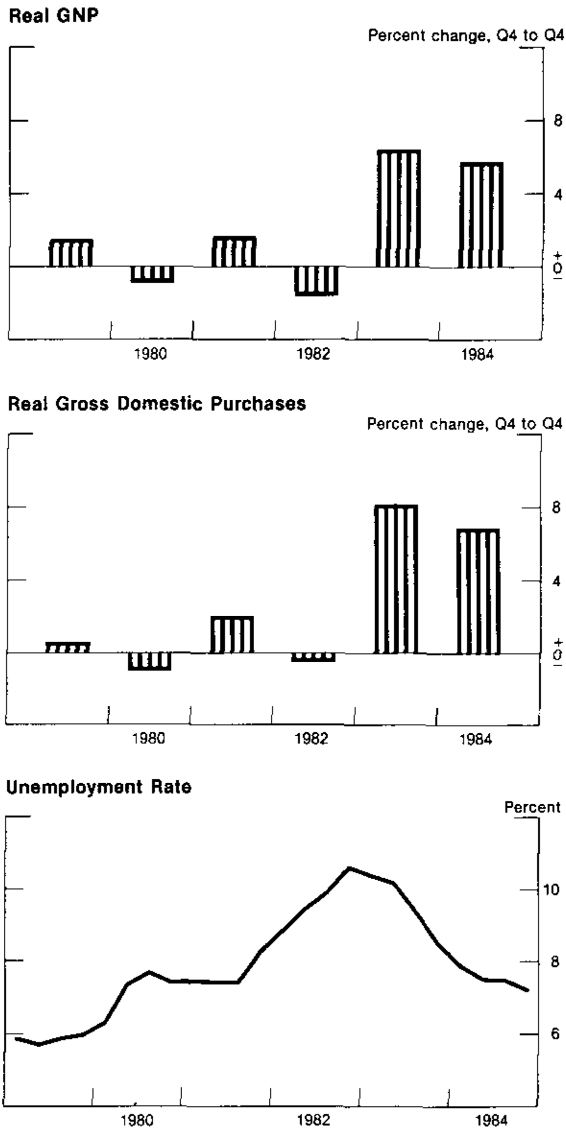
Section 3: The Performance of the Economy in 1984

The economy recorded major gains in 1984, with the real gross national product up 5-1/2 percent and the unemployment rate down more than 1 percentage point over the year. The growth in output and employment was exceptionally strong in comparison with experience in other post-Korean War expansions. But even more striking, in terms of its departure from past norms, was the extraordinary rise in domestic spending, which again appreciably outstripped growth in domestic production. Over the course of the year such spending rose about 6-3/4 percent in real terms. Consumers and businesses purchased greatly increased quantities of imported goods, whose relative prices were lowered by the appreciation of the dollar in exchange markets, and the U.S. trade deficit reached record proportions.

Last year's economic gains were achieved without a pickup in inflationary pressures, in part owing to the rise in the exchange value of the dollar. Aggregate indexes of prices rose about 4 percent or less, similar to rates of inflation recorded in 1983. Ample availability of industrial capacity here and abroad helped to contain price increases. Labor cost pressures also were limited, as wage increases actually were slightly lower than a year earlier. Labor markets continued to reflect the still considerable unemployment in the economy as well as the adjustments of wages in some sectors to the realities of forces associated with deregulation and foreign competition. Wage changes also reflected the favorable feedback effect of lower inflation on anticipatory or catch-up pay demands.

Although the nation as a whole has made substantial progress in the past two years toward the goals of sustained growth and high employment

Chart 1: The Performance of the Economy in 1984



along with price stability, important segments of the economy have continued to experience considerable difficulty. One symptom of continuing imbalances has been interest rates that, relative to the prevailing rate of inflation, have remained exceptionally high by historical standards. However, after moving upward during the first half of the year when economic expansion was especially brisk, interest rates retraced their advances in the second half of the year. At year-end, they were, on balance, a little lower.

Federal government tax and spending policies have provided substantial stimulus to aggregate demands for goods and services, but in credit markets the deficits have added strongly to the demands for funds and have been one important force keeping interest rates high. Moreover, there is general agreement that, unless legislative measures are enacted, budget deficits are likely to increase further, even in the context of a reasonably growing economy. This prospect, with its implication of continuing pressures on the supply of savings, has been a factor in the rise in the foreign exchange value of the dollar and the attendant emergence of enormous deficits in our trade and current accounts with other nations. Although, as noted above, the sharply higher value of the dollar has been an important factor in the movement toward price stability, inflationary pressures could become more apparent if the U.S. dollar were to decline sharply--a risk that could increase as fundamentally unsustainable fiscal and external postures are extended.

The Household Sector

The household sector continued to benefit last year from the economic expansion. Adjusting for inflation, the rise in disposable income from the fourth quarter of 1983 to the fourth quarter of 1984 was 5-3/4 percent, surpassing the large gain in 1983. This strong increase in income supported a rapid rise in spending for consumer goods even as the personal saving rate rose.

Household sector outlays in this expansion have been tilted more toward durable goods than has been typical. In the 1980-82 period, a time of relatively slow income growth and high unemployment, consumers had curtailed discretionary purchases of household goods. Since the end of 1982, however, strong employment and income growth and rising consumer confidence have been translated into an appreciable restocking of household durables.

The strength of automobile purchases in 1984 was a part of this restocking process. As the stock of existing autos has aged, replacement demand has grown. Most recently, reductions in gasoline prices have lowered operating costs. Automobile sales in 1984 rose to 10-1/2 million units, the highest level since 1979. The foreign share of the market declined, owing in large part to the impact of limitations on Japanese units during a period of expanding sales. Indeed, demand for domestic autos proved to be so strong that producers had difficulty supplying many of the more popular models, even though auto companies operated some factories at near full capacity over most of the year. Total auto production was up 14 percent from the preceding year, despite brief strikes in the autumn.

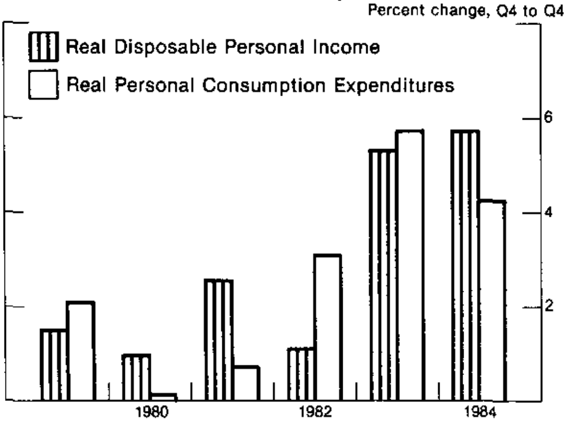
Spending for new homes slowed over the course of 1984, with rising mortgage interest rates through midyear a factor reducing housing activity. However, there were some initial signs of improvement in the housing sector at year-end, associated with earlier declines in interest rates during the fall. From the fourth quarter of 1983 to the fourth quarter of 1984, residential construction outlays, in real terms, were up 3-1/2 percent after an extremely rapid advance in 1983. For 1984 as a whole, 1.7 million new housing units were started. This was below the peak rates in the 1970s, but a marked improvement over the performance of the first years of the 1980s, as housing demand continued to be supported by favorable demographic factors and expanding incomes. Moreover, relatively stable house prices and the growing use of adjustable-rate mortgages made home purchases more accessible for many households.

The second year of strong growth in income and spending was accompanied by significant changes in household balance sheets. Late in 1983 and in the first half of 1984, financial assets declined relative to income--owing primarily to the sluggish performance of stock prices--retracing a portion of the strong gains made earlier in the recovery. However, the subsequent rise in equity prices helped to restore household asset positions to their previous high levels, and since the turn of the year, with stock prices up sharply, asset positions have improved further. Meanwhile, growth of household indebtedness picked up noticeably last year, and consumer installment debt as a share of disposable income moved to near its previous peak in the late 1970s.

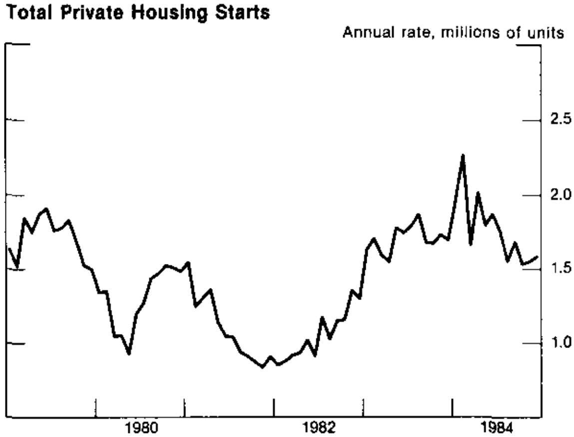
Despite the rise in indebtedness, there were few signs of increased financial stress in the household sector. The incidence of payment difficulties on consumer installment debt remained historically low and home mortgage delinquency rates were about unchanged for the year as a whole. Nonetheless, the proportion of problem loans in the home mortgage market has not receded from its recession high, and there is some special concern about future

Chart 2: The Household Sector

Real Personal Income And Consumption



Total Private Housing Starts



prospects in this area owing to the added risk exposure of homeowners who took on mortgages carrying adjustable features, especially those made with sizable initial interest rate concessions. The sustained high level of mortgage loan delinquencies appears to date attributable not so much to adjustable rate loans as to a combination of still high unemployment and more stable real estate prices than some borrowers had anticipated.

The Business Sector

The increase in business spending for plant and equipment was greater in 1984 than in 1983. In fact, the rise in gross business capital outlays over these two years combined was much larger than in any other post-World War II economic expansion. Profits in the nonfinancial corporate sector were up substantially in 1984, although by year-end the level had fallen back a bit owing to the slowing in sales growth.

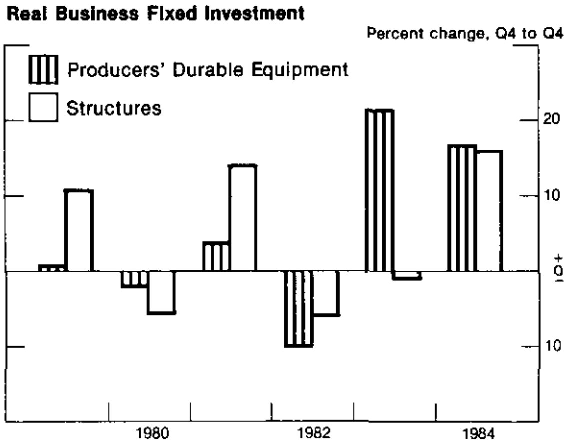
Growth in business fixed investment spending was strongest in the first half of the year, but continued at a double-digit pace in real terms in the second half. For the year as a whole, large gains were registered for both equipment and structures outlays. The ebullience of total spending reflected a number of factors, including the more favorable tax laws enacted in 1981, the desire to take advantage of technological advances, and the further narrowing of the margin of unused factory capacity under strong demand growth. Continued competitive pressure from foreign producers provided additional impetus for rapid modernization. At the same time, many U.S. producers of capital equipment, especially outside the "high-tech" area, did not fully benefit from this spending. Instead, foreign manufacturers captured an increasing share of capital goods purchased by U.S. firms; for domestic equipment spending, this share--approximately 25 percent--was nearly twice that experienced in the late 1970s.

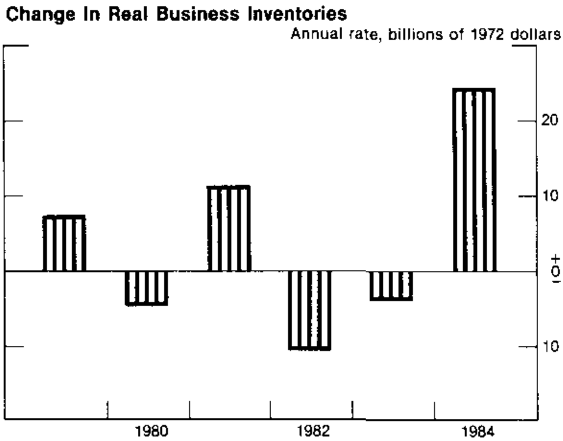
Businesses accumulated inventories in 1984 after reducing stocks in the preceding two years. In real terms, business inventories rose $24 billion, an historically large gain. Those gains were concentrated largely in the first half of the year, alongside the rapid pace of the expansion of final demand. When sales growth slackened in the summer and autumn, businesses quickly cut back on orders and production to avoid severe imbalances.

In order to finance the combined increase in capital spending and inventory investment, businesses relied heavily on external sources of credit. Nonetheless, gross issuance of new equity weakened as stock prices declined early in the year and then failed to surpass earlier highs when they rallied in the summer. After accounting for the retirement of equity associated with merger activity and share repurchases, the net issuance of stock was decidedly negative. Shorter-term borrowing was favored by business as in the first half of 1984, as firms elected to finance mergers initially through bank loans and commercial paper, and the high level of long-term interest rates discouraged bond issuance. In the second half of the year, merger financing slowed and the decline in interest rates contributed to some movement toward longer-term debt issuance. Even so, the traditional balance sheet ratios used to assess aggregate business financial strength worsened over the year: the ratio of loans and short-term paper to total debt of nonfinancial corporations rose, as did the ratio of debt to equity.

Severe financial strains, in many cases related to the high exchange value of the dollar, persisted in some of the nation's basic

Chart 3: The Business Sector





industries. Farmers continued to face less favorable export conditions than in much of the previous decade, land prices fell further, on average, and farm income remained depressed. As a result, farmers with large volumes of debt remaining from the late 1970s continue to face serious debt-servicing problems. The metals, agricultural implements, and some equipment industries also continue to face significant problems.

The Government Sector

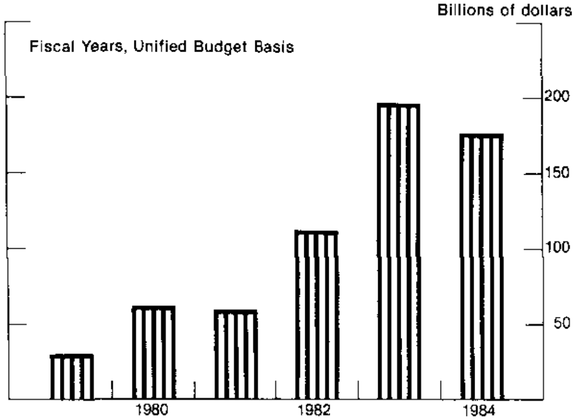
The expanding economy lifted federal government receipts in 1984. At the same time, outlay growth was limited by further declines in recession related expenditures and by a drop in agricultural support payments. Nonetheless, the federal budget deficit remained enormous, more than 5 percent of GNP and larger than total domestic personal saving. Moreover, at the end of the year the deficit was again rising.

Federal government purchases of goods and services, the component of the budget that directly adds to GNP and comprises about a third of total federal outlays, rose strongly last year. Excluding changes in Commodity Credit Corporation farm inventories, federal purchases were up nearly 5-1/2 percent, after adjustment for inflation. A major thrust to federal purchases came from defense spending, which increased almost 7 percent in real terms.

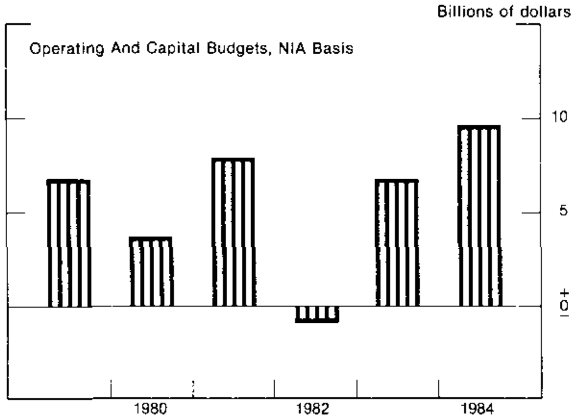
At the state and local government level, real purchases of goods and services rose 3-1/2 percent in 1984, following two years of no change. The renewed growth in such spending followed an appreciable improvement in this sector's fiscal position: state and local governments experienced a sizable operating and capital surplus in 1983 and early 1984 owing to the effects of the economic recovery as well as increases in tax rates.

Chart 4: The Government Sector

Federal Government Deficit



State And Local Governments



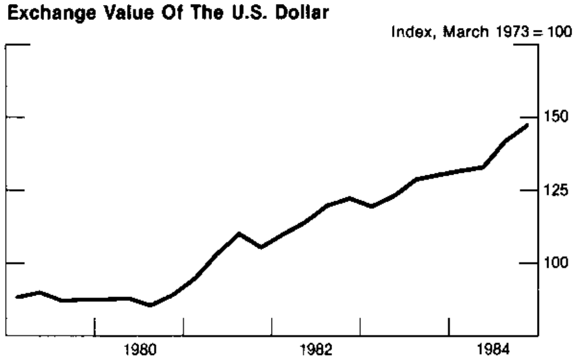
The Foreign Sector

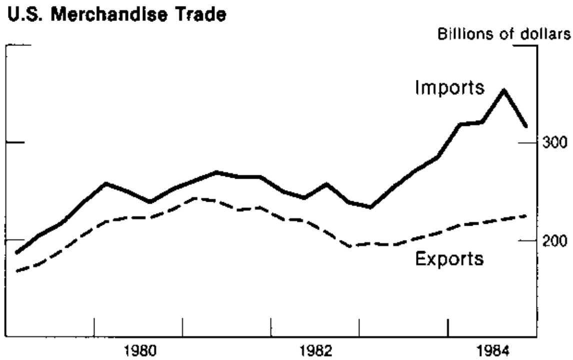
The appreciation of the dollar over the past four years directly contributed to the imbalance between exports and imports in 1984. On a trade-weighted average basis, the dollar climbed a further 12 percent during the course of the year, bringing the cumulative appreciation since the end of 1980 to about 65 percent, and the rise has continued into 1985. Part of the dollar's strength in the first half of last year may have been generated by a widening of the differential between real interest rates in the United States and real rates abroad; however, the influence of this factor appears to have been reversed in the second half of the year. The relative dynamism of the U.S. economy and success in curbing inflation helped attract capital from abroad. Conversely, relatively slow economic growth elsewhere and economic and political uncertainties in various countries also may have contributed to the dollar's appreciation throughout the year.

