FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1986

HEARING

BEFORE THE

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

NINETY-NINTH CONGRESS

SECOND SESSION

ON

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

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THE FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1986

THURSDAY, FEBRUARY 20, 1986

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

The committee met at 1:30 p.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Mattingly, Hecht, Gramm, Proxmire, Cranston, Riegle, Dodd, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today's hearing on the Federal Reserve's First Monetary Policy Report for 1986 comes at a critical time for our Nation's economy.

Economic expansion, which began in November 1982, has now entered its fourth year. This makes it a relatively long expansion in historical terms.

News this morning that real growth in the economy slowed to an annual rate of only 1.2 percent in the fourth quarter of last year raises concerns that the strength of the expansion may be ebbing.

At the same time, the economic indicators that normally presage an end to an expansion are not apparent in the economy today. Inventories are not excessive and capacity limits are not being pushed.

Monetary policy faces particularly perplexing choices. Last year the narrowly defined money supply grew almost 12 percent. Historical experience would suggest that such rapid money growth would need to be slowed to avoid a reacceleration of inflation.

Historical experience, however, also would suggest that efforts to slow such rapid money growth can first lead to a slowing of real economic growth, certainly not desirable in light of the relatively weak growth of the economy in 1985.

Oil price declines as well are complicating monetary policy. Do the oil price declines reduce the threat of a resurgence of inflation and give the Fed more leeway to stimulate the economy or, alternatively, do the oil price declines have the same impact as a tax cut and lessen the need for monetary stimulus?

Gramm-Rudman-Hollings raises yet more questions for monetary policy. Is there a need for monetary stimulus to offset the reduction in fiscal stimulus implicit in reduced Federal deficits and, if so, do the relatively long lags in impact of monetary policy mean that the Fed must undertake stimulation before the deficit cutting measures are agreed upon?

Finally, the decline in the value of the dollar on foreign exchange markets raises additional questions for monetary policy. When will this decline stimulate domestic production for both export and domestic consumption? Will the channeling of more domestic demand into domestic consumption lead to a resumption in the growth of monetary velocity?

All of these questions are obviously difficult to answer.

Chairman Volcker, we are happy to have you with us once again. Before I turn to you, I would like to turn to my colleagues.

Senator Proximire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Volcker, I am delighted to see that you are getting back on the right track on the problem of inflation.

I have been very concerned about what I think was the explosive growth of the money supply last year. Everybody in Government wants at almost all times to have easy money in Government and out of Government, the business community, the farm community and so forth.

Over the last 4 or 5 or 6 years you have been the one sober and effective voice in holding down inflation and I think you deserve a world of credit for it.

I thought that somehow you had drifted off the reservation in the last year, and I am glad to see on the basis of your testimony today and yesterday that you are back on track where I have always felt your heart really belongs.

As the chairman has so well said, there is no question that it is a tough, tough problem to fight inflation at any time. The latest concern of course is the dollar. There are many reasons why all of us would like to see the dollar continue to decline. It would certainly benefit many industries in our States and would provide, at least in the short run, more jobs. But I think the inflation problem is so serious that we have to be concerned about it.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I join with you and Senator Proxmire in welcoming the Chairman of the Fed to these hearings.

I have found that they provide a very important forum for discussing issues that are often overlooked, and that have an enormous impact on the health and well-being, not only of our economy, but the world economy and our children's future as well.

In reviewing, Chairman Volcker, the Fed report and the chairman's prepared remarks, I was struck by the positive overall outlook for the U.S. economy. The Federal Reserve projects continued steady growth with low inflation in a stable world economy, all in the context of reduced M1 growth. It is comforting to have the independent voice of the Federal Reserve echoing the confidence of the administration, for once, with regard to economic prospects for the coming year, that is 1986.

However, as you note, balancing this basic optimism is a list of areas of concern which, if you take them together, represent some very significant obstacles to the happy outcome we all seek. I am referring to continuing difficulties for the agriculture, energy, and manufacturing sectors of our economy, slow recovery in the trade account with initial recovery presumably on the import side due to lower oil prices and, third, significant international debt problems.

I know of nobody who has worked longer and harder on those problems than you; but even you must and do recognize the considerably worsened problems in certain key debtor nations like Mexico, Nigeria, and Venezuela because of falling oil prices.

There are, as you point out, continuing strains on thrifts and banks due to sectoral and international creditworthiness concerns, and there are uncertain prospects that Japan and Germany will assume a leadership role in the world growth necessary to draw world trade into better balance and to help troubled debtors earn essential foreign exchange.

While note is made of those problems, and I commend you for that, I have to tell you that I worry that perhaps too little attention is nonetheless being paid to those problems, given that they have dominated national and international policy debate for the last several years, and have been the subject of major legislative initiatives pending before the Congress. A scenario in which those issues I mentioned remain unresolved, no matter how solid the front of economists attesting to its validity, I think gives us some reason for caution.

I made more or less the same point with regard to the dollar exchange rate at the hearings we had on the confirmation of Governors Angell and Johnson. I have been and continue to be concerned about the exchange rate. I think it needs to be a very important focus of U.S. monetary policy.

I would like to be reassured by projections of healthy growth and improving trade balances. However, I think you perhaps may recall along with me that back in 1977, 1978 and 1979 when Tony Solomon was then Under Secretary of the Treasury he reported to us again and again that the weight of economic analysis and projections indicated that whatever problems there might be with the fall of the dollar, they were going to be infinitesimal, virtually immeasurable.

Those projections were wrong. There were heavy costs to the economy, as there have been costs to key sectors due to the record high of the dollar more recently.

So we must focus on these kinds of problems. I believe they can only be successfully addressed in a growing U.S. economy hopefully assisted by other countries who also would decide to grow steadily.

And that most importantly, Chairman Volcker, where you come in, is that our monetary policy must be fully consistent with and therefore supportive of such growth.

I would only add that Chairman Volcker describes the conduct of monetary policy as a day-to-day, week-to-week job. That is reassuring because it tells me that the Federal Reserve stands ready to make the necessary adjustments in policy and practice to deal with adverse developments.

Certainly the horizon, while it seems to be pretty clear, has some clouds. We want to keep them at bay, and maybe we can if the Fed is continually vigilant.

The CHAIRMAN. Thank you, Senator Heinz.

I would ask unanimous consent that a statement by Senator Dixon be included in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, we are here today to receive testimony from the distinguished Chairman of the Federal Reserve Board, Paul Volcker, on the Federal Reserve's plans for monetary policy. Monetary targets, however, as the Chairman knows only too well, cannot be set in a vacuum. There are a number of important factors that greatly influence the Fed's conduct of monetary policy. For example, monetary policy will be influenced by Federal budget deficits, by our terrible trade deficit, by changes in exchange rates, and by the foreign debt crisis.

There is great uncertainty in all of these areas. The Federal Reserve attempts to conduct monetary policy in a manner that will promote stable, long-term, noninflationary economic growth. However, there are real questions whether monetary policy tools alone can offset the influence of a failure to reduce budget deficits, our growing and much too high trade deficit, a too-rapid decline in the value of the dollar, and a new round of failures of Third World countries to be able to pay their foreign debts.

This is, it seems to me, a time of considerable challenge for the Federal Reserve. Our trade deficit was $125 billion last year and is going higher. The dollar has declined about 30 percent in recent months, which will be good for American exports, but which also carries a danger of adding to inflationary pressures and the cost of servicing our trade deficit and huge national debt. American productivity has not been growing as we would like, and our Nation's farmers face the worst crisis of this century. Oil prices are declining, which should benefit most American industry, but this too is a two-edged sword because it adds to the difficulty some Third World nations have in servicing their foreign debts.

In addition, this is a time of rapid and fundamental change in our Nation's banking system. The marketplace is changing, and the Federal statutory framework governing the industry has not kept pace.

I look forward, Mr. Chairman, to hearing from Chairman Volcker on the Federal Reserve's plans for the conduct of monetary policy, and on all the other issues I have mentioned. I am always glad to have the opportunity to have the benefit of his expert counsel and advice.

The CHAIRMAN. Senator Hecht, do you have a statement you wish to make?

Senator HECHT. Thank you, Mr. Chairman.

I don't have a statement, but I do have an observation.

Mr. Chairman, you have had such nice things said about you from all of the distinguished Senators. I never heard that so much. And then when my distinguished colleague from New York walks in with this big cigar, I think that means that perhaps you are on the right track. [Laughter.]

Senator D'AMATO. I was going to give him one. [Laughter.]

Ther CHAIRMAN. We only allow one to be lit at the same time. [Laughter.]

Senator D'AMATO. Mr. Chairman, I have had this wonderful occurrence in my life. I have become a grandfather for the first time. My daughter married a wonderful young man. I told him the story of how I was named after my grandfather. She rejected the idea. That would have resulted, if she were to name the baby after its grandfather, in a name of Alfonso Murphy. [Laughter.]

I would like to ask one of the photographers right beneath me if you wouldn't pass this over to Mr. Volcker in the spirit of a grandfather.

Senator PROXMIRE. From one to another.

Mr. VOLCKER. I welcome you to the ranks. [Laughter.]

Senator D'AMATO. Mr. Chairman, I would ask that my remarks be entered into the record as if read in their entirety.

OPENING REMARKS OF SENATOR D'AMATO

Senator D'AMATO. I would like to make an observation that in addition to the prepared text that I have submitted, I believe that prudence would dictate, it would seem to me, and would lend to the monetary stability and the economic growth that the Federal Reserve do all that it possibly can because the Congress is on the way to doing that which it can to encourage lower interest rates.

I think with the decline in oil prices will have a positive impact on productivity and inflation as a result of that is going to be a good one. The inflation rate will go down and productivity and economic growth will go up just in the areas that we would like to see it, and I would hope that the Reserve would see this as a unique opportunity, because you don't get this kind of dramatic drop in energy prices and this drop means too much to the GNP and so much to inflation rates.

We have felt the ravages of inflation when we had just the reverse take place in the seventies. And I would suggest that this would be an opportunity for there to be a concerted policy.

The discount rate, in my opinion, Mr. Chairman, should come down, and I reject the idea that that is going to be inflationary. It is going to put more Americans back to work and there is going to be more expansion in a positive direction of the economy and this is the opportune time for that to take place. So I add that as a part of my prepared text.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator D'Amato follows:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

I want to welcome Chairman Volcker to this hearing to discuss the Federal Reserve's monetary policies and their impact upon the American economy. Chairman Volcker's testimony and the Fed's monetary policy report that was issued yesterday are of great importance to me and my colleagues since the Fed's control over the money supply has such a profound effect on economic growth.

At present, the economy is entering a critical phase. It has experienced a record growth period since 1982. More Americans are working than ever before. However, the economic expansion we have enjoyed since 1982 has not grown as rapidly in recent months. It is important that monetary and fiscal policies are formulated and implemented in a manner that sustains economic growth without stimulating unacceptable high rates of inflation.

The ability to sustain economic growth and curtail inflationary trends will be complicated by certain external forces that will affect the American economy. For example the recent drop in the value of the dollar and the precipitous drop in the price of oil can have both potentially beneficial and harmful effects on the economy. While the drop in the value of the dollar will hopefully result in the reduction of our trade deficit, it may create inflationary pressures since domestic producers will not be subject to stiff price competition from foreign producers. With regard to the drop in oil prices, consumer spending will be stimulated but many banks that have made oil related loans will be placed in more precarious financial positions. The ultimate issues therefore are whether beneficial impact of these changes outweigh their potential harmful effects and whether economic policies can be formulated to lessen the destabilizing effects of these changes. I hope that we will be able to address these issues this morning to determine what the domestic economic outlook is for the remainder of this year.