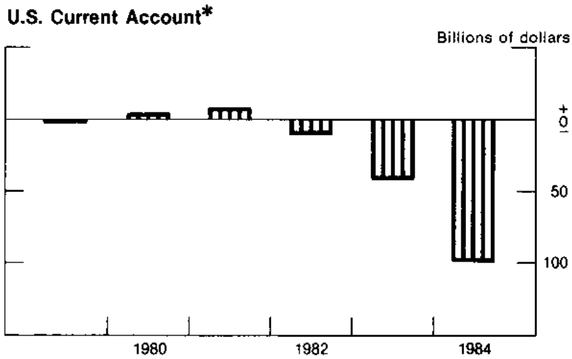
Notwithstanding a further weakening of the international competitive position of U.S. firms owing to the dollar's appreciation, and despite the sluggishness of foreign economies, the volume of U.S. merchandise exports increased by 9 percent in 1984. Exports to Canada, some of which are reimported after further fabrication, accounted for about a third of the rise, with Western Europe and Mexico receiving most of the remainder of the increase in exports. Economic growth in many developing nations, oil-producing as well as others, was limited by their debt servicing problems, and demand by those countries for U.S.-produced goods remained generally depressed.

The vigorous expansion of the U.S. economy and the strength of the dollar pushed the volume of merchandise imports sharply higher. Consumer

Chart 5: The Foreign Sector







*1984 is partially estimated.

goods, materials, and capital equipment shared in the increase. The merchandise trade deficit rose to about $110 billion. In addition to the growing trade deficit, net service receipts were reduced and the current account deficit was about $100 billion in 1984, compared with $42 billion in 1983.

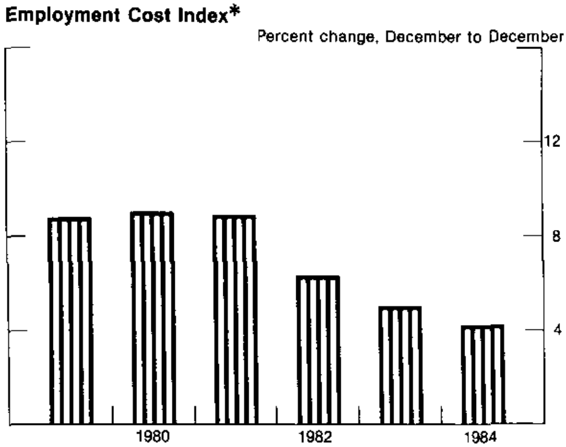
Labor Market Developments

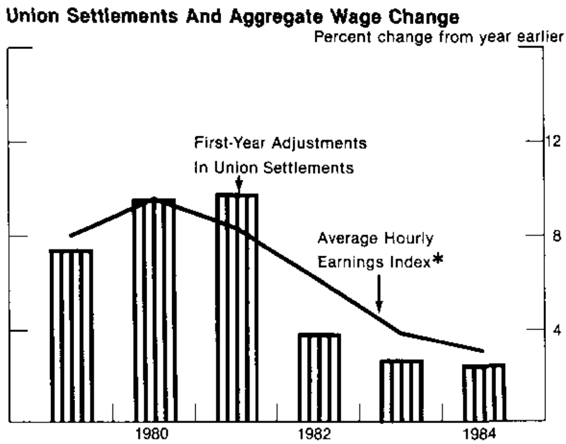
Developments in labor markets continued to be favorable during the second year of expansion. Reflecting the strength of activity and improved employment prospects, growth of the labor force picked up last year. But the number of new jobs expanded even more rapidly, and the unemployment rate was 7.2 percent in the fourth quarter, more than a percentage point below the rate at the end of 1983. Indeed, since the recession low in late 1982, nonfarm payroll employment has increased by nearly 7 million, the largest two-year gain in three decades.

In 1984, employment growth continued to be widespread across industries. The trade and service sectors each added more than one million jobs. And there was a gain in construction employment, owing in large part to a rise in nonresidential building. Government employment was up a quarter of a million, reflecting the rise in spending by state and local units. The manufacturing sector, which has borne the brunt of increased foreign competition, registered a large increase of almost three-quarter million in 1984; even so, the level of manufacturing employment remained below its pre-recession peak.

Wage developments in 1984 were more favorable to the control of inflation; even though labor market slack was reduced substantially further during the year, wage rates increased less than in 1983. The employment

Chart 6: Labor Market Developments





* Private nonfarm business sector

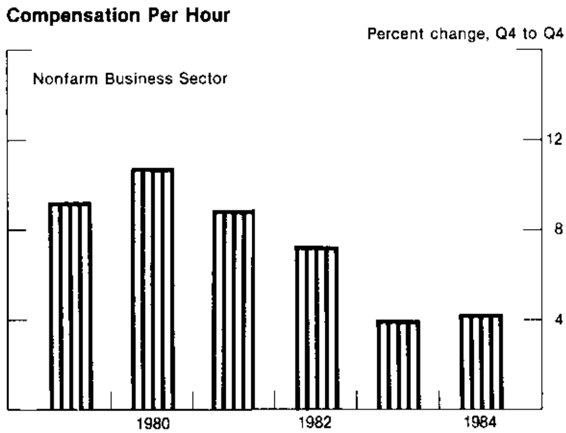
cost index, a comprehensive measure of change in wages and benefits, rose just 4 percent in 1984, nearly one percentage point less than the year earlier. Moreover, major collective bargaining agreements during the year showed no acceleration in nominal wage rates, even in those industries with improved economic conditions.

These wage developments suggest that inflationary expectations continued to moderate this past year; to an increasing degree, workers and managers now appear to be focusing on improving job security and on enhancing productivity, often in an attempt to remain competitive with foreign producers. Productivity increases in 1984 were substantial in the first half of the year, when output grew rapidly, and helped keep overall cost pressures down. Over the course of the year, labor productivity increased 2-1/4 percent, partly reflecting a cyclical adjustment to higher levels of output as well as apparently some improvement in the underlying trend rate of growth from the very low pace of the 1970s. The combination of moderate compensation increases and favorable productivity developments held down cost pressures on prices; unit labor costs rose 2 percent over 1984, less than a fifth of the rate experienced in 1979 and 1980.

Price Developments

Over 1984, the consumer price index rose 4 percent and the implicit deflator for the gross national product 3-1/2 percent. The increases in these broad indexes represent little change from inflation rates that have prevailed since the beginning of the expansion. The producer price index for finished goods, which excludes the prices of services, rose less than 2 percent last year; basic commodity prices, which had advanced more than 30 percent early in 1983, fell during most of 1984.

Chart 7: Price Developments



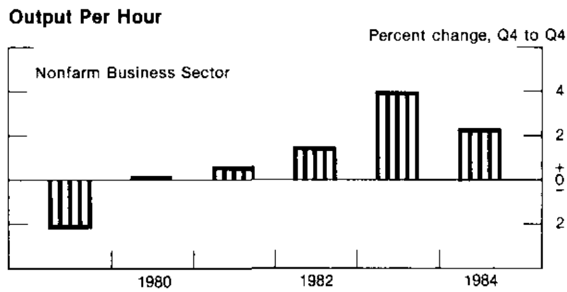
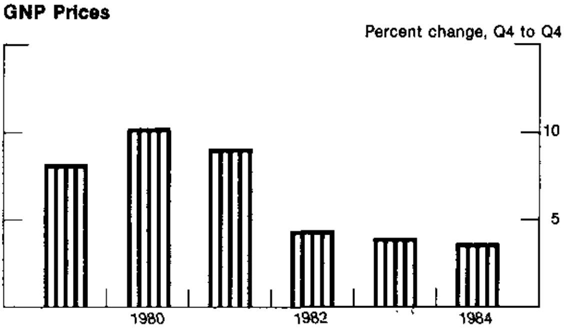
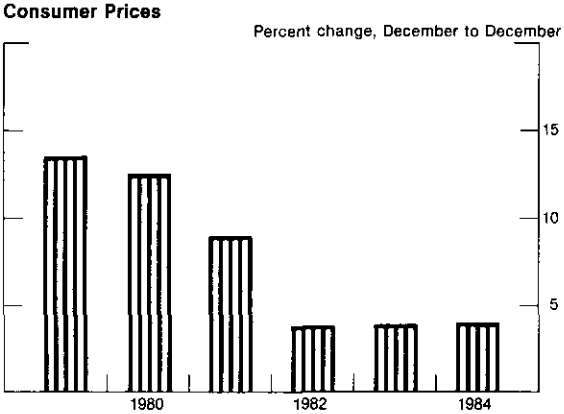
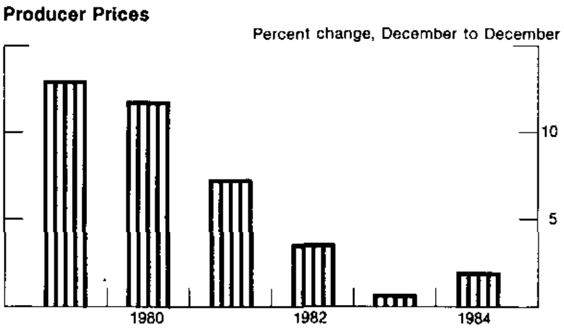


Chart 7: Price Developments--Continued







The relative softness of demand in world-wide markets and the strength of the dollar against foreign currencies played a large role last year in holding down prices of basic commodities. Importantly, energy prices, which have been a major factor in inflation rate movements for more than a decade, moved down. The weakness of demand during the recession and early recovery period restrained energy prices in 1981 and 1982; moreover, conservation measures and additional oil production capacity in many countries have continued to relieve energy price pressures.

Food prices at the retail level rose about in line with overall prices in 1984. Early in the year, food prices jumped sharply because farm supplies were limited by the 1983 summer drought and a winter freeze. However, supplies again became plentiful as the year progressed, reflecting more favorable harvests and sagging export volume.

Apart from the food and energy areas, consumer price inflation was little changed from a year earlier. The rise in consumer goods prices slowed appreciably, owing in part to the relatively small increase in prices of imported goods, as well as the accompanying competitive pressures on domestic products. Service prices rose more rapidly over 1984 than in 1983, although the rate of inflation in the sector remained well below those recorded in the early 1980s.

Section 4: Monetary Policy and Financial Developments in 1984

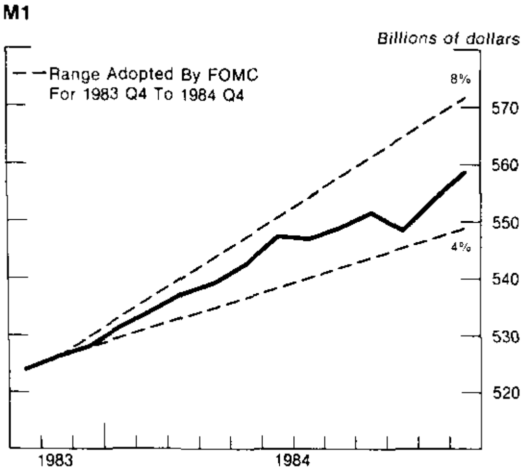
Monetary policy in 1984 aimed basically at supporting sustainable economic growth within the context of long-term progress toward price stability. The target ranges for the monetary and credit aggregates chosen by the Federal Open Market Committee last February, and reaffirmed in July, called for growth rates 1/2 to 1 percentage point below those set for 1983. Measured from the fourth quarter of 1983 to the fourth quarter of 1984, the target ranges for the monetary aggregates were 4 to 8 percent, for M1, and 6 to 9 percent, for M2 and M3. The associated monitoring range for the debt of domestic nonfinancial sectors was fixed at 8 to 11 percent.

Underlying these objectives was the Committee's expectation that the special factors distorting monetary growth rates in 1982 and 1983 would be less important in 1984, and that relationships among the monetary aggregates--particularly M1--and economic activity and inflation would be more consistent with historical trends and cyclical patterns. Portfolio adjustments associated with the previous introduction of new deposit accounts and with the steep drop in interest rates during the 1982 recession appeared to have ended. Furthermore, the economic expansion seemed to be reducing uncertainties about employment and income prospects that earlier had boosted demands for liquid precautionary balances.

Over the year, increasing evidence suggested that M1 was in fact behaving more in line with historical experience. As a result, this aggregate was given more weight in policy implementation than had been the case during the latter part of the cyclical downswing and early phase of the economic recovery. However, all of the monetary and credit measures continued to be

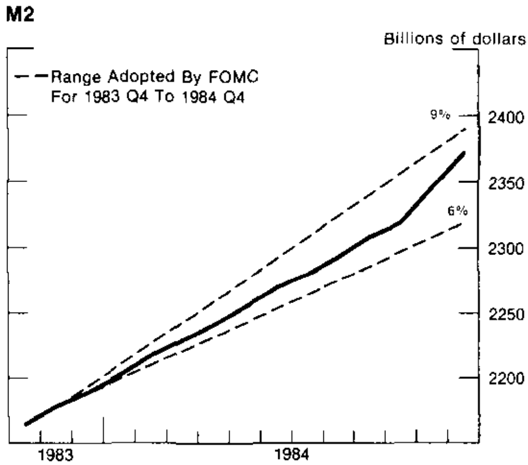
Chart 1

Ranges and Actual Money Growth



Rate Of Growth

1983 Q4 To 1984 Q4
5.2 Percent

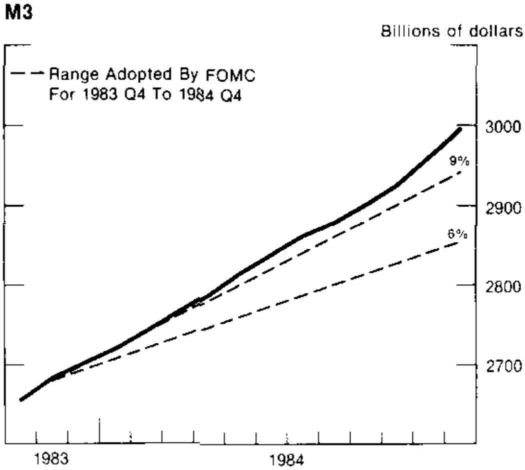


Rate Of Growth

1983 Q4 To 1984 Q4
7.7 Percent

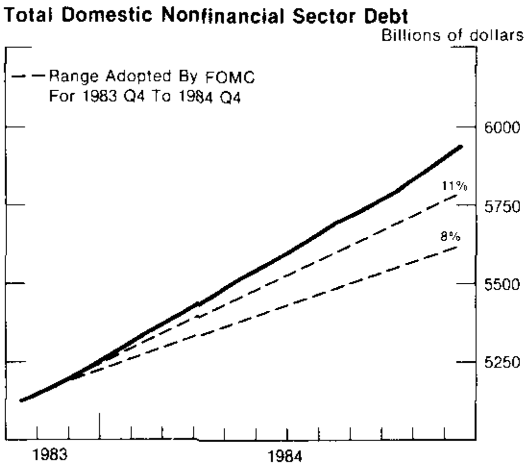
Chart 2

Ranges and Actual Money and Credit Growth



Rate Of Growth

1983 Q4 To 1984 Q4
10.5 Percent



Rate Of Growth

1983 Q4 To 1984 Q4
13.4 Percent

evaluated in light of the outlook for the economy and domestic and international financial markets.

Money, Credit, and Monetary Policy

The actual growth rates of M1 and M2 over 1984 were well within the target ranges established by the Federal Reserve, with M1 expanding 5.2 percent, somewhat below the midpoint of its range, and M2 increasing 7.7 percent, a bit above its midpoint. As had been anticipated in the mid-year policy report to the Congress, growth of M3 and domestic nonfinancial debt, at 10.5 percent and 13.4 percent, respectively, exceeded their ranges.[1] The relatively wide divergence between M2 and M3 growth rates reflected mainly substantial issuance of large CDs and other managed liabilities by thrift institutions and commercial banks in the face of heavy credit demands.

Credit growth last year was the most rapid on record, and much stronger relative to GNP expansion than historical trends would suggest. An unusually large volume of mergers and related activity, including "leveraged buyouts," involving nonfinancial corporations accounted for about 1 percentage point of the growth of overall debt. Around $75 billion of equity was liquidated in this process, with much of it replaced, at least for a time, with short-term debt. In addition, more than $10 billion of equity was retired through corporate share repurchases, frequently in defensive maneuvers to ward off unfriendly takeover attempts.

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1. The figures cited herein for the monetary aggregates are based on recent benchmark and seasonal adjustment revisions. Before those revisions, the 1984 increases were measured at 5.0 percent for M1, 7.5 percent for M2, and 10.0 percent for M3.

Even after allowance is made for the unusually large volume of merger-related borrowing, it is clear that total credit demands were exceptionally strong last year. Federal debt expansion, at more than 16 percent, was unprecedented for the second year of an economic expansion, both in absolute terms and in relation to income. Private domestic nonfinancial debt grew about 11-1/2 percent (abstracting from growth of merger-related debt issues), also faster than, but much closer to, comparable stages of previous recoveries.

The behavior of M1 velocity in 1984 was broadly consistent with past cyclical patterns. In contrast to the unusual weakness of the previous two years, over 1984 M1 velocity increased 4 percent, only a little above the average rate of growth during the second year of previous economic expansions. M2 velocity increased 1-1/2 percent, reversing two consecutive yearly declines. The strengthening of velocity over 1984 apparently reflected, in part, some unwinding of the precautionary and other motives that had swelled demands for liquid assets in 1982 and early 1983, as well as the rise of short-term interest rates in the first part of the year, and, in the case of M2, the abatement of dramatic inflows to money market deposit accounts (MMDAs) associated with the initial authorization of these accounts.

Demands for M1 balances, and for bank reserves to support deposit growth, were robust early in the year as the economy expanded rapidly. Credit demands also were very strong, and market interest rates began rising even as the Federal Reserve, through open market operations, was keeping the degree of pressure on bank reserve positions unchanged. In early spring, with credit and money demands continuing unabated,[1] and with economic growth continuing

1. Annual seasonal and benchmark revisions to the monetary aggregates subsequently lowered somewhat the growth of M1 in the first half of 1984 relative to what was estimated during the period.