Finally, I would urge that the Fed pursue a monetary policy that promotes a stable dollar and economy. Investor confidence in the dollar, the economy and our financial system is paramount to sustained economic growth. Policies that result in destabilization and inflation must be avoided.

I look forward to the testimony of Chairman Volcker and hope he will address some of the issues that I have raised.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Volcker, let me say that I welcome you before the committee. We have begun a process here in the Congress aimed at transferring $200 billion of resources from the Government to the private sector, and in order to facilitate that transfer obviously we need an expansive monetary policy with declining interest rates, first nominal and then real.

As I look at the monetary policy of the Federal Reserve Bank in the last 9 months I think it is the right policy. I would like to congratulate you on that policy and urge you to stay with that course so long as we in in Congress stay on bringing deficit under control and balancing the budget by the end of the decade.

I have no doubt about the ability of the private sector to absorb 200 billion dollars' worth of growth potential as over the next 5 years we lower the deficit from $200 billion hopefully to zero. And I am convinced that in that process we can see a decline in real interest rates, an expansion of economic growth in employment, a decline in the value of the dollar relative to foreign currencies, and I think your monetary policy given that objective at the current time is right on track and I commend you for that and urge you to stay with that policy.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

I just want to also welcome Chairman Volcker once again to the committee.

I guess for 5 years since I have been here you have been coming before the committee and maybe this time you won't say anything about raising taxes, and in fact hopefully we have in place something now that will address the spending side which I think is the true answer to addressing the deficit problem.

Of course, I also welcome you. I think you are now considered the second most powerful man in America and very few times do we have those people before our committee. So we do welcome you. [Laughter.]

I don't have a cigar to give to you, but——

Senator D'AMATO. You are not a grandpa yet.

Senator MATTINGLY. No. I hope not. [Laughter.]

But, I wish you would comment of course on the falling oil prices and the positive impact that it will have on the economy. Also I hope you will comment on the Baker plan, in reference to the international debt crisis which I think is very important.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator Mattingly follows:]

STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Mr. Chairman, I, too, welcome Chairman Volcker. It is not often that we have before the committee the second most important man in America. I look forward to your comments today on many important issues, including the monetary targets of the Fed, the effect of falling oil prices and the so-called Baker plan to ease the international debt crisis.

The CHAIRMAN. How much do you want to bet that he says that spending cuts are a first priority, but if we can get enough out of spending he favors a tax increase. [Laughter.]

Senator MATTINGLY. Wait a minute. You were here the last time. [Laughter.]

The CHAIRMAN. I have heard that many times over the last years. I know the answer to that question very, very well. I have three grandchildren, but when you are from Utah you don't pass out cigars when you have grandchildren. [Laughter.]

Candy or other things, but not tobacco products.

Chairman Volcker, please proceed.

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

Mr. VOLCKER. Thank you, Mr. Chairman and Senators.

I might say, first of all, I am particularly impressed by the quality of this cigar. It is quite out of my ordinary range.

Senator D'AMATO. I want the record to show that it is not Cuban. [Laughter.]

Mr. VOLCKER. I won't read my statement, Mr. Chairman; you have already touched upon many of the points I would have made and so have the other Senators.

I might just take a couple of minutes to summarize some of the points.

In setting out the monetary targets, which we do at this time of year, we have not substantially changed those targets from what we tentatively set out when we were before you last July. We do have a somewhat broader range for M1, 3 to 8 percent instead of the 4 to 7 percent. The center is at the same point.

LOWER RATE OF GROWTH IN 1986

There is considerable discussion in my prepared statement about M1 and its deviations from our intentions last year and the related decline of velocity and so forth. I will not repeat that here, but we are obviously looking forward to a lower rate of M1 growth in 1986.

As you indicated, after some slowing in GNP growth last year and a slower fourth quarter with a revised figure announced this morning, the more recent data does suggest some improvement in the economy, and I think the year is off to a good start without any reason to look toward a recession or downturn for some of the reasons you suggested.

We are fortunate on the price front in having the oil price decline which, among other things, tends to offset the adverse effects on inflation for the moment of the exchange rate changes.

But I would emphasize that we do face a number of, I think really unique problems and strains individually, and put together, and I would join Senator Heinz in saying I give some emphasis to these in my statement because I don't think they should be ignored; the bright prospects for this year and beyond really depend upon diffusing, managing, and coping with those problems.

WELCOME GRAMM-RUDMAN-HOLLINGS ACT

We still have the very large budget and trade deficits, and I certainly want to welcome the efforts that Congress has made and the spirit of the Gramm-Rudman-Hollings legislation to deal with that problem over a period of time.

I know there are constitutional and other uncertainties, but that basic effort has already had some favorable effect on the market, and I think it is crucially important that that effort be carried on, but in the best of circumstances you are left with a big deficit for the time being and you don't magically get rid of that deficit overnight.

I could make the same comment about the trade deficit. We have ourselves in a big hole here, and I think the conditions are now better partly because the dollar has declined, pointing toward some improvement, but you are not going to eliminate that trade deficit in a hurry.

To the extent that the dollar depreciation is part of the solution to that problem, I also have to emphasize, as some of you already have, that it is a two-edged proposition.

The dollar was too high, but we have had a lot of experience here in the past and other countries have had even more experience with the adverse effects of a cumulative decline in their own currency that has inflationary repercussions; a kind of self-reinforcing decline can potentially, if we are not alert to it, produce very real problems for the economy in another direction.

In that connection, I would just emphasize to you once again that, given the fact that the trade deficit and the budget deficit are not going to disappear very quickly, those deficits have to be financed, and they are going to have to be financed by a continuing inflow of capital from abroad.

How readily that capital is available is a very important factor in the outlook for our own capital and money markets and for interest rates, and that capital isn't going to be freely available unless there is continuing confidence in the currency, and I think we have to keep that very much in mind.