GROWTH OF MONEY AND CREDIT[1]
Percentage changes

Period	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter to fourth quarter				
1979	7.5	8.1	10.3	12.1
1980	7.5	9.0	9.6	9.6
1981	5.1 (2.5)[2]	9.3	12.4	10.0
1982	8.8	9.1	10.0	9.1
1983	10.4	12.2	10.0	10.8
1984	5.2	7.7	10.5	13.4
Quarterly growth rates				
1984-Q1	6.2	7.2	9.2	12.9
Q2	6.5	7.1	10.5	13.1
Q3	4.5	6.9	9.5	12.7
Q4	3.4	9.0	11.0	12.7

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions made in February 1985.
2. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

at an extraordinary pace, the FOMC adopted a somewhat more restraining posture toward supplying reserves, and both short- and long-term interest rates rose further as banks relied more heavily on discount window credit to meet their reserve needs. Borrowing for adjustment and seasonal purposes increased to around $1 billion in March and April after averaging about $650 million during the first two months of the year. In April, the discount rate was raised 1/2 percentage point, to 9 percent, to bring this rate into better alignment with short-term market rates.

Despite the absence of any further tightening of reserve availability by the Federal Reserve, pressures on private short-term interest rates intensified around early May in reaction to the well-publicized liquidity problems of Continental Illinois Bank.[1] Uncertainties related to the international debt situation also added to market concerns. In this environment, quality differentials between yields on private money market instruments and Treasury securities widened substantially.

While M1 growth early in the year remained in the upper part of the FOMC's target range, M2 increased at a pace slightly below the midpoint of its range even as the economy expanded rapidly. Growth in M2 relative to income may have been damped by substantial inflows to IRA and Keogh accounts, which are excluded from the monetary aggregates. Also, as market interest rates firmed, sizable spreads developed between these rates and yields on retail deposits and money market mutual funds, likely encouraging some investors to place funds directly in credit market instruments. M3, meanwhile, pushed

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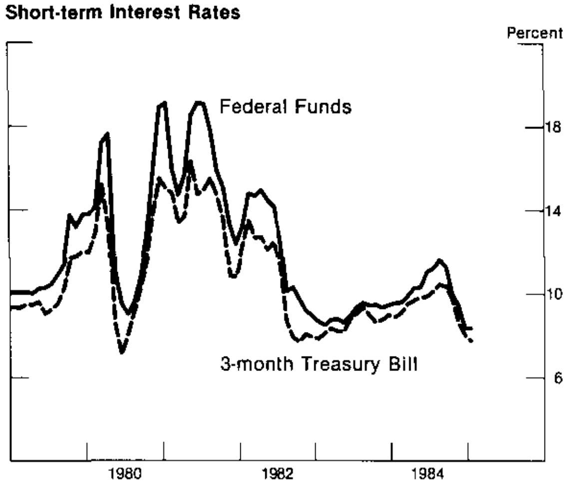
1. Large discount window borrowing by Continental Illinois Bank, beginning in May, was offset in terms of its impact on overall reserve supplies through open market operations.

Chart 3


Short-term Interest Rates
Percent
Federal Funds
3-month Treasury Bill
18
14
10
6
1980
1982
1984

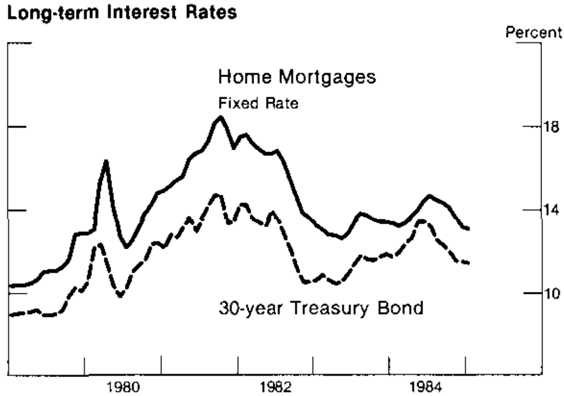
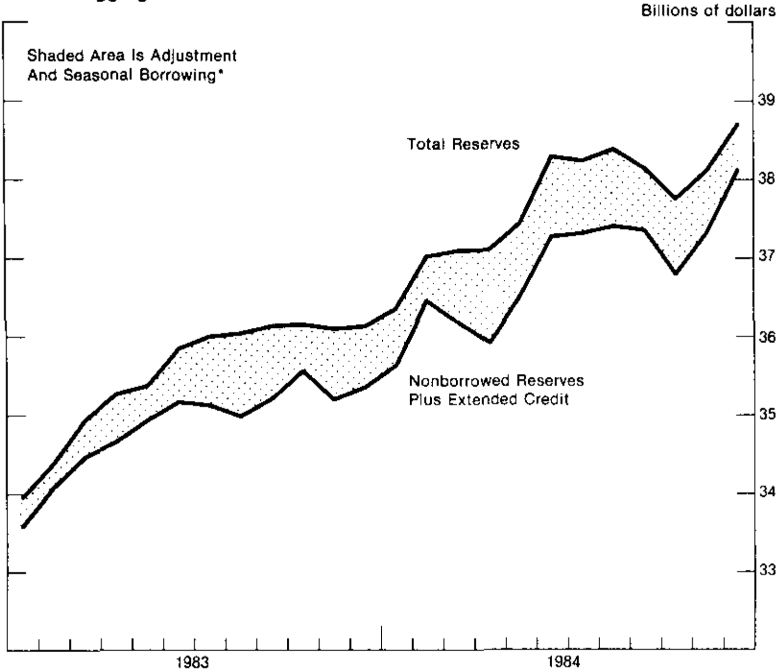

Long-term Interest Rates
Percent
Home Mortgages
Fixed Rate
30-year Treasury Bond
18
14
10
1980
1982
1984

Chart 4

Reserve Aggregates



* Excludes borrowing by Continental Illinois Bank beginning in May 1984.

above its longer-run range, as banks and thrift institutions issued large CDs and other managed liabilities to accommodate rapidly rising credit demands.

After midyear, economic expansion slowed markedly, particularly during the summer, tending to reduce transactions demands for money. Growth in M3, though remaining somewhat above the upper limit of its range, also moderated as demands for short-term business credit slackened and as some banks adopted more cautious lending and funding policies in light of the strains on financial markets.

Initially, the slowing in M1 was not resisted, as it reversed a bulge that had brought M1 growth well above the midpoint of the FOMC's target range. However, by late August and early September, as evidence appeared of much slower economic growth, with financial tensions high and with the dollar rising rapidly on foreign exchange markets, the Federal Reserve moved to lessen the degree of restraint on bank reserve positions. That process continued through much of the rest of the year. Borrowing at the discount window receded, reaching levels of around $575 million by late in 1984 and dropping further to around $340 million, on average, during January 1985. Total reserves and nonborrowed reserves, which had shown little expansion since June, increased markedly in the final two months of the year and into early 1985.

Mirroring the easing of reserve market conditions, short-term interest rates dropped considerably from their late-summer highs. Moreover, quality spreads on various money market instruments returned to within normal ranges as the strains related to the problems of Continental Illinois Bank remained contained and progress was made in Latin American debt negotiations. Responding to the provision of reserves and the reduced rates on alternative outlets for liquid funds, M1-type balances rose rather sharply in late 1984 and early 1985. Growth of M2 also was very rapid, as open market interest rates fell below average yields on MMDAs, small denomination time deposits, and money market mutual fund shares.

The easing in financial markets during the second half of 1984 was reflected in, and to an extent encouraged by, two successive reductions in the discount rate, first to 8-1/2 percent in November and then to 8 percent in December. By year-end, short-term interest rates were 2-1/2 to 3-1/2 percentage points lower than they had been during the summer, and 3/4 to 1-1/2 percentage points below their levels at the beginning of the year--in some cases near their cyclical lows of early 1982.

Long-term interest rates also declined in the second half of the year, in part reflecting some moderation of inflationary expectations. But for the year as a whole, most long-term rates declined by less than 1/2 percentage point, and remained above their earlier cyclical lows. The still relatively high level of long-term rates appears to be influenced by the continuing budgetary uncertainties, current strong demands for total credit, and lingering, though lessened, fears of inflation.

Other Developments in Financial Markets

Foreign savings financed a large share of the domestic borrowing in 1984. Net inflows of capital from abroad were more than double the already advanced pace of 1983, thus supplementing domestic saving and enabling the financing of the massive federal deficits at the same time that private investment expanded rapidly. Banks continued to intermediate substantial amounts of these inflows, and sales of Eurobonds by U.S. corporations reached record levels. Direct investment in the U.S. also was very strong, reflecting several large takeovers of domestic firms by foreign corporations.

Much of the credit market borrowing--particularly that related to merger activity--was at short term. Commercial paper debt of nonfinancial businesses surged more than 50 percent, offsetting two consecutive years of runoffs. With strong loan demands in business, real estate, and consumer areas, total loans at commercial banks grew more than 14 percent.

Given only moderate inflows to core deposits in the face of this brisk loan growth, commercial banks increased their outstanding CDs in 1984 by more than 14 percent, after having allowed a large volume of CDs to run off during 1983. Credit growth at banks was especially rapid during the first half of last year, reflecting a wave of bank-financed mergers. The bulk of the CD issuance was concentrated in this period and likely would have been even greater had not banks also borrowed heavily from their foreign offices. In the second half, loan expansion slackened appreciably, and large time deposit growth tapered off, as some earlier merger-related loans were repaid with the proceeds from issuance of commercial paper and other debt obligations and from selective sales of assets of the merged companies.

Strains on some sectors of the economy, as well as the effects of overly aggressive lending policies by some institutions, continued to be reflected in relatively high levels of non-performing and other troubled loans in a number of depository institutions. As the year wore on, there were signs of more forceful efforts to deal with these problems and their consequences. Loan loss provisions were significantly increased and steps are being taken to correct weaknesses in credit standards. The largest bank holding companies generally improved their capital positions over the year, partly in response to supervisory guidelines to raise capital ratios. These approaches will take time to bear full fruit, and progress in strengthening balance sheets will be dependent on reasonable profitability as well as on developments external to the banking system. In that connection, the strains in agricultural areas, on heavily indebted foreign countries, and in sectors of the energy industry pose continuing challenges.

In long-term markets, municipal bond offerings achieved new highs in 1984. Tax-exempt offerings were relatively light over the first half of the year as authority to issue single-family housing revenue bonds lapsed and as the market anticipated the imposition of retroactive ceilings on issuance of industrial revenue bonds (IDBs). But volume rebounded in early summer after passage of the Deficit Reduction Act, which reauthorized housing bonds and stimulated a flood of issues toward year-end to avoid stricter rules for IDBs and student loan bonds--effective January 1, 1985. Financial and non-financial corporations also raised record amounts through bond offerings; however, the maturities of new issues tended to be much shorter than in previous years, and many offerings carried provisions that essentially transformed these obligations into short-term or variable-rate debt.

Variable-rate instruments exhibited increasing popularity within the home mortgage sector as well. Adjustable-rate mortgages (ARMs) accounted for almost two-thirds of the number of conventional first mortgages on homes at major institutional originators in 1984, up considerably from only one-quarter of such originations the previous year. Thrifts, in particular, preferred to acquire ARMs rather than fixed-rate mortgages in an attempt to reduce their already acute exposure to interest rate risk. The widespread acceptance of ARMs by consumers was attributable partly to substantial initial rate advantages offered on ARMs compared with fixed-rate mortgages, as well as to other features that limited borrower exposure to higher future interest payments, at least for several years. Large initial rate discounts became less prevalent after the adoption of somewhat tighter standards both for purchases by federal credit agencies and for the underwriting of ARMs by private mortgage insurers. Yet, despite the shift toward ARMs during 1984, and increased consumer and business lending, the assets of thrifts remained heavily concentrated in relatively low yielding instruments.

The CHAIRMAN. Thank you, Mr. Chairman.

In your statement you note several instances last year when the Fed adjusted policy.

On page 11 of your statement, you say the Fed—and I quote—"began to exert some additional restraint on reserves in the early spring."

On page 14, you say that "Given economic developments, reserves could be provided more liberally" in the fall.

And finally you say that, "As monetary and credit growth continued at a relatively rapid pace into January, the easing process came to an end."

NEED FOR PUBLIC ANNOUNCEMENT

What harm would have resulted from a public announcement by the Fed policy at the time of each of these policy adjustments?

This is part of an old discussion you and I have had about whether we should have weekly reports, but in this case when you are making these policy adjustments, there's uncertainty in the market, what harm would come from letting everybody know?

Mr. VOLCKER. I think we did let everybody know. All of those policy adjustments were accompanied by discount rate changes, up and then, the last one, down. There hasn't been any further—no further easing. There has not been a discount rate change.

All those changes were also apparent in the marketplace, I think, as the decision was made, certainly within a few days, or a week, or two.

So these were not done in the dark of the night. We can't operate without it becoming known in the market.

The CHAIRMAN. Well, I understand that, but all I am saying, if that is the case and you are only talking about a week or so, what is wrong with just coming out and saying we have made a policy change rather than waiting for the signals; that would make it apparent to everybody who watches the market?

Mr. VOLCKER. Let me take the example of late last August and early September. The Open Market Committee meeting had taken place in about the middle of August, as I recall, and at that time there was not any very clear news that the economy had slowed down. The money supply had leveled off for a month or two, but was still, as I recall it—according to the figures we then had—above the middle of the range.

The Committee essentially decided no change in policy at the meeting, but that if certain things happened—if the economy appeared to be slowing in its rate of growth or the money supply remained sluggish—then we might consider easing.

But we had nothing to announce at that point. A few weeks later, the first very tentative steps were taken toward easing; that is, they were taken progressively over a period of time. It was hardly a situation, in my judgment, that justified any dramatic policy announcement at the end of August, when we began easing. It was, at that stage, a very limited, delicate, and reversible step.

Now, suppose we had announced, for example, we are easing. Then the market would have anticipated our easing much more than we were prepared to ease at that particular point in time. There was a progressive process of easing, and it seems to me we are better off in doing our thing, so to speak, in whatever limited way seemed appropriate at that point, without dramatizing it by making an announcement.

If we feel it is important, that there is an important change in policy that should be announced, we announce it; and we should announce it under those circumstances.

I don't remember when we first reduced the discount rate during the fall, but that was a policy announcement. It was clear before that the policy had eased.

The CHAIRMAN. Well, I understand there are no black and white answers and there are some gray areas of minor policy changes and——

Mr. VOLCKER. Minor policy changes sometimes become big ones, and sometimes they are reversed. That is our——

The CHAIRMAN. Well, I understand that, but what I am getting at is it seems to me, as I have watched the Fed for the last 10 years—and there are a lot of Fed watchers in this country—how much instability do we cause by the guesses that are going on out there about what you are doing?

I understand you can cause people to overreact by announcing policy and overly dramatize it, but on the other hand, it is a big game in this country of trying to guess what is going on, and I am wondering if more forthcoming information from the Fed might contribute to more stability and less guessing out there.

Mr. VOLCKER. It is a reasonable question. I think in this case I feel somewhat as you feel about the publication of the weekly money supply figures; they are more confusing than useful, and I think at some point we face that question in other areas.

We provide a lot of information. Our weekly operations are published within a day or two of when they are done. I presume what you are referring to is published directives of the Open Market Committee to the desk as to how they are to conduct operations in very vague terms, very general terms—as those directives I think must be; the issue is whether publishing them would add to stability and the performance of the markets or not.

All I can say is I have been observing this process for 30 years, and my own conviction is that in the end they will probably be the source of more confusion rather than less. I would rather let our actions speak for themselves than try to verbalize them all the time in necessarily imperfect words, words that are always subject to different interpretations anyway. We can't do anything without acting in the market. That is a very concrete action. Let that action speak for itself.

There is no doubt in my mind that if we are introducing a policy change—with a capital P—it ought to be announced, and I think we have done that.

EVALUATION OF PERFORMANCE

The CHAIRMAN. Let me take it one step further. How do we, Congress, evaluate your performance when some of the aggregates are within the targets, some of them are outside the targets, get the M's going different directions? How do we try and evaluate the sum of those different targets?

Mr. VOLCKER. I don't think it is easy because we are in a complicated business, and I don't think, frankly, myself, that you can evaluate our performance simply by looking at those targets.

We wouldn't have much of a performance if we hit all the targets but the targets were wrong, and the economy greatly inflated or greatly deflated. In the end you have to look at the final results, and I think what really makes it difficult is that we are one influence on those final results for the economy. How is the economy doing? How is inflation doing? There are many other things that affect those results at the same time, but how can you separate out our influence?

I don't have any easy answer to that, other than obviously, the kind of hard slogging process of continuing analysis. I just don't think there is any number that is going to give you that result.

Congress, I might say, has given us in that respect, a fairly vague mandate. I think we understand it, but if you wanted to be more precise in holding us to particular results, you would probably have to be more precise in the directive you give us, such as has often been suggested—that the central bank ought to have responsibility for price stability, period.

That is not the way our charter reads, for perhaps good reason, but if it did, then you would have a very much more precise measure of results or lack thereof.

The CHAIRMAN. Well, as you know, I don't want Congress attempting to dictate targets.

Mr. VOLCKER. No.

The CHAIRMAN. And we certainly do not have the ability to do so, to make those kinds of judgments. I think they would too often be made on a political basis, and we would have had swings up and down in the——

Mr. VOLCKER. No, I agree with that. I just meant being more precise about an economic target—price stability or whatever.

I am not sure you want to do that, but if you want to have a very precise measure of whether we have performed, I think that would be the precise, simple measure. You would have to give us a precise, simple order; I am not thinking of the monetary targets, but something beyond that.