When one looks at the outlook for trade and when one looks at the outlook for the world economy. of which we are part, and given the exchange rate change that there has been, our prospects for 1986 are at least as dependent, probably more dependent, on growth abroad.

We are not going to have very good markets for our exports and we are going to have very heavy competition on the import side unless there are profitable markets in other countries for our products and for their own products.

MIXED SIGNALS

There have definitely been question marks in that outlook. The signals are mixed. Some of them have improved somewhat, particularly on the continent of Europe, but they have very high levels of unemployment. The outlook in Japan tends to be toward slower growth rather than more rapid growth. As their exchange rates appreciate, that is a restraining factor on their growth. On the other hand, their outlook for price stability is very good.

They have made a lot of progress in that direction and they now have the favorable effects on prices of their currency appreciation, and they also have the favorable effects of oil, prices as we do, on their price levels. It remains to be seen whether those economies can grow, not by relying on increased exports to us and a bigger trade deficit by the United States, but by homegrown expansion and stimulation.

I think it is also obvious that while the oil price decline has potentially very favorable effects on the inflation outlook, offsetting the exchange rate problem, in the short run it releases purchasing power and it also has adverse effects.

It has distinctly adverse effects in important regions in the United States and it adds to strains on some financial institutions, some parts of the financial markets, and it particularly adds to the already heavy pressures on some developing countries, notably that one just to the south of us, the very important country of Mexico.

Senator Mattingly I believe referred to the Baker initiative. I would simply say here that I think the basic premises of that initiative are still very valid. It was a very desirable initiative.

The challenge that it faces is increased by the impact of the oil market on some of the heavily indebted developing countries. That makes it only more urgent to proceed in the directions that that plan contemplates, not only in terms of the changes that have to be made within those countries to make their economies more efficient, more effective, more competitive, more open and more creditworthy, but also—the other side of the equation—what is absolutely essential seems as a complement is what the creditor countries can do to make sure that they do have markets for their products and that when they are doing the right thing they have adequate financing for their external deficits. It simply puts even more emphasis on that initiative to make it all work.

DEPRESSING PRODUCTIVITY FIGURES

One point that I don't think any of you touched upon I will just mention. I think it is a longer run factor, but the productivity figures last year were rather depressing reading. There was no increase in productivity, which is surprising particularly in a period when the overall economy was growing. It was growing at a slower rate of speed, but nonetheless growing; outside the manufacturing sector, it was growing quite rapidly.

I don't know if that has enormous implications for our policy approach in 1986, but you look at it over a longer period of time, in relation to the inflation problem, for instance, if productivity does not in fact grow more rapidly than it has been growing recently, it puts a very definite limit on the growth potential of the economy, how much excess capacity and how much excess labor force we really have, and the figure was depressing enough last year to call it to your attention.

I hope and suspect that part of the difficulty may simply be the difficulty of measuring output in the service side of the economy. Nonetheless, it is disquieting.

I would simply conclude by noting a matter which I know has been a frustration to you, Mr. Chairman, and other members of the committee—that we do really face a very confusing almost chaotic kind of situation in the banking world, the thrift world, and the financial world when we are trying to apply law that is really now outmoded because of a changing financial environment, changing for market reasons and changing for technological reasons.

So that it is difficult for us and it is difficult for other banking agencies to interpret existing law in the light of present needs. I think the courts find it equally difficult. We get conflicting decisions and we get confusion. There is a lack of coherence, and that is bad enough, but I think it reaches the point where that lack of coherence does bear upon the safety and soundness of the system.

I appreciate your efforts to try to deal with that and hope that we can get some breadth of congressional guidance on these very difficult issues during the course of this year because I think time is growing short.

[The prepared statement of Chairman Paul Volcker follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

February 20, 1986

I am pleased once again to appear before this Committee to discuss the approach of Federal Reserve policy within the larger economic setting at home and abroad.

As you know, 1986 has begun with the economy continuing to move forward after more than three years of expansion. Today, more people are employed relative to the working age population than ever before recorded. Unemployment has continued to fall. Happily, the continuing expansion has so far been achieved while inflation remained at the lowest rate in more than a decade.

Looking ahead, there are some highly encouraging signs as well. The larger employment increases in recent months are reflected in relatively confident attitudes by consumers. Manufacturing output as a whole, which had been sluggish during much of 1985, is again rising even though many areas continue to face strong competition from abroad. Lower interest rates and higher stock prices -- buoyed in part by the action of Congress in improving prospects for declining federal deficits in the years ahead -- have made it less expensive to finance new business investment and housing. With few exceptions, excessive inventories, often in the past a harbinger of economic adjustments, appear absent.

While productivity growth has been rather disappointing, wage restraint in much of industry and lower commodity prices have kept costs under control. The sharp break in oil prices should be an important force cutting costs and prices in the period immediately ahead, in the process releasing real purchasing power to U.S. consumers. Moreover, changes in exchange rates and the welcome initiatives taken by the Congress and the Administration toward budgetary restraint offer the potential for dealing with two of the major, and interrelated, imbalances in the economy that I have spoken about with you so often -- the enormous fiscal and trade deficits.

Altogether, the opportunity clearly remains for combining sustained expansion with greater price stability in the period ahead, building on the progress of the past three years. In

my judgment, the present expansion -- already longer than the postwar average for peacetime years -- is not about to die from old age or sheer exhaustion. We don't have the pressures on capacity, the excess inventories, the accelerating costs and prices, or the rising interest rates that have typically presaged cyclical downturns in the past.

Yet, any claim that we live in an economy in which every prospect pleases would be idle pretense. There are evident points of economic pressure and financial strain, some of them aggravated by the sharp decline in oil prices itself. While the adverse trends are being changed, the deficits in our budget and trade accounts will take years to correct. And, we have long since passed the time when we could, with any validity, insulate ourselves from the difficulties of neighbors and trading partners to which we are bound by strong ties of finance and trade.