The CHAIRMAN. With our inability to give ourselves precise, simple orders on handling fiscal policy I don't think we're in a position to——

Mr. VOLCKER. What we are both saying is the economy and circumstances may be too complex for those precise, simple orders and therefore a precise, simple measure of performance; that's the world. But I do think our performance can be evaluated. It just can't be evaluated by meeting any particular target.

If we kept setting out targets and they appeared inappropriate and we kept missing them you'd obviously have a legitimate reason for complaint, but we haven't consistently missed them and I think the targets have been reasonable. So you don't have that gross kind of measure.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Chairman Volcker, I want to tell you that I'm reassured by your statement that you've made no commitment to step down and I'm hopeful that you will, as I suggested, serve out your term. Although, as you indicated when you were confirmed you have made no commitment to do so, I earnestly hope that you would do that and I'm delighted to see that you haven't made a commitment otherwise.

Now, you say on the top of page 24, "Consistent with that approach I indicated earlier the progressive process of easing reserve positions undertaken in the latter part of 1984 has ended." Now, that sounds like no more Mr. Nice Guy and I welcome that but I want to make sure I interpret that properly.

Mr. VOLCKER. That's not the equivalent of tightening, you understand.

Senator PROXMIRE. I understand.

Mr. VOLCKER. We were reducing——

Senator PROXMIRE. But it's the end of easing——

M1 RISING RECENTLY

Mr. VOLCKER. It's the end of a process where the pressure was reserve positions. Remember bank borrowings were falling. We brought that process to an end, and that is the definition I am using of tightening or easing here, pressures on reserve positions. We have been a bit more cautious in providing reserves because the money supply has been rising fairly rapidly recently. I would not call that a tightening at this point but a little more caution.

Senator PROXMIRE. Now, I have also the "Monetary Policy Report to Congress Pursuant to the Full Employment Balance Growth Act of 1978" that accompanied your statement today and it's released as of today. Nowhere does there seem to be an acknowledgement of the fact that remarkable growth of the economy in 1984 was preceded by three of the biggest deficits in the history of this country, $109 billion in 1982, $195 billion in 1983, $175 billion in 1984. It seems obvious to me that these kind of back-to-back-to-back deficits are bound to stimulate the economy. And I don't see how that figures in your analysis. Certainly the fact that we project this year, 1985, a deficit of $222 billion, the biggest ever, it seems to me is another stimulative force which I don't see given substantial weight in the analysis. Maybe I missed it.

Mr. VOLCKER. I think it's certainly discussed under the government sector. It may not be discussed quite in the terms that you put it. I don't have any problem with what you're saying. I make some allusion to it in my own statement. Let's stipulate that this is a strong expansionary thrust in the economy.

Senator PROXMIRE. Well, I'm happy to get that. Yesterday I asked Mr. Nisken and he said that deficits have no expansionary effect whatsoever. He said they had nothing to do with effective demand. I don't want to argue that point with you because you've given your answer.

Mr. VOLCKER. Let me, if I may, just——

Senator PROXMIRE. Yes, sir.

Mr. VOLCKER [continuing]. Say that this foreign deficit at the same time is a strong force moving in the other direction, and those phenomena are not entirely unrelated.

Senator PROXMIRE. Now, there's a very, very powerful case that can be made that inflation seems to be well under control. I don't agree with it. You obviously don't agree with it and I'd like your answer to the fact that in the first place we have very high unemployment on any kind of an historical basis, 8.5 million people out of work, 7.4 percent of the civilian work force. So the wage pressures on prices should be low particularly with productivity, as you say, increasing too.

We have an energy glut. Plenty of oil, plenty of other energy resources. We have a food glut. The prospects for food prices seem to be good. Nominal interest rates are down.

We have persisting the anti-inflation effect of the trade deficit. The fact that when we buy from abroad it's cheap and when they sell here they hold down prices in this country.

It seems to me that that is a very, very powerful argument. The Federal Reserve doesn't have to be quite as concerned about inflation as they've been in the past.

What is your response to the argument that we have inflation whipped now and that monetary policy doesn't have to worry about inflation anymore, at least for the next couple of years?

INFLATION UNDER CONTROL

Mr. VOLCKER. I think the simple answer to the question of whether we have inflation whipped is to look at the numbers; inflation is continuing at a rate of speed that a decade ago provoked price and wage controls.

Now, I do think that improvements have been made, that we're considerably better off than we were some time ago and as you mentioned, I think, that has given us a little greater flexibility in the implementation of policy recently.

But some of those factors are, as your question implied, temporary so that we have to be very careful that some of the continuing elements in disinflation, some of the continuing forces working toward more stability, are nourished and can persist.

Over time, of course, that takes restraint on the money supply. But I'm thinking in a more immediate sense of the price/wage/productivity situation where nominal wages are going up considerably slower than they were some time ago; that has been consistent, of course, with increases in average income because——

Senator PROXMIRE. Of course, any kind of caution here, it seems to me, is likely to reduce the prospects for diminishing inflation.

Your projection indicates that you feel inflation will stay fairly close to what it is now, drop maybe a little, marginally. The Fortune magazine predicts an increase in inflation to about 8 percent in the coming year. At any rate, if we have real growth which you projected around 3½ to 4 percent, unemployment won't change very much and that's very discouraging for millions of Americans who don't have jobs now.

What's the answer to their argument that we ought to ease monetary policy even more?

Mr. VOLCKER. We do have a decline in unemployment indicated from 7¼ down to 6½ or——

Senator PROXMIRE. You know it hasn't dropped since May.

Mr. VOLCKER. It's a drop of one-quarter to one-half a percent.

Senator PROXMIRE. It's the same level it was last May.

Mr. VOLCKER. We're a little lower on the average.

Nonetheless, I think the answer to your question is we're not interested in getting some brief spurt in activity which may, indeed, reduce the unemployment rate a little faster in the short run at the expense of generating forces that are going to bring that to an end in a short period of time.

What we want to do is sustain growth, and if we're going to sustain growth, I think it is terribly important that we not let those inflationary forces get the upper hand once again; that involves a balancing judgment, I suppose, as to the economy moving ahead in a context of, hopefully, further progress against inflation. That may not produce as much unemployment reduction in the next 6 months as you would otherwise get, but it offers a lot more promise that those reductions in unemployment can continue and that we won't fall back in recession, and I think that's far more important.

REDUCTION OF $50 BILLION

Senator PROXMIRE. Now, you've been quoted as saying we need to cut the budget deficit by at least $50 billion in fiscal 1986 to maintain credibility with the business and financial community.

President Reagan submitted a budget which proports to do that. However, according to the CBO it is only a $37 billion cut. They say the President's budget includes about $13 billion in paper cuts in the defense budget, that is, money the Pentagon never had. It is something like the head of a company who is thinking about giving himself a 20-percent pay increase, then cuts the increase in half, and then brags that he took a 10-percent pay cut. In reality he gave himself a 10-percent pay increase.

If CBO is right, would you not agree that the President's budget proposal may be deficient not only in the out years but in the next budget year as well?

Mr. VOLCKER. No; I'm not familiar with the CBO analysis but let me say that $50 billion figure that gets a lot of attention is in response to a question I answered: That if you're going to make an impact on market psychology, if you're going to give the impression of credibility and force in dealing with the budget problem you've got to come up with a figure in that neighborhood. In fact, they said upward of $50 billion.

Part of that credibility is measuring from an honest base, so to speak. I'm not an expert on just what that base should be in defense spending. But to the extent an impression is conveyed that the numbers are not real, obviously you lose the psychological force of the cuts.

This always has come up in these terms because the cuts aren't being made for many months or even a year or more. The question is: What kind of impact will you get on the market today? To which my response is, you've got to have a pretty forceful program to expect expectational effects on the market today.

Senator PROXMIRE. Now, how do you account for the extraordinary strength of the American dollar. Despite reductions in U.S. interest rates, the dollar continues to reach new highs. What's keeping the dollar up?

Mr. VOLCKER. I can't explain it. I can't provide any fresh, new insights into this question. We've had a period when the dollar's been going up, when some of the basic indicators have been going in directions that you would think would not produce a stronger dollar, namely, interest rates have been going down, and the trade account and current account deficit are getting larger. Nonetheless, the dollar goes up.

I don't think there is any doubt that interest rates are still relatively high compared to many foreign countries, that's one factor. There is a good feeling about this country as a place to put your money, both for economic and political reasons.

I think there is a certain sourness—if that's the word to use—a certain pessimism in Europe and elsewhere about their own economic prospects or political stability relative to the United States. That's tended to put money here.

One factor of considerable importance which isn't often mentioned—not often mentioned in my statements either—is we're talking about a net capital flow. Part of that increased net inflow is a reduction in outflow. Part of that reduction in outflow has been related to much less active lending policies by our banks in developing countries and elsewhere for which the reasons are obvious.

So even if there was no increased inflow, of which there has been some, you would have had a sizable net increase in capital inflows simply because our banks are lending less abroad in Latin America and elsewhere. That's simply a reflection of the problems in Latin America; nothing more or less than that.

The CHAIRMAN. Senator Heinz.

SIGNIFICANT REDUCTION IN DEFICIT

Senator HEINZ. Mr. Chairman, thank you very much.

Chairman Volcker, on page 21, you indicate that your projections of inflation in the range of 3½ to 4 percent, the real growth of the economy, the anticipated progress in lowering unemployment—all of these are spelled out on the previous page, page 20—are all premised on your assumption that the Federal budget deficit would be significantly reduced in fiscal year 1986 relative to baseline projections.

Therefore, you were assuming a deficit reduction in the neighborhood of the $50 billion in 1986 and subsequent years that the President has called for; is that correct?

Mr. Volcker. Yes; now, these are projections for 1985. That is the order of magnitude of the budget cuts we were assuming for 1986 and the effect you would get in 1985 would have to be very largely expectational. There's some overlap, but I——

Senator Heinz. Right.

Were the Congress not to take those steps, to what extent would you revise your projections for 1985?

Mr. Volcker. I can't give you a numerical answer to that. This is a collection of numbers for members of the committee, but I think the risk that is aggravated in that case is what happens in financial markets, what happens in interest rates and what pressures come on the Federal Reserve, to monetize debt under those conditions. I think people would feel there would be lower growth and higher inflation, but I can't quantify that. I don't want to suggest it would be necessarily large during 1985 when we're talking about a different period.

Senator Heinz. But were action not taken would you be willing to endorse the following statement which, I think, you've made. You would see it first in interest rates. There would be some pressure to monetize the debt. If that did happen it would tend to stimulate inflationary expectations and perhaps some inflation. Those two factors combined would have a negative effect on growth and presumably unemployment. All of this in 1985. But the real effect and the major effect by implication would be in 1986.

Are you saying that we would have quite high interest rates through the possibility of substantial inflation and an economic downturn in 1986 if Congress doesn't address the budget deficit?

Mr. Volcker. All I'm giving you is a sense of direction, certainly, for 1985. You tell me whether—we assume something in the neighborhood of $50 billion.

Senator Heinz. Let's assume it's in the neighborhood of zero.

Mr. Volcker. All right. I mean I was going to say if it's in the neighborhood of $40 billion I may not find those differences marked except psychologically.

If it's in the neighborhood of zero I do think you will get higher interest rates next year. That increases the risks in terms of economic activity and at the same time it leads to pressures, which we will resist, to have a more expansionary policy than we should have in terms of the long-term inflationary problem.

I don't want to suggest we will not resist those pressures, but that's the direction in which they come.

Senator Heinz. I think that it's good to—and I know you've made that point before—but I think it's good to make it continually. We have not solved the budget problem as yet.

Mr. VOLCKER. I think the risk that you're running on the budget, if I may say so, Senator—to dramatize it a bit but not unrealistically—is what happens if that capital inflow stops? Apparently, we can go along pretty nicely on the surface as long as we're getting a lot of loans from abroad. But those are not entirely within our control and if they stop, even with changes made in the budget, and all the more if no changes are made in the budget, we have some very real problems.

You've got to begin to get that budget deficit out of the way, against that contingency, which could happen any time.

Senator HEINZ. Well, you anticipate my next question because the only way we apparently, as I understand your testimony, are making all ends meet and having such economic success is by virtue of the fact that we are substituting foreign capital in this country where it is needed and a lot of it, apparently as I understand your comments, is being used for consumption. Is that an adequate understanding?

Mr. VOLCKER. We've had a pretty good investment growth so I can't say——

Senator HEINZ. But let me—I, I——

Mr. VOLCKER. I can't say we've wasted all that.

Senator HEINZ. I'm at fault in phrasing my question. That the importation of foreign capital, although it may be used for investment purposes, facilitates borrowing by others for consumption—for the purposes of consumption.

Mr. VOLCKER. It facilitates borrowing for any purpose. Now, we——

BURDEN OF DEBT AS A NATION

Senator HEINZ. You, yourself, made a strong point as I recollect that our burden of debt as a nation—not just Government debt but consumer debt and business debt and debt for leverage buyout——

Mr. VOLCKER. Increasing, yes.

Senator HEINZ [continuing]. Is growing not only substantially faster than the GNP but it is reaching a level in certain sectors where you worry about it and you mentioned the corporate financial sector in particular.

Mr. VOLCKER. Yes.

Senator HEINZ. Let me ask you this: Do you think we should do anything about restraining the growing overburden of debt which either corporations have engaged in or banks have facilitated by either restricting corporations or banks in some way?

Mr. VOLCKER. I'm not an expert in this area, but I don't myself see any way you can importantly regulate mergers, leveraged buyouts. I don't see how you can get the Government in all these particular decisions. I think you can do two things, broadly. You can obviously reduce the Government deficit directly; that's what we're talking about, that big element in debt.

I do think our tax system has a bias against equity and in favor of debt, and as part of the tax reform effort I would hope that that would be addressed. It's been a chronic thing; it's still there, and it does influence all these decisions, and I would hope that that would be addressed.

Finally, I think that we, as banking supervisors and regulators have a responsibility. This is not all bank-financed, but banks themselves have a responsibility for encouraging prudence when evaluating a merger, or a leveraged buyout, or whatever. It doesn't mean they're all wrong, but they should certainly be looked at pretty carefully to see that in those particular cases people aren't getting overextended.

Senator HEINZ. Maybe we could discuss what the Fed should be doing to encourage that prudence, along with other bank regulators, on another day, but it seems to me an important and critical question.

Going back to your concern that the flow of foreign capital might be cut off, last June, the International Finance Subcommittee of Banking held a hearing, and I engaged in some purple prose with Martin Feldstein, as I recollect, asking him the somewhat rhetorical question of whether the United States had become a foreign capital junkie.

What I hear you saying is that we have become a foreign capital junkie, and we're facing severe withdrawal pains.

Mr. VOLCKER. We haven't faced any severe withdrawal pains, because it hasn't been withdrawn.

Senator HEINZ. We haven't experienced them. We've faced them.

Mr. VOLCKER. We face them the day that it stops, yes; unless we're prepared for it. I can draw you a pretty picture, where you are reducing the Federal budget deficit at the same rate of speed that foreign capital is receding and everything balances out quite nicely and the economy gets the benefits of a better trade position. In that picture, pressures on the market are relieved by the fact that you're reducing the budget deficit; that is what I am pleading for. let's get in that position where we're prepared for that.

EFFECTS FROM THE STRONG DOLLAR

Senator HEINZ. You have discussed with great erudition all the factors that have been affecting capital flows, exchange rates and the like, but nonetheless, there seems to be a problem that we have to contend with some way or another. It is stated that our farmers are the most efficient agricultural producers in the world. It is stated by people such as the chairman of Motorola, which is a very competitive high-tech company, that there are many industries in the United States, like farmers, that are the most competitive in the world. And indeed, we have been through a very painful period, 4 years, almost, where we have done a tremendous amount of reorienting of our economy, so that it is substantially more competitive. And if you look at the Europeans, we are way ahead of them in so many ways, shapes or form. We are an extremely competitive economy. And yet the exchange rate system, in spite of our underlying competitiveness, has failed to bring the dollar in line with that underlying competitiveness.

It's not that there aren't reasons. We've been over the reasons, but the question is, should we just stand back and say, and allow the exchange markets, which apparently are not sensitive to this factor that they're supposed to be sensitive, to wipe out our farmers and our competitive industries and our exporters and those industries that are competitive, but import sensitive.

It is fine to say, "Senators, reduce the deficit." And let's say we do that. Do you think that's really going to make the dollar weaker? No; it's going to make the dollar stronger. And therefore, after we do what you've suggested is our main policy imperative, and we should do it, I fail to see how that is going to have helped the exchange rate system realign with the underlying competitiveness of the U.S. economy.

Mr. VOLCKER. Let me give you two responses. Let me approach it from the viewpoint of doing nothing, and then I think you're in a position of driving the dollar down or hoping the dollar gets down; I don't know what the technique is.

Senator HEINZ. No; you misunderstand my question. My question is not that we shouldn't do anything in terms of the budget deficit.

My question is, We've got a problem. If we do what you say we should do, we still have a different kind of problem. We may avoid other kinds of problems, but we still have a serious problem.

Mr. VOLCKER. Let me approach it from that end.

Senator HEINZ. What do we do about it?

Mr. VOLCKER. I guess I would dispute the premise in the second part of your comment. I don't know what would happen. If tomorrow, you said the budget deficit was going to be appreciably reduced, it wouldn't surprise me at all if the dollar suddenly went up, because people would say, "My goodness. You can bet our policymakers in the United States are finally taking care of something we are concerned about." And the dollar goes up.

In terms of a little longer term equilibrium, I think you have then created the opportunity, and we would create the fact, that the dollar will be in a better competitive alignment. We will not be so dependent upon those capital inflows; our interest rates will be lower in this country, and that will be a factor pushing out or attracting less of this foreign capital under those circumstances.

Senator HEINZ. Mr. Chairman, our interest rates are already lower.

Mr. VOLCKER. They're lower than they were, but not lower than they are abroad. I'm not ready to say all the laws of economics have been repealed and lower interest rates don't have some impact on the dollar over a period of time, all things equal; you would have changed the shape of policy, so that we have lower interest rates, we have less dependence upon foreign capital inflows, and in time you would find a better competitive equilibrium in the dollar.

I think the danger that you're running now is that you may get that better competitive equilibrium anyway, because this confidence in the dollar may be diminished, but right now it's a question of picking your poison. We have the trade deficit. If we didn't have the trade deficit, all those pressures would come back on domestic investment, so we've got a no-win situation.

Senator HEINZ. Yes. We may be in a no-win situation. It seems to me that if we are unable to get, for reasons that are somewhat only guessed at, the exchange market to align properly with our competitors, we're driven toward several alternatives, none of which are particularly welcome. We are driven toward taking action under the GATT for balance-of-payment purposes, holders of tariffs across the board without preference to any sector. That's one fairly unpleasant alternative.

Mr. VOLCKER. I'm not so sure that our condition is permitted by GATT either, but go ahead.

Senator HEINZ. Another unpleasant alternative is massive intervention in the foreign exchange markets, the creation, as one of your, I guess, New York Fed governors suggested on February 14, a strategic currency reserve that intervenes to the tune of $100 million a day one way or the other.

A third unpleasant alternative is some kind of investment equalization tax, which we tried once before.

None of these are very pleasant things to contemplate, because they all have some rough bite on the other side, even though they undoubtedly would, in one way or another, bring about the redressing of the underlying of the failure of exchange rates to align with our competitiveness.

I don't ask you to comment on all those. My time has expired.

Mr. VOLCKER. I would make one general comment. I think in the way things are set up now, none of those things would work. They're not only unpleasant, they wouldn't accomplish the purpose. They either would not reduce the exchange rate—they might increase it, if the capital flow continued—or if that was successful in shutting off the capital flow, then you'd just transfer the problem back to internal markets and you'd be wondering what happened to your housing industry.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. Before I call on the next Senator, I'd like to recognize the presence of Senator John Stennis.

Senator, we're honored to have you with us. You're one of the giants of the Senate, and I value the opportunity I had to serve on Armed Services with you, when you were chairman of that committee.

So we appreciate you being part of the Banking Committee today.

Senator STENNIS. Thank you, Senator, very much, for such a warm welcome.

The CHAIRMAN. Senator Proxmire is not here, and my practice has been in the past to welcome Senators on the basis of their appearance, but I also throw it out to your side. Senator Dixon was the first one here and made his statement. He would be next and then Senator Riegle, but I would leave it up to you gentlemen, what——

Senator RIEGLE. You were here before me.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I apologize for not being able to hear your testimony. As you know, I went on the House side to a subcommittee of the Banking Committee to testify on Congressman Annunzio's legislation, but I did read your testimony and appreciate your comments contained in it.

PROGRESS OF CONTINTENTAL BANK

I see that the Continental Bank's need for borrowing from the Fed has declined, and that the bank generally seems to be doing better than many expected.

May I ask you first, Mr. Chairman, are you satisfied with the Continental's progress and second, how would you assess the efforts of the new management team there?

Mr. VOLCKER. I think I'm generally satisfied that given the conditions the bank inherited, real progress has been made over these past 6 months or so. I think that reflects well on the management team.

Senator DIXON. Well, I want you to know that I thoroughly supported what you did there, and I am sure that I speak for the Illinois financial community, when I say that we're well pleased. I think John Swearingen is an exceptional man. Governor Ogilvie, who's not of my political persuasion, but a warm friend, has just recently been placed on the Board of Directors, and I want you to know that all of us applaud the choice by Bill Isaacs and others, such as yourself, of that fine gentleman to serve on the Board.

Now Senator Heinz alluded a little bit to the farm problem. I'd like to develop that a little bit with you, because there's a real crisis, as I think you know, going on out in the farm belt, and as you point out in your statement farmers are being crowded out of credit markets, and land values are falling right to the floor. There's a real danger that a significant number of farmers won't even be able to plant a crop this year. Agricultural banks are also suffering. The number of banks on the problem list keeps climbing and bank failures are rising, even though we're in the third year of a recovery.

I'd like to ask you what kinds of solutions you'd recommend to deal with the problems of agricultural banks and farmers who desperately need debt restructuring.

Mr. VOLCKER. When I look at the banking side, certainly there are pressures, and there are going to be stronger pressures due to the general situation that you describe. We are fortunate that, as a group, those banks are probably the strongest banks that we have had, historically. Their earnings have been good, their capital is good, their liquidity, by and large, is good now. And they're going to need every bit of that strength, in terms of dealing with this problem. We're going to get some failures there. We had some failures. They tend to be of pretty small banks, and they tend to be fully insured, so it doesn't have the same systemic implications as some other situations might have. But there's going to be very heavy pressures there.

I think we can—from the viewpoint of our responsibilities—maintain the continuity of banking services. I think we can deal with this without disrupting the financial system, but there are going to be some particular communities that are going to be very hard hit, and their local bank may go. That is a hardship for those communities. There's no two ways around it.

SQUEEZE ON INDEBTED FARMERS

The basic problem, of course, is this grows out of the pressures on indebted farmers. I think the farmer who didn't have so much debt may not be getting rich these days, but he can maintain himself. When you've got debts of 40, 50, 60, 70 percent of your property values, and those property values are diminishing, you've got a squeeze. Frankly, I don't see any outcome to this problem that does not involve losses of some fringe of farmers who are, indeed, very heavily indebted. If you've got a typical farm with a mortgage at 60 or 70 percent of your property value, you cannot, at any where near present prices, earn enough money to pay the interest on that debt. The situation just gets aggravated every year.

Senator DIXON. Well, could I interrupt you to ask you this question, Mr. Chairman.

You know some of us—well, most of us in this committee, I think, supported your point of view and the administration's on passing legislation in the last Congress for additional money for the IMF, and now we go home in some of our States, and the people there say, aren't American farmers just as deserving of help?

And I wonder what your response to that would be. I remember your very strong position before this committee in support of additional funding from the IMF. That wasn't all too popular where I come from. I followed your lead, as did the chairman and others, with some reluctance, I think I might add.

What do you say to that?

Mr. VOLCKER. I want to be very careful. I would say, in broad terms, sure, they're deserving of the same kind of help, but what kind of help is it legitimate to give? What kind of help certainly is legitimate for the monetary authorities to provide? We can provide liquidity help, on the one side. Liquidity is not the problem here. By and large, there's plenty of money out there in those rural banks, if they had creditworthy borrowers. They will be able to lend to their creditworthy borrowers. I have no doubt that the farmer who isn't deeply indebted is not going to have any trouble getting money. The problem is one of creditworthiness, and that is something that money in itself isn't going to solve.

Senator DIXON. Some would argue out there that when we appropriated that—what was it, $8.5 billion for the IMF? There was some creditworthiness questions pertaining to a good many countries—Argentina, Brazil, Mexico, to mention a few, and they're in worse shape than some of the farmers I know back in Illinois.

Mr. VOLCKER. I think it's perfectly right to say there was a creditworthiness question. That question was raised, but with a little more experience, we have been able to say that most of those big countries have, in fact, been able to get their accounts in order, externally, at least for the time being, as we expected. Many countries that were running big deficits are now running a surplus or have cut that deficit way down.

Mexico, for instance, is now running a surplus. Looked at from the standpoint of a farmer, can he do that?

Senator DIXON. I don't want to be argumentative with you, but I would argue that the American farmer is a fairly good investment risk in the long term. These terms are cyclical.

Mr. VOLCKER. I think they are, too.

Senator DIXON. Mr. Chairman, you'd be the first—you're here always talking about the cyclical experience.

STEPS TO HELP THE FARMERS

Mr. VOLCKER. I don't disagree with that at all, except that some fringe group may just be in too deep. Something we're trying to do, certainly in the Federal Reserve, is quite parallel to an attitude that was taken toward some of these big foreign loans. We have not only asked, we have directed, at meetings where this point is made, that our examiners, in dealing with their rural banks—we don't have so many rural banks, but we have some—should not in any way discourage forbearance by the bank, when its in the bank's own interest and in the farmer's interest and in the interests of working out, over a period of time, the best arrangement in a particular circumstance.

If a farm loan of that sort is to be classified, it has to be reviewed by the examiner's superiors to make sure that the examiner is not overreacting in classifying more than is justified, in terms of the actual prospects for that loan.

We put in place a number of procedures that, in essence, are quite comparable to the attitude we took toward the bank loans, on a much more massive scale, some of the heavily indebted developing countries. In the end, a bad loan is a bad loan. If the loan is really bad, we classify it in either case.

Senator DIXON. Just in conclusion, Mr. Chairman, I don't know if this question has been asked prior to my returning from the House side, but do you have a dollar figure on the budgetary savings, at least contemplated by the administration's budget, the domestic cuts and then of course the increases on the military side?

What is your——

Mr. VOLCKER. For the overall budget?

Senator DIXON. Yes.

Mr. VOLCKER. I think the actual figure they had for cuts in 1986 was $50 billion even, as they measured them.

Senator DIXON. Do you have any dollar figure on what a freeze across the board would entail—domestic spending programs, entitlements, military spending—an absolute freeze?

Mr. VOLCKER. No, I think the administration, as I understand it, has argued its program is the functional equivalent of a freeze, but I haven't got that calculation.

I think there are many different ways of measuring a freeze and what you mean by a freeze.

Senator DIXON. Well, I wonder whether it would be possible for you to make available to some of us on the committee your analysis of that comparative—those relative figures—a comparative analysis between the administration's budget, which contemplates massive domestic cuts and substantial spending increases on the military side and no freezing of entitlements, compared with a direct freeze across the board in all categories—entitlements, military spending, domestic programs?

Mr. VOLCKER. No; I would be glad to. I think you have to make a number of assumptions here as to what you mean by a freeze, but I could supply some——

Senator DIXON. At last year's level.

Mr. VOLCKER [continuing]. Some calculation, yes.

Senator DIXON. Or this year's, I should say.

Mr. VOLCKER. I would be glad to do that.

[The following information was subsequently supplied for the record:]

Chairman Volcker subsequently furnished the following information in response to a request from Senator Dixon:

Alternative concepts of a "budget freeze" could be used to characterize different approaches to containing federal spending. At an aggregate level, one approach would be to maintain total outlays in FY 1986 at the FY 1985 level. By Administration estimates, this would amount to $960 billion and would require reducing outlays in FY 1986 by $64 billion from current services levels. This overall approach could be implemented in a variety of ways, since all budget categories need not be affected similarly. In fact, interest outlays, for example, cannot be frozen. Removing net interest on the public debt, but freezing the total of remaining outlays, yields the Administration's target for FY 1986: total outlays of $974 billion, $50 billion less than current services outlays. Freezing the current-dollar value of all appropriations, including defense, and omitting cost-of-living adjustments for entitlements would apply the freeze concept at a disaggregate level to those budget categories amenable to Congressional control. This approach, however, would reduce outlays by an estimated $38 billion from current services levels--the actual level of outlays would rise $26 billion between FY 1985 and FY 1986.

Senator DIXON. I thank the Chair.
The CHAIRMAN. Senator Mattingly.
Senator MATTINGLY. Thank you, Mr. Chairman.
Mr. Volcker, I just want to get back to the trade issue.
If interest rates go down 1 or 2 percentage points, do you think the dollar will still remain strong as it is today?
Mr. VOLCKER. I think I would have to believe that if it went down 1 or 2 points it would be less high than it would otherwise be. But the dollar has been very strong. I am not going to predict that it would go down.
Senator MATTINGLY. But don't you believe the United States would be just as safe a haven for foreign investment, probably even greater?
Mr. VOLCKER. It would be as safe a haven.
But, I suppose it depends upon why interest rates went down. If the budget was reduced and that produced the 1-percent decline in interest rates or a 2-percent decline in interest rates, there is nothing in that procedure that would at all weaken confidence in the United States.
Senator MATTINGLY. You agree however, irrespective of what caused them to go down. I don't mean the budget deficit going down by tax increases or reductions in spending, but declines in interest rates.
All I am saying is if interest rates dropped, say, 1 point, the United States will be as safe a haven and foreign investments are not going to dry up, right?
Mr. VOLCKER. I suppose in the terms you ask the question I would answer yes.
Senator MATTINGLY. Yes.
Mr. VOLCKER. But let me just make a point, that if we, the Federal Reserve, attempted to drive interest rates down by greatly expanding the money supply—and suppose we were successful for the short run—I assure you the United States would then not appear to be as safe a haven from the standpoint of many foreign holders of money.

POSSIBLE SOLUTIONS FOR THE TRADE PROBLEM

Senator MATTINGLY. Right. But, you know, what I am getting to. There has to be eventually, hopefully sometime soon, some answers to the trade problems that we have. Everybody talks about the overvalued dollar, but I don't see the dollar dropping that much, and I don't think anybody else does either because the U.S. economy is strong.
You know, it is how do you go about coming up with a trade solution. Eventually, I assume that you would have to believe, like I would believe and as do many others, that somebody is going to have to talk to some of these countries about reduction of some of their barriers.
Mr. VOLCKER. Obviously, that is one. There are two very constructive things that could happen in that connection: getting their barriers lowered and simply getting the economy moving a little faster abroad would help our exports.

Senator MATTINGLY. There has been a lot of talk about moving to some type of price rule; in other words, targeting money supply growth to some basket of commodities to try to help stabilize the dollar, maybe give it a more clear and precise value.

Will you comment on that idea, and do you think it would be helpful or harmful?

Mr. VOLCKER. I don't know of any basket that is adequate for the job. In general intellectual terms——

Senator MATTINGLY. How about gold?

Mr. VOLCKER. That is one I thought of that I am not sure is adequate for the job at the moment. We went off the gold standard not so long ago because it was thought to be deficient. I know that is one that is proposed.

Senator MATTINGLY. Before you answer that, put aside gold, and think in terms of creating some new basket to use as a barometer.

Mr. VOLCKER. Let me try to approach your question this way.

That would be one way, that would be a very precise way—let's say you passed a law to that effect—of telling us to stabilize the price level. I assume that would be the purpose of it.

Now, you could express that thought much more broadly and simply say, "Look, your No. 1 job is stabilizing the general price level." This apparently would go one step beyond that and say we want you to stabilize the general price level, but we want to give you a very precise rule about how to go about that, that is, with some basket of commodities.

I think at that point a lot of technical problems arise. Can you define a basket of commodities that has a high probability of being consistent with the kind of economic performance you want in the economy generally when its price is held stable?

That is a pretty big assumption to make about the relative price of whatever commodities are in the basket and whatever else is going on in the economy.

We could conceptually stabilize such a basket of commodity prices. The question is whether and over what period of time that would give you the results that you want in the economy as a whole. We could have a big technical discussion as well as a general discussion about the merits of trying to stabilize a particular basket of commodities of that sort.

It is a very old idea that has certain attractions intellectually, conceptually. I have some doubts about its workability in practice.

Senator MATTINGLY. Are you saying such an approach would not exacerbate the problem?

Mr. VOLCKER. I don't think it would cure this trade problem. I think that idea would fall or rise on whether in fact it was effective in producing more price stability and whether that price stability would be consistent with the kind of performance in the economy we want.

Senator MATTINGLY. Well, I guess that is what I am trying to achieve. I mean, we are trying to create stability.

Do you think this approach would have more or less stability? I think it is a critical point.

Mr. VOLCKER. Well, I think it is, and I would like to get to price stability. You offer me a mechanism through a commodity basket or something else that has more promise of getting to stability. I am not going to say only bad things about it.

I am not sure it is better than simply telling us more clearly, if that is what you want, to aim at stability as best we can, that you want us to report to you and tell you how we are doing, you, the Congress, are interested in a broader measure of stability than some limited basket. I think we would probably be better off.

Senator MATTINGLY. Good. I think Congress thinks anybody that tries to trade would probably think it is better off.

Mr. VOLCKER. I don't see why that stabilizing a basket of commodities is going to help the trade problem that you started with.

Again, you get back to this kind of problem that Senator Heinz raised in the short run. If people really thought that was going to be of great help in stabilizing our prices, more money would likely run into the United States, not less, and we would have the dollar go up some more.

I think that process is self-limiting. I think we should not be misled by that initial reaction. This money can't come in forever. But I don't know how much short of forever is the answer.

Senator MATTINGLY. Well, I guess that is almost like the dog chasing its tail, If the dollar stays strong, as the United States becomes stronger economically, and you know the dollar is going to keep on getting stronger, our competitive position weakens unless we can somehow stabilize the price of the dollar.

Mr. VOLCKER. My problem, I guess, is so long as we have this big deficit——

Senator MATTINGLY. That is not the only answer.

Mr. VOLCKER. So long as we have this deficit that has to be financed, we ought to be down on our knees every night, in some sense, thanking our lucky stars that we got a strong dollar and got a big capital inflow because that is the way we are getting the budget financed; if we didn't have it, I don't know how we would get the budget financed.

Senator MATTINGLY. Well, I think the strong and healthy economy in the United States is sort of like a welcome mat for the dollars coming in, and I don't think it is going to change.

Mr. VOLCKER. Fine, but if nothing else changes, what will eventually change is that the more and more money you borrow, that in itself will begin to undermine the confidence that people now have.

That is true of any borrower. If he gets enough loans, at some point the guy says enough. It may be too late at that point, but that eventually happens.

CURRENCY INTERVENTION

Senator MATTINGLY. I sort of hate to get off the trade issue, but Secretary Baker spoke last week about intervention in the foreign markets, currency intervention.

Are we going to continue doing that?

Mr. VOLCKER. What we have been doing has been quite limited. My own view is that there are times when intervention can be useful, that by and large it is a tool of limited influence but there may be particular times when it is useful, and I think we ought to stand ready to do it when we conclude that there is a combination of circumstances that makes it useful.

That could be this year, next year, any time.

Senator MATTINGLY. What role do you all play in that, the Fed?

Mr. VOLCKER. We do it.

Senator MATTINGLY. Good. [Laughter.]

That is a good simple answer. Good.

Mr. VOLCKER. I think we do it vis-a-vis the Treasury. I think this is a process where we do it when essentially both are agreed and we don't do it when both are not agreed.