Most of these threats, in magnitude and in combination, are unique, certainly in our postwar experience. They demand our full attention if we are to deal with them successfully.

Take, for instance, the trade problem. The dollar had risen to extraordinarily high levels by early 1985, with the effect of undercutting our trade position vis-a-vis major industrial competitors. At the same time, the relatively rapid growth in demand for goods and services in the United States, at a time of sluggish growth abroad, attracted a large volume of imports. The net result was to drive our trade deficit to a rate of close to $150 billion by the end of last year and to about $125 billion for the year as a whole.

No doubt, given the extreme values the dollar had attained internationally in 1984 and early 1985, an adjustment in exchange rates has been a necessary part of achieving a better competitive equilibrium and of responding to destructive protectionist pressures. That was explicitly recognized in the meeting of the Finance Ministers and Central Bankers of the five leading industrialized countries in September. By now, a substantial adjustment in exchange rates has been made, placing our producers in a stronger competitive position.

But we also know, from hard experience here and abroad, that changes in actual trade flows necessarily lag changes in exchange rates by a period extending into years, that currency adjustments can assume a momentum of their own, and that sharp depreciation in the external value of a currency carries pervasive inflationary threats.

No doubt, some depreciation in the dollar, after the rapid run up, could be absorbed without a sharp or immediate impact on domestic prices. But we cannot afford to be complacent. Inevitably, prospects for balance in our internal capital markets -- and therefore prospects for interest rates -- remain for the time being heavily dependent on the willingness of foreigners to place huge amounts of funds in dollars and on the incentives for Americans to employ their money at home. In essence, the financing of both our current account deficit and our internal capital needs -- so long as the government deficit remains so high -- is dependent on an historically high net capital inflow. Clearly, the orderly balancing of our demands for funds with supply in those circumstances requires continued confidence in our currency.

I recognize and appreciate the importance of the efforts that the Congress and the Administration have made to place the budget deficit on a declining trend. I know that effort will continue to require the hardest kind of choices. But we can also see some of the potential benefits in improved market sentiment. The net result should be both to reduce risks of inflation and to make us less dependent on foreign financing in the years ahead.

At the same time, oil imports apart, improvement in our trade balance for the next year or longer is in large part dependent not on depreciation of our currency but on greater growth by our trading partners. More competitive pricing is of limited value when foreign markets are not growing strongly, and when producers abroad do not themselves have expanding, profitable markets at home.

Prospects in that respect remain quite mixed. There have been signs of somewhat stronger growth in Germany and elsewhere in continental Europe. However, it remains questionable whether that growth will in fact be strong enough to reduce appreciably continued high levels of unemployment, now averaging more than 10 percent for the continent as a whole. In Japan, where unemployment is historically at much lower levels, growth by those same historical standards is sluggish, with the appreciation of the yen itself a restraining factor.

As appropriately emphasized at the September G-5 meeting, a better world equilibrium, including more rapid improvement in our trade balance, is clearly dependent on structural and other measures to deal with the sources of the imbalances. The Gramm-Rudman-Hollings legislation represents one important approach to that end. Stronger growth patterns in other leading countries are also directly relevant. The opportunities for policies to work toward that result this year appear to be greatly enhanced by the strongly beneficial effects of the declines in oil prices and the appreciation of their currencies. Both developments reinforce the already strong prospects for price stability in those countries.

Should oil prices remain close to present levels, that development will also be a powerful force offsetting, and in the short-run probably more than offsetting, the direct and indirect effects of the lower international value of the dollar on our overall price performance. At the same time, the effect is to release real purchasing power and cash flow to American consumers and oil-consuming businesses. The potential addition to real consumer income should work in the direction of offsetting the effects on purchasing power that some have foreseen in the full implementation of the deficit reduction program called for by the Gramm-Rudman-Hollings legislation over the course of this year.

With similarly beneficial effects for other consuming countries, that is part of the basis for a sense of growing optimism about world economic prospects. But, of course, the effects are sharply adverse for energy producers, affecting important regions in the United States where energy production and exploration loom so large, and therefore prospects for investment as a whole. The added strains for certain already

heavily indebted developing countries are even more acute. Moreover, the pervasive pressures on much of the agricultural sector in this country remain, although recent legislation by the Congress addressed and should help stem further deterioration.

These sectoral strains and imbalances point up the crucial importance of maintaining the essential safety and soundness of our financial system, and in particular our depository institutions. For a long time, that was something we in this country thought we could take for granted. And it was partly that feeling, combined with accelerating inflation and other factors, that contributed to much more aggressive lending behavior over the years -- lending that has led to unanticipated problems in a period of disinflation and greater competitive pressures. Today, measures to protect the basic financial fabric necessarily assume a high priority, and that effort will require appropriate action by the Congress as well as the regulatory authorities.

Finally, in surveying the economic setting for monetary policy, I must call to your attention the disappointing record with respect to productivity over recent years viewed generally at least as recorded by the standard national statistics. Developments in that respect during 1985, when productivity for nonfarm businesses as a whole showed no growth, are hard to explain. In manufacturing, where recorded performance is substantially better than in other sectors, the slower productivity growth may be a reflection of the levelling of output. But other sectors were growing relatively fast, without reflection in productivity improvement.

Perhaps part of the seeming problem lies in the inherent difficulty in measuring the volume and quality of output in the dominant service sector of the economy. But the results do raise further questions about the growth potential of the economy as recorded by the GNP statistics -- how fast can we expect the GNP to grow in a sustained way without excessive pressures on human or physical capacity. Over the past six months, for instance, the unemployment rate has dropped by a

full 1/2 percentage point -- desirable in itself but accompanied by a recorded annual rate of output growth of only 2-3/4 percent.

In the end, it is largely productivity that governs prospects for per capita income growth; together with growth in the number of workers, it sets a limit on our total economic growth. Fortunately, in developing monetary policies now, we do not need to reach precise judgments about our long-term growth potential; today, capacity utilization is still somewhat below, and unemployment somewhat above, average levels for periods of business prosperity. Recent productivity trends, nonetheless, do introduce an unwelcome cautionary note about the longer-run.