Senator MATTINGLY. Good. The only thing in your testimony and speeches I would like to change is bringing up the subject of raising taxes. For us folks that are looking at the spending side of this budget, it sort of weakens some of the resolve on the other side for people who like to raise taxes.

You know, there are those of us who don't want to raise taxes.

Mr. VOLCKER. I would hope it would strengthen your resolve if you don't want to raise taxes. I don't think I mentioned it, but I hope that little threat——

Senator MATTINGLY. No, you didn't today. I think, however, you did the other day.

Mr. VOLCKER [continuing]. Lying in the background, that just encourages you to reduce expenditures.

Senator MATTINGLY. I forget where I was traveling in Georgia, but I picked up the paper and saw where Volcker alludes to the need for a tax increase.

Mr. VOLCKER. All I have said is if you can't do it on the spending side, then you have to look at the other side.

Senator MATTINGLY. But you don't really want to do it on the taxing side?

Mr. VOLCKER. On economic grounds, I would rather do it on the spending side, but you have to decide all those other things.

Senator MATTINGLY. Good.

Thank you very much.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

In your remarks today, on page 4, you say that there is a need for a sense of urgency, and then on page 9 you say in a real sense we are living on borrowed time—we are living on borrowed money and time.

And I agree with you, and I generally agree with the ideas you have presented in your statement designed to straighten the situation out. And just as you are expressing in your comment about living on borrowed money and time, it looks to me as if time is running out here.

BREAKTHROUGH ON DEFICIT IS GETTING DIMMER

As I look at what is happening both on the Budget Committee, on which I sit, and watching the whole budget process, both at the White House end of Pennsylvania Avenue as well as here, it looks to me as if the chances of a significant breakthrough on the deficit are getting dimmer, as that is the general reading of the situation. All the deadlines have slipped, all of the things that you might measure indicate that despite a lot of high hopes early in January there isn't much measurable progress going on, and certainly there has been almost no participation by the President himself.

But to give you a further example of that, today and yesterday on the Senate floor, where the Meese nomination is being held up by those who represent farm States and who are greatly concerned about the farm credit crisis, consideration of deficit reductions measures are not being undertaken although I sympathize and understand the plight of the farmers. But I would just cite that as another example of the fact that is something that is going to cost money. I think we need to come up with some kind of an answer, but that, in a sense, presumably moves us again away from the notion of some kind of a nice, neat package solution to the deficit problem.

But what I am getting to is the point that Senator Proxmire raised with you earlier today, and that is that I think that unless we break the back of this problem, of this fiscal dilemma—and I don't see us making much progress toward doing that—I think at some point we are likely to face a crisis of confidence. I don't know exactly when that comes, but I think the thing that would probably bring it to a head as fast as anything would be a failure to act on the deficit and the fact that you might decide somewhere down the line in the absence of solving that, that for reasons of your own that you are going to have to leave the job you are in.

And I would be very concerned about that, not that anybody in Government is ever totally indispensable. But I think your role in instilling a sense of confidence here and abroad is of a size and dimension now that, in the absence of resolving this financial deadlock problem, you were to leave your present position it would be a very serious blow to the confidence many have in our monetary policy and our ability to correct the deficit crisis we now face.

I say that based on conversations that I have had with people, not just in the financial markets, but people in major business and industrial sectors across the country.

So I would just urge you to consider that. Whether we are successful in coming up with a breakthrough on the budget or not, I would hope that we would not see a disruption of the leadership at the top of the Fed sometime later on this year because I think that could be just one more factor that could cause people to really get a much more serious case of the jitters about the future.

I just wanted to share that thought with you, and to have it put on the record because I think it is a very important reality and not necessarily a pleasant one for you or anybody else, but I think it is part of the quandary that we are in here.

Let me just ask you this question on the issue of the foreign loans that are pouring in here. Obviously, I am very concerned about this, representing a State that is being damaged badly by the import invasion and the drying up of export markets.

I am wondering how long this reliance on foreign credit can go on. Can it go on indefinitely? Is it reasonable to imagine that for 2, 3, 4, 5 years all this foreign capital is going to continue to pour in here and that we can continue to buy foreign durables, which is where the bulk of the spending is going in the trade deficit?

So we are spending, in a sense, our own capital. Our own equity money leaves the country in exchange for these consumer durables, which, you know, are not investments, as we would normally think of them. They are not capital investments.

Can this just go on indefinitely? Can we just count on the world to continue to make up for our insufficient savings rate and overspending?

Mr. VOLCKER. The whole thrust of my analysis would be that it cannot go on indefinitely, but I can't predict for you how long it can go on. We are a big and strong country—Senator Mattingly and others have made the point—and it could go on for a while. It's already gone on for a while.

But it also is true that this flow has to get bigger each year as things now stand, because we now have to pay interest on what we borrowed last year. And the dollar's gotten stronger and our trade position is not going to improve.

I think the answer is it can't go on indefinitely, but I can't give you any good feeling of what time horizon is relevant here. All I know is I would like to do what is necessary, internally, to get prepared for that day as soon as possible, particularly since it's very uncomfortable while it's going on. It's very nice to have the deficit financed and this investment financed but it's not very nice to be the farmer or whoever else is fighting the imports or not exporting.

Senator RIEGLE. Well, the thing that concerns me is that as the economy remains strong and as the news generally is upbeat, housing starts, other things—at the present time inflation remaining low——

Mr. VOLCKER. People say why do anything?

Senator RIEGLE. Pardon?

Mr. VOLCKER. And people say why do anything?

Senator RIEGLE. Exactly. And if you've been watching closely what's happening here in the Senate, you can detect this type of attitude. Senator Dole announced early-on that he was going to produce a major deficit reduction package even before the President's budget got here and that effort has just been stopped cold insofar as one can tell.

And on the Budget Committee the chairman there who's determined to try to do something about the problem has now said that he's had to revise all of his deadlines and push them back so it seems that we're really grinding to a halt here on the question of a major reduction of the deficit. I'm talking on the order of the $50 billion that has been put forward as the target.

I'm very worried about it because it seems to me that time is running out and that even now the intervention in the currency markets, even a slight intervention, forces you into a sort of match against the speculators, at least, that's what I've witnessed in the past. Then it becomes like a card game with everybody attempting to show down the other guy. If you intervene a little bit then the other guy is sort of forced to up the ante and then if you want to really beat the speculators in international currency, you really have to come down hard, and I get the sense that if for other reasons you're not too anxious to do that at this point or think that that's wise. So it's not surprising to me to see the value of the dollar kick up again yesterday.

FLEXIBILITY NEEDED

Mr. VOLCKER. I think you need a little flexibility if you're going to do this effectively.

Senator RIEGLE. Well, it sounds to me like at some point if you really want to turn that thing around, you're going to have to intervene in a pretty substantial and sustained way and I don't get the sense that you're close to doing that.

Mr. VOLCKER. Well, I think the effectiveness of intervention depends upon whether it is moving with or against other, more fundamental, forces. And that's, of course, a matter of judgment at any particular time. But there's no point in intervening if, in fact, basic forces are going in whichever direction they're going.

But I also think sometimes the market can move in ways that aren't necessarily consistent with continuing forces for a time and intervention may be useful in demonstrating, particularly on a coordinated basis, mutual concern or, in other circumstances, lack of concern about this.

Senator RIEGLE. If foreigners decided to start to withdraw some of this capital, how fast could it be withdrawn?

Mr. VOLCKER. They can't. You can't withdraw the capital unless you find somebody else to sell it to. And if nobody wants to buy it, what happens is not the capital goes out, but the exchange rate goes down, our interest rates go up. And the price will change.

Senator RIEGLE. Well, don't you continue——

Mr. VOLCKER. You can't withdraw capital when you're running a current account deficit. You've got to borrow. The only thing you argue about is the terms and conditions upon which you borrow. Individuals can take it out but it can't go out as the whole.

Senator RIEGLE. So if people want to unload financial assets in the United States, they just have to sell them and they can sell them for whatever the market price is.

Mr. VOLCKER. That's right. They have effects on the interest rate and on the exchange rate.

And you might say, fine, so the exchange rate goes down, then we won't have the trade deficit. Then I have to ask you, How are you going to finance yourself?

Senator RIEGLE. Well, that's my question. If foreign lenders decide that they're not going to continue to cough up these additional increments of capital, it seems to me that we could find ourselves with a shortfall in quite a hurry.

Mr. VOLCKER. No question.

Senator RIEGLE. Could it be within a matter of days or weeks? I mean if the psychology changed, how fast would we see the impact in terms of a shrinkage in new foreign capital being available?

Mr. VOLCKER. I think you'd see the impact in the markets very fast, because once it happens the markets begin anticipating it and you could see the reaction——

Senator RIEGLE. So it can happen almost overnight?

Mr. VOLCKER. In terms of market impacts, yes.

Senator RIEGLE. One final thing here and I want to be quick on the time, although, I notice the chairman's been generous as is normally his custom.

QUESTION OF FARM BANK FAILURES

I want to go to the farm loan problem and I'll be very quick about it. In 1983, of the bank failures in the country—the insured commercial banks—11 percent of those were what would be called farm banks, principally, farm economy centered banks. In 1984 the total failures had jumped from 11 percent representing the farm sector banks up to 32 percent and so far in 1985 it's up to 50 percent, and the numbers are really stark in terms of what we're looking at and this is the reason that the farm State Senators are on the floor right now blocking the Meese nomination because of the profound sense of urgency.

My question is this: What is the best estimate you can give us as to the dimension of this farm credit problem through these farm banks? I won't cite the rest of the figures unless you want me to in terms of the number of banks that are involved here. But there are a large number of them.

What I'm concerned about is if we see a toppling or a beginning of a toppling of a larger number of these banks, particularly in those sections of the country, how are we going to go about maintaining credit—normal bank credit—in those areas so that we don't have a situation where suddenly the whole commercial fabric and network in those areas is damaged or can't function and, how serious is this problem? What are its potential dimensions if it were to continue and grow at these rates out over the next 6 or 9 months here?

Mr. VOLCKER. The pressures in some areas of the farming community are very intense. Let me stipulate that.

So far as the banking problem is concerned, there are about $200 billion, as I recall it, of agricultural loans outstanding of which something on the order of $80 billion is the Farm Credit Administration and $40–$45 billion is the Farmers Home Administration, a Government agency.

Commercial banks have something like $45 billion and then miscellaneous lenders have the rest. The $45 billion that the commercial banks have is probably among the best of this credit; those are the farmers that went to normal, commercial sources. And, as I said earlier, they are among the best of our banks.

So you get a combination of the best of the farm credits and some of the best of our banks, none of which says many of those banks are not going to be strained, that we're not going to have more failures this year than we had last year. That's the way the year is starting out and since the pressures are there and growing greater that is going to happen. These tend to be quite small banks. It's a very serious problem in some cases partly because they are small and in very small communities. They may be the only bank in the community. Nobody may want to buy them, even for nothing if it's an FDIC sale, because they don't see the profitable opportunities in that small community. It is a very serious problem for that community.

Is it a manageable problem in terms of its more general implications for the financial system, for the banking system in general? Yes, I think it is a manageable problem but that doesn't mean there is not the hardship in the local community.

Senator RIEGLE. So you don't foresee a possibility that the farm sector of the country could get caught in a credit crisis and a collapse in land values.

Mr. VOLCKER. That's a somewhat different question.

CRISIS SITUATION

I think large sectors of the farm community are in crisis and many farmers are caught in a squeeze between heavy debts and falling land prices. No doubt about it.

That's what we were discussing earlier. A good many of those farmers, I'm afraid, are going to fail; that doesn't mean they can't go back into farming and those farms can't be operated but they're not going to be operated at the level of what they are at present.

Senator RIEGLE. I'm more concerned about the effect of a credit collapse on the change in the underlying value of the assets that is widespread enough so that you not only have this pattern of certain communities getting hit very hard, but in the aggregate you have a kind of gathering storm that could spread out——

Mr. VOLCKER. You have the potential problem that these failures of individual farms, and pressures on many more farms lead to pressures on land prices that go beyond, let's say, some economic equilibrium; those pressures on land prices then set off another round of bankruptcies and failures.

I think that kind of potential pressure exists. I find experts in this area have a hard time telling me now that they think land prices have been driven below some long-term economic point of viability. But I think that risk is urged by many people out there on the firing line and I think it is a potential danger, whether or not it's happening right now.

Senator RIEGLE. My time is up. I hope to come back on that question.

The CHAIRMAN. I might say we've got the Thatcher speech at 11 o'clock.

Senator RIEGLE. Incidentally, if I may, I've got a box of cigars here. My wife and I had a baby daughter 2 weeks ago and I thought I would bring you what I hope is an adequate cigar, so, help yourself to at least one when you finish.

Mr. VOLCKER. That's too fancy. I've been making my resolution to cut down on smoking and you're not helping. [Laughter.]

The CHAIRMAN. Senator Riegle, I might ask this question——

Senator RIEGLE. Senator Garn can't have one; he's in training, so you can have his.

The CHAIRMAN. Well, I've got other problems besides being in training. If you're a Senator from Utah you don't smoke anything.

Senator RIEGLE. I see. [Laughter.]

The CHAIRMAN. The question I was going to ask, we do have to leave within a couple of minutes to get over to the Thatcher speech. I potentially scheduled to come back this afternoon. Senator Proxmire and I discussed that we have no requests from other Senators to reopen this afternoon. All of them want to submit their questions for the record.

Senator RIEGLE. Senator Dodd has some, by the way.

The CHAIRMAN. So I would just ask you if that would satisfy your situation to put the rest of your questions in for the record or if you don't want to go to Thatcher's speech——

Senator RIEGLE. Well, actually, no disrespect to her, I'd rather hear Volcker.

The CHAIRMAN. Well, would that be satisfactory to submit the rest of your questions for the record?

Senator RIEGLE. I think so. Will Senator Stennis have the opportunity to—I see.

The CHAIRMAN. He certainly would have that same opportunity and the thing I wanted to use the last minute for is to see if he had any statement he wished to make before we left.

Senator STENNIS. Well, I want to thank you again for inviting me to come. I was very much impressed with some of this testimony but I was expecting to be a bit impressed. I've been reading much of what Chairman Volcker has been saying and also talking some to Mr. Volcker. I don't mean to overcompliment him but he's a great asset to the Government at this time in his field. If you have another hearing I'll be around somewhere.

The CHAIRMAN. He manages to show up here several times a year whether he wants to or not.

But may I apologize to my colleagues on the committee and to Chairman Volcker for, first of all, the early start and the truncation of the hearing. As I say, we had no anticipation that Mrs. Thatcher would be speaking, that we would have a joint session while the hearing was scheduled.

Senator Cranston has a statement he wishes to submit to the record. By unanimous consent we would do that.

[Statement of Senator Cranston follows:]

STATEMENT OF SENATOR CRANSTON

Mr. Chairman, I will make just one brief remark because I am most interested in hearing what Chairman Volcker has to say to us today. I am most concerned about the structural problem in our economy, particularly on the fiscal side. The Congress is in the process of enacting a so-called down payment against future deficits which is so critically important to the Federal Reserve operation and the economy as a whole. Lower inflation and interest rates certainly have inspired confidence and a period of calm in which Congress can proceed with this very important task. I know that monetary policy has made its greatest contribution simply by reducing inflation and holding it down. This in turn directly reduces the cost of carrying the public debt and helps the Congress predict cost and revenues. It is a two-way street however; both fiscal and monetary policy would be more effective if instability in both is reduced.

That is why the budget is the No. 1 priority with me in this Congress and I hope to all of us in Congress.

The CHAIRMAN. We would also leave the record open for questions from any of the members on both sides of the aisle for your response as rapidly as you can for the record.

And I thank everyone concerned. The committee is adjourned.

[Whereupon, at 10:30 a.m., the hearing was adjourned.]

[Response to written questions of committee members follow:]

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

March 12, 1985

PAUL A. VOLCKER
CHAIRMAN

The Honorable William Proxmire
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

I am pleased to respond to your written questions submitted in connection with the Senate Banking Committee's February 20 hearing on monetary policy. Your questions concern the amount of debt resulting from leveraged buyouts and our views on leveraged buyouts and other merger-related activity.

Question 1.

You and SEC Chairman John Shad have said in the past that there is too much debt resulting from leveraged buyouts and takeover activity.

* What is the basis for your concern?

* How much debt is resulting from this activity?

Answer:

In 1984, nonfinancial corporations liquidated an estimated $85 billion in equity through mergers, leveraged buyouts, and share-repurchase programs. Only a small portion of these retirements--probably less than one-quarter--were financed by new equity or noncredit sources. The remainder were financed with debt, including a large amount of short-term bank borrowing. Based on flow of funds estimates, borrowing for all merger-related retirements contributed perhaps 1 percentage point to the 13-1/2 percent growth in domestic nonfinancial debt in 1984.

Equity retired through leveraged buyouts, per se, totaled about $12 billion last year, based on available estimates. As implied by their name, these transactions entail high levels of debt, a large share of which has been extended by banks. The high volume of debt relative to equity involved in these transactions raises concerns from a supervisory perspective over the potential risk for firms involved in the activity and for the lenders providing the credit.

Typically in a leveraged buyout, the debt is collateralized in part by the assets of the acquired entity--often inventories or accounts receivable. The success of the buyout and the ability to service the debt hinge significantly upon the future earnings stream and cash flow prospects of the new company. In many cases the debt may carry a variable interest rate. Thus, a heavily leveraged firm will be vulnerable to adverse economic events that might alter the projected stream of cash flow or to unexpected pressures in financial markets that raise interest rates and the cost of servicing the debt. The value of collateral also would be affected by changes in the economic environment. To the extent that leveraged buyouts

The Honorable William Proxmire
Page Two

weaken balance sheets and increase the exposure of firms to market risks, they raise concerns as well about the risks for institutions providing the credit.

For these reasons, the Federal Reserve has actively urged banks to be fully mindful of the potential risk in evaluating loans for leveraged buyouts and to ensure that prudent lending standards are applied. Specific guidelines have been issued for bank examiners to follow in reviewing a bank's involvement in leveraged buyout financing. A copy of Federal Reserve guidelines is enclosed. The Board will, of course, continue to monitor these and other types of merger activities and associated lending practices. I would hope also that the investment community will apply caution in appraising various types of financial arrangements, such as junk bonds, that are being used by companies involved in takeovers and other merger transactions.