Monetary Policy

Any description of the opportunities and risks in the current economic situation points up the fact that the formulation and implementation of monetary policy need to take account of a variety of sometimes conflicting objectives and criteria. In the current setting, other policy approaches -- toward the budget, toward international finance, toward trade, and toward other areas --

are obviously critical to the success of the common effort, just as the pervasive and indirect effects of monetary policy can bear upon the success of other policies beyond the strictly financial. Moreover, institutional and economic changes have strongly affected the behavior of certain policy guideposts -- notably M1 and debt -- relative to other economic magnitudes. Consequently, I do not believe that in current circumstances there is any escape from the need for a substantial element of judgment in the conduct of Federal Reserve policies.

That need was illustrated in 1985. Over the course of the year, monetary policy remained in a generally accommodative mode in the sense that pressures on bank reserve positions were both limited and little changed. The discount rate was reduced once in the spring, from 8 to 7-1/2 percent, and most market interest rates declined by 1 to 2 percentage points, generally reaching the lowest levels since mid-1979 or before.

As illustrated in Charts II and III attached, the broader monetary aggregates, M2 and M3, remained generally within the ranges targeted at the start of the year. At the same time, however, the narrowly defined measure of the "money supply," M1, grew persistently above the range set both at the start of the year and again after the range was reset in July (see Chart I). That aggregate ended the year almost 12 percent above the year earlier level, an historically high rate of growth.

In technical terms, that large "overshoot" was permitted in the light of a persistent and sizable decline in M1 "velocity" -- that is the relationship between M1 and the nominal GNP. That decline in velocity was apparent whether measured contemporaneously or with a one or two quarter lag between money and GNP. In other words, the exceptional growth in M1 seemed to be matched by an equally exceptional decline in velocity, suggesting the high M1 growth in 1985 does not imply the same inflationary potential, at least for the near term, as in the past.

Less abstractly, the judgment of the Federal Open Market Committee as the year developed was that the rather strong restrictive action that would have been necessary to maintain M1 within its targeted range was not justified in the light of the different signals conveyed by the much more restrained growth in M2 and M3, the slower growth in overall economic activity, the margins of capacity that remained, and the continuing progress toward price stability. For much of the year, the dollar remained high, and that fact was another strong signal that monetary policy was not unduly liberal.

We were aware, of course, of some conflicting evidence. During much of 1984 and 1985, domestic demand -- the spending of consumers, businesses, and governments -- continued to expand at a rate well beyond the rate of domestic output, measured by the GNP. In fact, the rate of demand increase, if maintained, would probably be beyond our long-term growth potential. In that sense we continued to live beyond our means, at the expense of a widening trade deficit.

Moreover, private as well as public debt continued to accumulate at an historically rapid rate, running above the

9-12 percent "monitoring range" set out at the start of the year. The aggregate debt statistics, portrayed in relation to GNP on Chart IV, exaggerate the problem to some degree. There has been massive issuance of tax-exempt securities in anticipation of tax law changes, for re-investment in Treasury securities pending subsequent refundings, and for a variety of projects requiring new capital. Many of these activities lead to "double counting" in the aggregate statistics because both the new municipal debt and the debt acquired in employing the funds borrowed are included in the total. At the same time, substitution of debt for equity by businesses continued unabated, with about $100 billion of equity retired by a combination of stock repurchase programs, so-called leveraged buyouts, and as part of mergers and acquisitions.

The strongly rising stock market and lower interest rates had the effect of greatly increasing consumer wealth, measured by current market values, and lowering the cost of capital to business. Nonetheless, the trend of debt creation,

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with its implications of greater leveraging and potential financial fragility, remains disquieting, particularly in an environment of progress toward greater price stability. Indeed, as I suggested earlier, there is already ample evidence in the financial area of the consequences for individual institutions of extended financial positions and unduly loose credit standards. The crises in the thrift industry in Maryland and Ohio, where federal insurance and supervision were absent, illustrated in an extreme form the consequences of essentially speculative lending and lax market practices.

A more pointed question for the deliberations of the FOMC has been the lasting significance of the sizable increase in M1. We are well aware, as I have often reported to this Committee, of the long history and of the economic analysis that relate excessive money growth to inflation over time. The operational question remains as to what, in specific circumstances, is in fact excessive in the light of recent velocity behavior.

That question is greatly complicated both by the changed composition of M1, which now includes accounts that receive interest close to market levels and clearly have a large "savings" as well as a "transaction-oriented" component. The disinflationary process and the associated decline in market interest rates also have implications for the willingness to hold money.

Enough evidence has now accumulated since the peak inflation years to suggest two conclusions:

(1) That the long upward trend in velocity of 3 percent or so characteristic of most of the postwar period -- when inflation and interest rates were generally trending upward -- will probably not be typical of a world in which inflation and interest rates are trending downward and in which M1 has a growing savings component.

(2) That M1 may be more sensitive to short-term fluctuations in interest rates.

For 1985 specifically, our work strongly indicates that much of the unexpected decline in M1 velocity was a response to the sharp reduction in interest rates late in 1984, continuing at a lesser pace over much of last year. In a context of contained inflation, a generally strong dollar, and more muted economic growth, the decline in interest rates did not appear in itself to risk excessive economic stimulation, with renewed inflationary potential. Moreover, neither of the broader monetary aggregates, which remained within their target ranges, confirmed excessive monetary expansion.

Looking ahead to 1986, the FOMC decided to take account of the greater uncertainty associated with the relationship between M1 and economic activity and prices by adopting a relatively broad M1 target range of 3-8 percent. While wider, that range is centered on the same mid-point, 5-1/2 percent, as the tentative 4-7 percent range set out last July. In fixing that range, the Committee anticipated that velocity would not

drop at nearly the rate of 1985. Without some reversal of the sharp drop in velocity last year, growth toward the upper end of the range could well be appropriate. More broadly, the Committee agreed that changes in M1 would be evaluated in the light of the presence -- or absence -- of confirming evidence of excessive growth in M2 and M3. For both those aggregates, the tentative growth ranges of 6-9 percent set in July were reaffirmed.*

As set out in Table II attached, in establishing these target ranges, members of the Federal Reserve Board and Reserve Bank Presidents anticipated the economy would grow somewhat more rapidly than in 1985 and that the unemployment rate would continue to decline gradually. Views on the outlook for prices were rather mixed, with some anticipating measurable further progress toward stability, particularly in the light of the oil price

*These new ranges, and the related monitoring range for debt, in comparison with ranges for 1985 are shown in Table I.

decline, while others expected that the consequences of the lower exchange rate may, for a time, put stronger upward pressure on prices. While the "central tendency" of the projections for real growth is lower than that of the Administration, so are most of the projections of prices by participants in the FOMC. The differences are not so large as to suggest, in themselves, inconsistency with the monetary growth targets; indeed, several Board Members and Presidents anticipated real growth in the 4 percent area. I might also note the somewhat lower unemployment rate generally anticipated by the Committee participants suggests more limited productivity growth than implied by the Administration projections.

Monetary policy is implemented day-by-day and week-by-week by determining the appropriate degree of pressure on bank reserve positions in the light of monetary growth, judged in the context of the flow of information about the economy, the outlook for prices, and domestic and international financial

markets, including the value of the dollar in the foreign exchange markets. In the latter connection, circumstances now are, of course, very different than during most of 1985. The potential inflationary implications of further depreciation of the dollar, while likely to be offset for some time by lower oil prices, need to be fully considered in the implementation of policy.

At present, with the various monetary aggregates at reasonable levels relative to their new target ranges, and taking account of the cross-currents in other factors bearing on policy implementation, there has been no occasion for significant change in the degree of pressure on bank reserve positions. As you know, both intermediate and long-term interest rates have been declining to the lowest levels seen in years and the stock market has been ebullient. The justification, and the sustainability, of those developments lies in a combination of prospects for budgetary restraint, the favorable impact of lower oil prices, and improved inflationary expectations and performance. The challenge for monetary policy, insofar as it can contribute, is to help assure that those favorable prospects for maintaining progress toward stability can be a reality in the context of a growing economy. The implementation of policy will be conducted in the light of that objective.

Related Approaches

I referred earlier to the pressures in some areas of the credit markets growing in large part out of the backwash of overly aggressive lending policies in the earlier climate of accelerating inflation. Indeed, those concerns have been aggravated in more recent years by a continued highly aggressive approach by some institutions seeking high returns, with their own liabilities effectively underwritten by federal insurance. These problems, and appropriate responses to them, are too large a subject for me to deal with in the time available today; we have discussed them before on a number of occasions.

I do want to report, however, that the Federal Reserve has underway a number of initiatives to help deal with the problems more effectively. They include strengthening our force of examiners and supervisory personnel so that they are equipped to meet higher standards in the frequency and intensity of examination of member banks and holding companies. Certain regulatory steps have been undertaken as well. Specifically, we have issued for public comment a proposal for a framework of "adjusted capital/asset ratios" designed to supplement our present capital standards. The proposed standards are designed to take account of the different characteristics of bank assets and to incorporate allowance for off-balance sheet risks that have been proliferating rapidly at major banks here and abroad in recent years. I know other regulatory agencies have comparable initiatives underway in the supervisory and regulatory area.

By its nature, this supervisory effort must be a continuing process, although it has particular relevance in this turbulent period.

Moreover, I can only emphasize to you again my long-standing concern that you act, and act soon, to modernize our basic laws governing the structure and nature of our depository system. After decades of little change in the legal structure, technological and market developments have together created a new competitive environment. That change, without a coherent legislative framework, has sown enormous confusion about the proper and legitimate role of banks, bank holding companies, thrift institutions, and their commercial and financial competitors. Regulatory decisions attempting to apply current laws, sometimes conflicting in themselves, are regularly challenged in the courts. The results are capricious as both regulatory bodies and the courts inevitably reach different conclusions in ambiguous circumstances.

The courts themselves in recent decisions have emphasized the need for fresh Congressional guidance. I can only reiterate my own view that, without such a review, the banking and thrift industries are left adrift, driven to exploit perceived loopholes

in present law on the one hand, while on the other hand, their basic and regulated business is undercut by commercial organizations and investment houses operating without the protections provided by the federal "safety net." The result is a clear threat not only to the coherence but also to the safety and soundness of the whole. Time is growing short.

From another perspective, the decline in oil prices has presented an enormous new challenge to a few countries that have been heavily dependent on oil resources for the development of their own economies. The problem is particularly acute with respect to Mexico, with which we have close trade and financial relationships, but it is certainly not limited to that country.

In the broadest terms, the initiatives outlined by Secretary Baker some months ago for managing a "second stage" of the international debt crisis provide a constructive and needed overall framework for dealing with problems. He emphasized the importance of achieving a solution in the context of overall financial and economic policies conducive to sustained growth. That, in turn, requires complementary actions by the borrowing countries, by creditors, and by multilateral development institutions alike.

In essence, the borrowing countries themselves -- "Baker Plan" or not -- appear to have the strongest kind of incentives to take those actions necessary to improve the efficiency and competitiveness of their own economies, including the development of their potentially vast non-oil resources. Those fundamental measures will be more effective, with faster results, to the degree those nations also have greater assurance of access to growing external markets for their products. Resistance to protectionism should, of course, be easier to achieve in a context of an expanding world economy, the prospects for which should be enhanced by the same decline in oil prices that makes the pressures more acute for oil producing countries.