Question 2.

The March 4, 1985 edition of Business Week featured a cover story on mergers and acquisitions in which the point was made that the huge debt being incurred for some of this hostile takeover activity was being incurred during a period of strong economic growth and generally declining interest rates but "Come the next recession ... there will be hell to pay."

* Is this a legitimate concern?

Answer:

As noted in the Business Week article that you cited, the recent merger activity and heavy borrowing has been incurred during a period of strong economic growth and lower interest rates. To my knowledge, there have been no failures of note or defaults on debt by firms involved in recent large transactions. Some of these companies have begun to restructure their balance sheets, in some cases by selling off assets and repaying debt or funding short-term debt with other sources of financing. Nonetheless, in the event of a recession or sharply higher interest rates, some acquiring firms, or firms taken privately through leveraged buyouts, no doubt would find their heavy debt to be quite burdensome. But prudent lending practices, as outlined in our guideline and established by lenders, take these eventualities into consideration, and if sound practices are followed, failures associated with heavy leveraging will occur only in exceptional cases.

Sincerely,

Paul

Enclosure

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

TO THE OFFICER IN CHARGE OF EXAMINATIONS
AT EACH FEDERAL RESERVE BANK

SUBJECT: **Leveraged Buyouts**

Leveraged buyouts have become an increasingly important and prevalent acquisition financing technique which, by definition, entail high levels of debt. Bank involvement in leveraged buyouts and the manner in which some leveraged buyouts have been structured have potential implications for the quality of bank loan portfolios. Examiners should be aware of the characteristics of this financing technique and its potential effect on a bank's loan portfolio and overall financial condition.

General Background

Although leveraged buyout arrangements may vary from case to case, they typically have a number of characteristics in common. Generally, each involves the financing of an acquisition of a company, or a subsidiary or division of a company, by a group of private investors and/or company managers. Normally, the investors or managers put up a relatively small amount of equity, borrow heavily against the company's assets and future cash flow and buy out existing owners or shareholders. Often at least a portion of the debt is secured by the assets of the acquired entity, generally accounts receivable or inventory. In particular, the financing arrangements usually include (a) senior debt, secured or unsecured, often provided by banks and other institutional lenders and representing the largest share of the buyout financing; (b) subordinated debt and/or preferred stock in the form of paper taken back by the seller; and (c) common equity supplied by the new owners. Debt levels amounting to seven to ten times equity and more are not unusual in leveraged buyout situations. The viability of leveraged buyouts is predicated upon the strength, stability and future prospects of the earnings and cash flow of the acquired entity.

Once a company has been acquired in a leveraged buyout its assets and liabilities are revalued at market value. This usually results in a write-up of asset values, and, consequently, a higher amount of depreciation expense than before the buyout. These higher depreciation charges, coupled with the large interest expense deductions on the acquisition debt, reduce the taxable income associated with the purchased company and, therefore, reduce the income taxes that the company must pay. Most leveraged buyout companies pay little or no income taxes during the first few years after the transaction.

Banks participating in financing these arrangements often earn an up front fee of 1/10 percent to 1/4 percent while the agent bank may take an additional 1/4 percent annually for monitoring the collateral and handling the paperwork. Banks have extended both secured and unsecured loans for leveraged buyouts in the form of revolving credits and term loans. These loans may carry a fixed or variable interest rate ranging from prime plus 1-1/4 percent to prime plus 2-1/2 percent for senior debt and prime plus 3 percent at a minimum for subordinated loans. Some loans have been structured in such a way as to require the payment of interest only for the first two or three years following the buyout. In addition to these primary loan facilities, banks may extend ancillary lines of credit which may be drawn upon only for the payment of interest, usually when interest rates on variable rate primary loans exceed a certain pre-determined "cap" rate. While intended to provide the borrower some initial temporary protection from unfavorable interest rate movements and heavy debt service obligations, these arrangements could mask emerging debt service problems and postpone the timely recognition of potential credit weaknesses in a bank's loan portfolio.

Supervisory Considerations

The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.

In addition to unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.

In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual leveraged buyouts. The following general guidelines are provided to underscore and supplement existing loan review procedures.

1. In evaluating individual loans and credit files, particular attention should be addressed to i) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan; ii) the trend of the borrowing company's and the industry's performance overtime and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage; and iv) the reliability and stability of collateral values and the adequacy of collateral coverage.

2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

3. Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements.

4. The bank's pricing, credit policies and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.

5. Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.

6. Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors.

This interim letter sets forth some general considerations and draft guidelines for use in reviewing leveraged buyouts. Reserve Banks are instructed to carefully review a bank's leveraged buyout financing activities and to forward comments and suggestions for modifying, expanding or strengthening these procedures as additional experience is gained in appraising these credits. Enhanced guidelines will be provided in the future. Comments or questions may be addressed to Richard Spillenkothen or Jerry Edwards.

JOHN E. RYAN
DIRECTOR

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

April 11, 1985

PAUL A. VOLCKER
CHAIRMAN

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

Dear Chairman Garn:

Thank you for your letter of February 26 enclosing written questions in connection with the hearing held on February 20. I am pleased to enclose my responses to the questions for inclusion in the record of the hearing.

Question: The soaring value of the dollar is causing very serious problems for U.S. manufacturers that must compete with foreign producers. The high level of U.S. interest rates has been blamed for the rise in the dollar's value, and the U.S. budget deficit has been blamed for the high interest rates.

Recently Great Britain raised interest rates sharply in an effort to support the value of the pound sterling, but the dollar continued to rise against the pound. Does this cause you to question whether lower U.S. interest rates would stabilize the dollar on foreign exchange markets?

Answer: I do believe interest rates are a factor in the strength of the dollar. Partly for that reason, exchange market developments have increasingly in recent months been a factor in FOMC deliberations. Our ability to influence international interest rate differentials consistent with other objectives is, however, limited. As I have often emphasized, inflationary increases in the money supply in our attempt to keep interest rates lower would soon be counterproductive. Lower interest rates as a result of lower budget deficits would, in contrast, be healthy.

I do not believe the recent sharp increase in U.K. interest rates, and subsequent exchange market developments, suggest differential interest rate movements are not significant.

The increase in U.K. interest rates did, in fact, suffice to stabilize sterling's average exchange value though not its value against the U.S. dollar alone. Because the dollar was strengthening against foreign currencies generally, it also rose somewhat further for a time against sterling. Subsequently, sterling strengthened and U.K. interest rates have retraced part of their increase.

Question: The argument has been made that reducing prospective federal budget deficits would "remove the last remaining economic cloud on the horizon for the U.S. economy," and that the result could be an even more rapid capital inflow into the U.S.

Do you agree? Could action to reduce the budget deficit lead to an even stronger dollar as more capital flowed into the U.S.?

Answer: Other things equal, meaningful action to reduce the deficit should ultimately be reflected in a lower level of real interest rates in the United States, which in turn would be reflected in the value of the dollar. I cannot discount entirely the possibility that, in the short-run, effects on confidence might lead to a higher dollar, but I believe the basic economics in time point the other way.

The dollar exchange rate has obviously been highly volatile and subject to expectational and psychological influences. At some point rising trade deficits and increased dependence on capital inflows could provoke an over-reaction, with the dollar under sharp downward pressure. That risk of over-reaction would, in my opinion, be reduced by action to close the budget deficit. In other words, prospects for an orderly external adjustment, with minimal interest rate and economic dislocation, would be enhanced.

Question: What is your evaluation of the seriousness of the credit problems facing our agricultural banks? How should the bank regulators respond? Should rules for classifying loans be eased?

Answer: Recently, many farmers and farm sector borrowers have been subject to financial pressures brought on by depressed commodity prices, heavy debt burdens along with interest rates that remain high both historically and relative to current inflation, declining land values, and natural disasters. These financial pressures have in turn been reflected in loan delinquencies experienced by the nation's financial institutions. Some borrowers who are experiencing financial difficulties face the prospect of foreclosure on their farm properties, or the failure of their small businesses. Some of these problems are transitory, however, and some borrowers may well be able to resume payments when general economic conditions improve. Under these circumstances, we recognize that financial institutions may find that the most prudent banking policy is to stretch out payments and adopt, selectively, a policy of forbearance rather than to take the more drastic actions of foreclosure or forcing a borrower into bankruptcy.

Clearly, the problems are serious, but we are fortunate that the great majority of farm banks have entered this period with substantial capital and earnings. They, in effect, have a cushion for absorbing larger losses. While failures may well increase, I do not anticipate they will be in a different order of magnitude than last year. I do not believe the basic rules for classifying loans should be changed, but I do believe those rules should be applied with the kind of understanding about forbearance described above.

Most of the agricultural loans in State member banks are reviewed by System examiners located in Federal Reserve Districts in the Southern, Midwestern and Western sections of the United States. The Reserve Banks located in these areas have an intimate understanding of the unique economic and financial conditions facing farmers and farm-related businesses. Federal Reserve farm sector examiners receive training in evaluating agricultural loans and have considerable expertise and experience in dealing with the special economic and financial problems confronting farmers and small businesses. In short, Federal Reserve examiners are aware of, and sensitive to, problems in the farm economy and their effects on the quality of agricultural loans.

I would also like to note that, as part of our effort to stay abreast of conditions in the farm economy, members of the supervisory staffs of the Reserve Banks frequently meet with representatives from banking organizations in agricultural states to discuss the financial condition, problems and prospects of farmers and farm-sector banks.

The specific policy of the Federal Reserve, which has been in effect for some time, is to refrain from taking any supervisory action that may discourage banks from forbearing on loans or otherwise working with farmers and small business borrowers who are experiencing temporary difficulties in meeting their debt service obligations. This policy has been the subject of official directives, in both 1983 and 1984, to the 12 regional Federal Reserve Bank examination departments from the Director of the Board's Division of Banking Supervision and Regulation. The Federal Reserve issued these directives because it recognizes that the economic environment has resulted in unusual financial pressures for a rising number of bank customers, particularly farmers and certain small businesses.

We believe that selective forbearance is in the public interest and should be encouraged <u>when it is consistent with safety and soundness considerations</u>. The Board's policy directives, therefore, call for particular sensitivity on the part of examiners to the current special problems of agriculture and small business and for examiners to avoid criticizing bank management that adopts a prudent forbearance policy in the circumstances described.

In order to ensure that our policy is fully and consistently carried out, we have also modified and strengthened our review procedures for examination reports of farm sector banks. Pursuant to this effort, each Reserve Bank has designated a special senior review examiner with a high level of expertise and experience in examining and supervising farm banks. This specially designated senior review examiner is responsible for reviewing the examination report of each farm sector bank for compliance with the Federal Reserve's policy before it is forwarded to the bank. The special senior review examiner has been instructed to determine whether farm loan classifications are based on established criteria and are well-supported by the loan write-ups. Furthermore, the special senior review examiner is under instructions to ensure that examiners' comments, conclusions or recommendations do not imply criticism of bank management for exercising an appropriate and prudent degree of forbearance. Examination reports not consistent with these policies must be appropriately revised before they are forwarded to the bank's management and board of directors.

Question: What is your evaluation of the current international debt situation and its current effect on the health of the U.S. banking system?

Answer: The improvements in external accounts in Mexico and Venezuela in Latin America, and in Yugoslavia and Hungary in Eastern Europe, produced current account surpluses last year. Brazil's current account deficit was essentially eliminated, and a number of other countries had reduced deficits.

This progress was facilitated in many cases by significant increases in exports, particularly to the United States, and in most cases was accompanied by a recovery--or at least a slower rate of decline--of imports. Such developments, coupled with continued moderate capital inflows, contributed to sizable increases in the international reserves of many of these countries and to the prospects of reduced demands for extraordinary external financing in the future. At the same time, most of those countries managed to achieve domestic growth.

Against this background, several of the major borrowing countries were able to move on to a second phase in their adjustment and financing programs. One important initiative, when warranted by progress in adjustment, has been planning for longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed to in principle between the commercial banks and Mexico and Venezuela; serious negotiations have begun with Brazil and Yugoslavia.

However, it is also evident from developments in 1984 and the first months of 1985 that the process of adjustment which began in 1982 is far from complete, particularly on the internal side. Progress in coping with both internal and external problems in a few countries has been limited. In these circumstances a higher level of risk remains, and cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required. The need for imaginative and constructive solutions to the problems faced by individual countries is not over.

The improvements in the external situation in the major developing countries have of course removed some doubt about these countries' capacity to service their debts. This development, in turn, has taken some financial pressure off of the developing countries' creditors, including, importantly, U.S. banks. However, for the foreseeable future U.S. banks will need to continue to work closely with the debtor countries, multilateral institutions, and creditor countries in order to solve the financial problems of the developing countries. An abandonment by the banks of their responsibility in this endeavor would jeopardize the gains made so far and run the risk of undermining the health of the international financial system.

Question: Over the last year, the Federal bank agencies have been working to establish uniform positions on capital.

> On Feb 11 - the FDIC approved its new capital rule-- 6% total capital, 5.5% primary capital.
>
> The Comptroller voted for the FDIC rule and indicated OCC would be approving a similar regulation in the near future.
>
> The Fed too has proposed similar capital requirements but plans to revise its existing guidelines rather than adopting a regulation.

Why do you believe guidelines are superior to a regulation? In the final analysis, will uniformity be achieved? Even with regard to intangibles?

Answer: Guidelines are preferred because of the greater flexibility they permit in dealing with complex capital adequacy matters. Guidelines provide the Board, when assessing the capital adequacy of an institution, greater latitude to take into account its individual financial characteristics as well as the general state of financial market conditions. The Board believes, moreover, that failure to meet minimum capital levels should not automatically be construed to be a violation of a regulation and hence a violation of law, particularly when the Board would have to consider capital adequacy in the context of a broad range of factors in acting upon applications. In this same vein, when a institution's capital position is judged to be deficient, the Board will be in better position to tailor the nature and timing of actions that it orders be taken to correct this situation to the special circumstances facing the institution than would be possible under the more rigid structure of formal regulations.

On the question of uniformity, the Board believes that the capital requirements of the three federal banking agencies, though not identical, are largely uniform. Each agency has agreed to a minimum primary capital ratio for banks of 5.5 percent and a minimum total capital ratio of 6.0 percent. The agencies have also agreed on the definition of the primary and secondary components of capital.

The only significant area of difference is the treatment of intangible assets for purposes of computing the capital ratios of commercial banks. The three agencies made a strong effort to achieve uniformity in the treatment of intangible assets but, unfortunately, were unable to reach full agreement. The FDIC and the Comptroller of the Currency adopted regulations that would require the deduction of all intangibles except for mortgage servicing rights in computing capital ratios. The Federal Reserve's guidelines, on the other hand, require the deduction of goodwill but not other types of intangibles.

Intangibles are assets whose values and income flows are, at least in some important cases, more uncertain and unpredictable than other kinds of assets. Accordingly, the Board agrees that these assets should be treated with special care in assessing the capital adequacy of a banking institution. The question is how should this be done? Apparently, the FDIC and OCC have concluded that mortgage servicing rights have sufficient predictability of value to warrant recognition in assessing capital adequacy while all other intangibles do not. The Board, on the other hand, believes it preferable to evaluate the nature and character of all intangible assets on a case-by-case basis. This preference is reflected in the Board's capital adequacy guidelines for bank holding companies which do not require the automatic deduction of any intangible asset for purposes of calculating capital ratios. At the same time, the guidelines indicate that companies should avoid excessive balance sheet concentrations in any category or related categories of intangible assets and that all such assets will be given particularly close scrutiny in assessing the capital adequacy of an institution.

In the interest of making its capital requirements for banks more uniform with those of the FDIC and Comptroller, the Board decided to require the deduction of goodwill from capital before calculating capital ratios, because the value of goodwill appears to be less certain--particularly if an institution were to come under financial strain--than other types of intangibles. Thus, the Board's approach differs from that of the FDIC and OCC only in that it makes no automatic deduction for "other" intangible assets (other than goodwill). This reflects the Board's judgment that these "other" intangibles may have a certainty of value and income flow more in line with mortgage servicing rights than goodwill. The Board would stress, however, that it intends to give close scrutiny to all intangible assets in appraising a bank's capital position.

Question: The FDIC proposes to:

> Release the names of banks and bank officers who are the subject of formal enforcement actions.

Some believe this kind of market discipline might cause more instability than it would prevent--while others believe it would cause bank management to take regulatory criticisms and memorandum of understandings more seriously so as to avoid a formal action.

What is your view? At what point does disclosure present more of a concern for bank regulators than an enhancement of the supervisory process?

Answer: In considering the question of the public disclosure of enforcement actions, it should be noted that a good deal of disclosure already takes place. For example, companies that are required to file public financial statements must also disclose any enforcement actions. In addition, the banking agencies make public on an annual basis case-by-case summaries of supervisory enforcement actions. These summaries do not identify specific companies or individuals, but they do provide detail on the enforcement provisions of individual supervisory actions and the specific types of problems the actions are intended to correct. In certain egregious cases, the Federal Reserve has disclosed the names of individuals or companies subjected to civil money penalties for engaging in improper conduct or violations of substantive banking regulations. Finally, information is made available to the public quarterly on a bank's aggregate loans to its executive officers, principal shareholders and their related interests.

The question accurately sets forth the basic arguments for and against disclosure of formal enforcement actions. It would seem a reasonable presumption that the threat of public disclosure might have some deterrent effect on insiders inclined to abuse their positions or otherwise engage in improper or self-serving activities. Partly for that reason, we maintain the right to disclose such action in some instances. The further argument is made that disclosure will tend to cause management of a bank to be more responsive to orders from its supervisor to take actions to correct problems and/or cease improper activities. That possibility must be balanced against the fact that public disclosure in some instances might have important counterproductive effects, since it could disrupt a bank's funding ability and weaken its financial condition, thereby aggravating a delicate situation which the supervisory action was intended to correct and making an orderly solution more difficult or impossible. In addition, our experience suggests that if it were understood that supervisory agencies would, as a matter of routine, disclose all enforcement actions, financial institutions or individuals subject to such proceedings would be less inclined to cooperate in the examination process. As a consequence, discovery and correction of problems and improper practices would be made more difficult.

In balancing these considerations we believe routine or across-the-board public disclosure of all regulatory enforcement actions is not desirable and intend to maintain supervisory discretion on this matter. In support of this position, we would note that the enforcement statutes specifically give the banking agencies discretion to maintain confidentiality of enforcement proceedings. In so doing, the statute recognizes that public disclosure, under certain circumstances, could do irreparable and unwarranted harm to the bank, frustrate regulatory action designed to rehabilitate the institution and, therefore, may not be in the public interest.

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

Sincerely,

Paul

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

April 11, 1985

The Honorable Mack Mattingly
United States Senate
Washington, D.C. 20510

Dear Senator Mattingly:

In response to a request from Chairman Garn, I am pleased to enclose my responses to the written questions you submitted in connection with the hearing held on February 20.

Question: Last Friday, a Florida District Court ordered the Comptroller of the Currency not to issue any final approvals for limited-service banks, i.e., nonbank banks, pending a final decision by the Court. Since most of the applications for nonbank banks have been filed by bank holding companies, thereby requiring approval also by the Federal Reserve, what effect will the Florida District Court decision influence your action when considering applications?

Answer: On March 15, the Board announced that it had suspended further processing of the pending applications from bank holding companies to acquire nonbank banks as a result of the Florida District Court order. The Board took this action because the court's order, unless reversed or limited, eliminates the ability of the holding companies to open nationally-chartered nonbank banks. Since the applications can no longer be consummated, the Board has decided to suspend action on the applications during the time that the court's injunction is in effect. If the issues raised by the District Court are resolved in a manner allowing the Comptroller to grant final charters for nonbank banks, the Board would act on these applications promptly. Upon refiling, applications that had been pending at the Board for 60 days or more before being returned would be processed within 30 days of refiling if no substantive changes had occurred, or within 60 days if the initial 60-day processing period had not expired before the application was returned.

Question: Last March, when the Federal Reserve Board approved the nonbank bank application for U.S. Trust Corporation, 3 strict conditions were placed on transactions between the trust company and other affiliates and subsidiaries of the parent holding company. The Board recently accepted "comments" about whether such restrictions should be lifted. I hope the Board will maintain these restrictions, especially in light of the Florida District Court decision, to prevent interstate banking without the approval of Congress.

Can you shed some light on where the Board is headed on this issue?

Answer: Transactions between nonbank banks and their affiliates raise difficult issues, and the Board determined to proceed cautiously with respect to a possible relaxation of existing limitations on such transactions by soliciting public comment on these issues. As a result of its decision to suspend processing of the nonbank bank applications as described above, however, the Board does not anticipate taking any action on the general issue of transactions with affiliates unless the District Court injunction is reversed or limited. The Board nevertheless may be required to consider some limited questions in this area since the injunction does not encompass state chartered nonbank banks, and one such application continues to be pending before the Board.

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

Sincerely,

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

April 11, 1985

The Honorable Alan Cranston
United States Senate
Washington, D.C. 20510

Dear Senator Cranston:

In response to a request from Chairman Garn, I am pleased to enclose my responses to the written questions you submitted in connection with the hearing held on February 20.

Question: Assuming Congress does what it can to reduce the deficits through spending cuts, let's assume equal the target set by the Administration and clearly a large deficit remains; for monetary policy purposes would it be more beneficial to enact a revenue neutral tax reform package or should we just tighten up present law and raise revenue by enhancement as in the past?

Answer: As I have said on a number of occasions, I believe that, from a purely economic perspective, it is desirable to lower deficits as much as possible by reductions in spending. There are, of course, important considerations of national security, and domestic noneconomic goals, that may limit the size of achievable spending cuts. In my view, if the structural deficit cannot be closed over some reasonable period of time by spending cuts alone, then revenue measures should be taken. If revenue increases are necessary to achieve these objectives, the Congress must again balance various economic and noneconomic considerations. In this context it would seem desirable to take the opportunity to strengthen the tax system through base broadening, simplification of the tax code, and reduction of inefficiencies associated with the current tax system.

Question: The "lead characters" in last year's economic and financial drama were unquestionably the budget, deficit and the dollar.

These three factors that so dominated the landscape last year are little diminished in importance this year. Each is still pushing the economy, inflation and interest rates in opposite directions.

Of these three factors, the deficit and the budget more easily lend themselves to analysis. The dollar however, is much more of a puzzle. With the Fed having added a considerably more stimulative monetary policy to an already stimulative fiscal policy, one ordinarily would have expected the dollar to have weakened substantially. But instead it has reached a historic high, could you give us an explanation for this?

Answer: I would not characterize Federal Reserve policy as considerably more stimulative in a longer-run sense. While M1 growth has been fairly rapid for a few months recently, this comes after several months of relatively slow growth, and we expect it to slow in coming months. The Federal Reserve achieved M1 growth at slightly below the midpoint of its 1984 target ranges, and expects to achieve growth within those ranges in 1985. Financial markets appear to have reasonable confidence that this will be the case, otherwise inflation expectations would have been increased and bond prices and the dollar would have dropped substantially. I have no ready explanation for the dollar's overall strength aside from the continuing relative attractiveness of dollar-denominated investments produced by high real interest rates (associated with our budget deficits) and the strength and stability of the U.S. economy.

Question: I am concerned about the strong dollar and what it is doing to our trade deficit, and in particular the already hard hit domestic farm industry. There are rumors in the foreign exchange markets that foreign central bankers are deliberately looking the other way while the dollar soars sky high, so that when it becomes over bought they can profit on the downturn.

Do you think there is any merit to these rumors?

Answer: No. Foreign central banks have sold, net, substantial amounts in exchange market intervention since the G-5 announcement on January 17. They would probably have been willing to sell more if such sales were thought to be needed and if the United States had been willing to intervene on a larger scale.

Question: What option does the foreign market have in dealing with the dollar's vigor?

Answer: Foreign authorities could tighten monetary policy very markedly, but this would have a deleterious effect on economic activity, which is none too brisk in Europe. Probably the best policies would involve structural changes, possibly including tax cuts in some cases, which would increase incentives and the flexibility of foreign economies, thereby improving the overall performance of those economies.

Question: Will there be any emergency effort on our part to force the dollar down?

Answer: Speaking for the Federal Reserve only, I would not foresee any emergency response of Federal Reserve policy to the dollar's strength. A substantially more expansive monetary policy would certainly cause the dollar to drop, but such a course would be self-defeating in that it would worsen future inflation in our economy. The soundest policy change the United States could make to reduce various distortions in our economy, including those arising through the channel of the high dollar, would be to reduce substantially our structural budget deficit.

<u>Question</u>: Are any U.S. protectionist measures warranted by this situation such as the surcharge?

<u>Answer</u>: The short answer to your question about protectionist measures is no. In general, protectionist measures would tend to raise, not lower, the value of the dollar. So long as demand for the dollar remains as strong as it evidently is, protectionist measures that tend to restrict the supply of dollars to the rest of the world would tend to bid up the price. Those whose products compete with imports might be protected, but only at the expense of consumers and exporters (including farmers). If other countries retaliated -- as well they might -- exporters would be even more adversely affected.

Proponents of one widely discussed proposal for an import surcharge claim that their proposed measures would act to lower interest rates and the dollar. However, in my view such an impact would derive not from the surcharge, but rather from the associated measures to reduce the budget deficit. One of my serious concerns is that imposition of a surcharge would make it more difficult to enact more fundamental deficit-reduction measures.

Question: Recently, Treasury investigation of banks non-reporting of currency transactions in money laundering operations point to a serious weakness at the Treasury and Comptroller of the Currency examination and supervision procedures.

Would you comment on what kind of steps should be taken to precipitate earlier detection of this kind of behavior in the banking system?

Answer: Upon our request, the Reserve Banks suggested several measures which would, in their view, result in better compliance with the Bank Secrecy Act. Their suggestions were as follows:

1. Instructions regarding the examination of third-party transactions at nonbranch facilities of banks, such as cash control centers and special foreign exchange units should be expanded and clarified.
2. Uniform audit standards, similar to the minimum standards established by the FFIEC for banks' foreign exchange departments, should be established for on-site examinations.
3. The Treasury regulations should be clarified and strengthened in the following important respects:

(a) require that any exemption from reporting be approved by a bank's board of directors or a committee thereof;

(b) provide clear, narrowly-defined criteria for approving exemptions;

(c) require documentary evidence to support approved exemptions;

(d) require financial institutions who file forms with the Internal Revenue Service and/or the U.S. Customs Service to obtain a receipt from those agencies as proof of filing (this could be accomplished by revising the forms to include a perforated receipt which would be returned to the bank and retained in the institution's records); and

(e) make clear that forms must be sent to <u>both</u> the Internal Revenue Service and the U.S. Customs Service when a transaction takes place <u>and</u> when currency is transported into or outside the United States in connection with that transaction. The Reserve Banks have observed that in such cases many banks believe that if a form is filed with the Internal Revenue

Service, no form need be filed with the U.S. Customs Service, or vice versa. The existing regulations require both forms to be filed.

4. Implement automated surveillance systems at the Reserve Banks to permit more timely detection of a bank's unusual cash activity. Manually prepared records presently maintained by some Reserve Banks are not conducive to this type of monitoring. Board staff and officials from the U.S. Department of the Treasury are now studying automated surveillance systems.

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

Sincerely,

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

April 11, 1985

The Honorable Christopher J. Dodd
United States Senate
Washington, D.C. 20510

Dear Senator Dodd:

In response to a request from Chairman Garn, I am pleased to enclose my responses to the written questions you submitted in connection with the hearing held on February 20.

Question: You have suggested that a substantial reduction in the federal budget deficit will lower interest rates. Would you please explain, then, why interest rates have dropped substantially over the last few months when the Budget Director was revising his deficit projections upwards by some $50 billion?

Answer: I have suggested that a substantial reduction in the federal budget would result in interest rates being lower than they otherwise would be. During the period to which you refer last fall, there was very sluggish growth in M1, signs of much slower growth in economic activity, and a very strong dollar internationally. In these circumstances, the Federal Reserve reduced the degree of restraint on banks' reserve positions. In all these circumstances, interest rates declined over the summer and fall, as you noted, despite the continuing deficit. Subsequently, interest rates have risen moderately during a period of relatively little change in economic or reserve conditions. Interest rates are at high levels historically. Actual and potential market pressures from continued large budget deficits are only one factor in market developments, but they have been, in my judgement, a persistent and important factor.

Question: You have indicated that the Open Market Committee's projections for a healthy economy over the next year are premised on significant action against the budget deficit. What would happen to the economy if the deficit is reduced by only $25 billion, or by nothing at all?

Answer: I expect that market participants have now built into their expectations, and their actions that affect interest rates, some amount of deficit reduction. If no action were to be forthcoming to lower the deficit, interest rates might, therefore, rise; they would, at least, be higher than otherwise. Although these financial market pressures would not, necessarily, precipitate an economic downturn, an opportunity to begin reducing imbalances in our capital markets would be foregone, with an implication of continuing stresses and strains in certain key areas. For example, problems in the agricultural sector, earnings difficulties of thrift institutions making the adjustment to financial deregulation, and relative sluggishness in areas of the economy exposed to international competition could persist and even be aggravated. The ultimate adjustments would be made more difficult, and risks of more adverse developments increased.

Question: The President's budget deficit estimates are premised upon continued strong growth of the economy. Assume that the Congress were to enact budget cuts of the magnitude recommended by the President, but we still had a recession next year. Assuming a recession of modest proportions, what would the deficit be in fiscal 1987?

Answer: Using Administration or CBO estimates of the sensitivity of the budget deficit to economic developments, zero real growth of the economy over the four quarters of 1986--consistent with a mild recession and certainly a rise in unemployment--could add between $70 billion and $100 billion to the FY1987 budget deficit. This deficit increase, although alarming to contemplate, is less worrisome than the structural deficit that would persist in the absence of congressional action. During recessions, while the reduction in taxable incomes and increases in income-support spending add to federal credit demands, private credit demands usually fall off along with private spending, taking pressures off of credit markets and allowing interest rates to fall, damping in turn the decline in private spending. Deficits arising from this source would diminish as the economy recovered. By contrast, the structural deficit that would persist even in times of healthy economic activity represents federal credit demands that would compete with private demands during periods of economic recovery and expansion.

Question: One thing I've learned from you over the years is that just about everything in our economy and in the world economy is interconnected. If we were to reduce the budget deficit too rapidly, it could easily tilt the economy into a recession, which of course would increase the deficit. Therefore, how long do you think we should take to get the deficit down to manageable proportions in order to avoid such a result?

Answer: Clearly, attempting to eliminate a very large structural deficit--estimated by CBO to be more than $170 billion in FY1986 and rising thereafter--all in one step would be destabilizing for the economy. But I do not think that that is likely to happen. In an economy that is likely to produce GNP at more than a $4,000 billion rate in 1986, deficit reduction of the magnitude proposed by the President should be accommodated easily. Furthermore, actions to put the deficit on a predictable steady downtrend over a period of years would be helpful in allowing households and firms to adjust to the steps being taken and, in particular, in allowing interest rates to come down from the levels that would otherwise prevail.

By reducing the imbalances in the economy, deficit reduction progressively over the next few years will, in my judgement, improve prospects for sustaining orderly growth. Deficit reductions so large and abrupt as to be potentially destabilizing appear well beyond anything being considered in the Congress.

Question: In your testimony, you suggest that both employers and employees are beginning to behave as if inflation was reasonably well under control. Under these circumstances, what do you think accounts for the fact that real interest rates remain at close to historical highs?

Answer: The lowering of inflation expectations that appears to be building into wage and price setting also appears to be affecting financial market participants. This improvement is, undoubtedly, a factor in the decline in long-term nominal interest rates by more than two percentage points from their 1984 peaks. Surveys of the long-term inflation expectations of financial analysts, for example, also show a gradual decline. But the average rate of inflation expected by financial investors over the next several years remains above very recent inflation experience, as those who have seen how fast inflation can reignite remain very cautious. This caution is one factor keeping long-term interest rates up, and real rates high relative to actual inflation. Fear that continued large budget deficits will be monetized at some time in the future likely contributes to these cautious attitudes.

In addition, Federal budget deficits are a factor keeping interest rates high relative to expected as well as actual inflation. Not only the large current deficit but also the prospect for structural deficits and government credit demands to remain large for the indefinite future is keeping real interest rates fairly high, especially rates on longer-term securities and mortgages. Foreign capital inflows can partly mitigate interest rate pressures from the deficit for a while, but these flows are probably not offsetting all the current effects of deficits on credit markets, and this ready availability of foreign capital is not infinitely sustainable. Thus, investors are concerned that at some uncertain time in the future, in the absence of significant Federal government deficit reduction, rates will have to rise to help sustain the flow of foreign capital and to reduce the credit demands of businesses and households.

Question: As you point out, the high value of the dollar and the huge trade deficits are hurting a number of domestic industries, including exporters. You have suggested that a reduction in the federal budget deficit would alleviate some of these problems. What else could we do to lower the trade deficit?

Answer: The causes of the strong appreciation of the dollar are not fully understood, but one can point to three broad factors: (1) interest rates partly related to the federal budget deficit; (2) in general, the vigor and dynamism of the U.S. economy relative to others' (especially in Europe); and (3) the belief that the United States is a secure, stable country in which to invest.

As I have said on many occasions, I believe forceful action to reduce the budget deficit would help to achieve lower interest rates than would otherwise be possible. So far as the other two factors are concerned, we do not want to inhibit the vigor of our economy or to act in a way that would call into question its fundamental soundness or security. Indeed, we should, to the extent possible, act to ensure that the dynamism and fundamental competitiveness of the U.S. economy are increased. Over time, more price stability and productivity will help the trade balance.

I have suggested that other industrial countries should act, where feasible in light of their inflationary situation, to reinvigorate their own economies. Markets for our products would then improve. Combined with efforts on the part of several key developing countries to make appropriate adjustments in their economies, other industrial and developing countries would also be viewed as more attractive alternatives to the United States as a place to invest. Upward pressure on the dollar would subside and the world economy would be better balanced.

Question: If the value of the dollar should come down, either as a result of actions we take or as a result of other forces, that will raise the costs of imports which, in turn, will increase inflation in the United States. What would you estimate the increase in inflation to be, assuming first a modest drop in the dollar and, then, a more significant drop?

Answer: Econometric work suggests, other things equal, a moderate depreciation of the dollar of, say, 10 percent, against the currencies of major industrial countries, on average, would raise the rate of consumer price inflation by roughly 1/2 percentage point per year for a period of about three years following the depreciation. The impact on the price level eventually would reach about 1-1/2 percent. This estimate assumes that foreign exporters would absorb some of the effects of the decline in the dollar into lower profit margins and that import prices would rise by less than the full amount of the depreciation. It also assumes that higher import prices would lead to higher prices of domestically produced goods that compete with imports, and would result in some increase in wage demands (with a lag). Moreover, the depreciation would exert additional upward pressure on domestic prices by raising net exports and aggregate demand.

Everything else equal, a larger decline in the dollar would have a proportionately larger impact on domestic inflation. In present circumstances, I believe a relatively moderate depreciation of the dollar might have little or no visible inflationary effect because it would merely be reversing recent appreciation and profit margins of many foreign exporters are unusually high. A large fall, on the other hand, could pose the risk of reversing some of our hard-won gains in reducing expectations of inflation, so the effects could be increased. Much would depend on the setting of any decline. If the dollar depreciated because of a decline in interest rates resulting from a significant cut in the budget deficit, for example, its effects on inflation would be mitigated by the reduced fiscal stimulus to the economy. If the dollar dropped sharply when domestic demands are particularly strong, the inflationary effects would be magnified.

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

Sincerely,