The restructuring process can be greatly assisted by cooperation with such institutions as the World Bank and Inter-American Development Bank, which have funds available for substantially

larger loan programs in support of fundamental economic adjustments, and with the International Monetary Fund. On that basis, I believe necessary margins of external private investment or loans can continue prudently to be made available to meet essential external needs. Indeed, without complementary policies by international institutions and creditors, the will to find constructive outward-looking solutions to the problems by the borrowers themselves will inevitably be undermined, and the adverse implications would extend far beyond the economic arena.

For some heavily indebted countries that either import a sizable portion of their energy requirements or are essentially neutral in that respect, recent developments should ease the task. But I *do not in any way want* to *minimize* the challenge for others -- for Mexico, Ecuador, Nigeria, and Venezuela. What I do suggest is that the fundamental premises of the total effort by borrowers and creditors alike in managing the debt situation remain valid. I believe that, with will and wisdom, the basis remains for working through this inevitably difficult period in a way that ultimately will reinforce prospects for longer-term growth.

Conclusion

I conclude as I started.

With constructive policy responses, recent developments carry the potential for enhancing prospects here and elsewhere for a sustained period of growth in a context of price stability. Those are the common goals of the Congress, the Administration and the Federal Reserve.

But if those goals are to be actually achieved, we also must clearly recognize, and collectively deal effectively with, points of strain and danger, some of them stemming from the very successes of the past.

- Economic history is replete with examples of countries that, in attempting to correct over-valuation of their currencies, failed to take

advantage of their improved competitive positions. Too often, they lapsed into a debilitating and self-defeating cycle of external depreciation and internal inflation, at the expense of an eroding loss of confidence, higher interest rates, and impaired growth.

It would be foolish to presume that the United States is somehow immune from that threat -- we had too much adverse experience in the 1970s to indulge in wishful thinking in that respect. Instead, in our monetary and fiscal policies, we need to be realistic about the danger and be fully sensitive to the need to maintain confidence in our currency. 25

- Fortunately, the sharp decline in energy prices now underway should, for months ahead, help assure satisfactory price performance overall, making the job of maintaining progress toward stability much easier. But those lower prices are no unmitigated blessing.

They create new uncertainties and stresses for some regions of the economy, for some financial sectors, and particularly for some important developing countries and trading partners. Those stresses need to be contained and dealt with in a constructive way, and we need to guard against conditions that might lead to a repetition of past energy shortages.

· The sense of greater confidence about our fiscal prospects still needs to be converted into reality. Whatever the fortunes of the Gramm-Rudman-Hollings legislation in the courts or the merits of that particular approach toward the problem, the direction and broad spirit of the effort is essential if we are to correct deep-seated imbalances that, sooner or later, would only undercut our bright prospects.

- The success of all our efforts is dependent in substantial part on complementary policies by other countries -- their

success in enhancing their growth and stability, in opening markets to others, and in helping to deal with points of strain in the international financial fabric.

Most other industrialized countries have, as a matter of priority, been deeply concerned with restoring price stability and reducing fiscal deficits. Remarkable strides have been made toward those goals. However, their growth, at least until now, has been heavily dependent upon rising trade and current account surpluses. Today, there appears to be a prime opportunity for encouraging "home grown" expansion, larger imports, and better international balance.

-- For the longer run, I welcome the call by the President to consider what steps might be desirable to achieve and maintain greater exchange rate stability internationally.

No one should think that task is a simple one. It cannot in any way substitute for disciplined and complementary domestic policies among the leading nations. Indeed, meaningful progress would imply even greater demands on those policies and on international cooperation. But surely we have had enough experience, here and elsewhere, with the distorting effects of extreme exchange-rate volatility to make that effort to reexamine the international system worthwhile. In a fundamental sense, that is a corollary of the simple observable fact that the economic fortunes of all countries -- including the United States -- are inextricably interlocked.

We have come too far, and the stakes are too high, to fail to rise to the evident new challenges.

We have to recognize that depreciation of our currency does not in itself provide a fundamental solution, and is in fact a two-edged sword.

The budgetary effort must be sustained.

If we expect to benefit from the break in energy prices, we must collectively respond to the points of strain.

We need to be patient when patience is required. The trade and budgetary and financial problems will be with us for some time; at the same time, we need to be insistent in carrying through the measures to deal with them constructively.

In much of this, I recognize the Federal Reserve and monetary policy have a vital part to play. Given the cross-currents in the economy and sometimes conflicting signals among the guideposts to policy in today's setting, there will be a high premium on careful judgment. But through it all the basic objective does not change. We are convinced that sustained growth in the United States -- and much more -- is dependent upon maintaining progress toward price stability over time. And given our weight in the world, that same stability must be one of the foundation stones of a prosperous, integrated global economy.

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Chart I

M1 Target Ranges and Actual

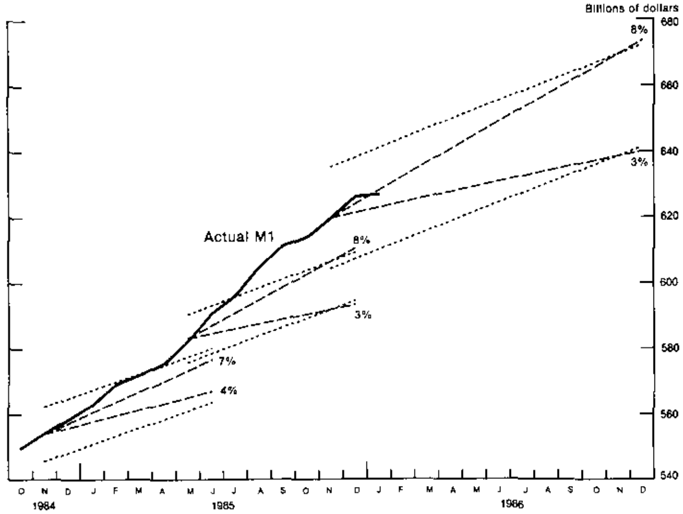

Chart II

M2 Target Ranges and Actual

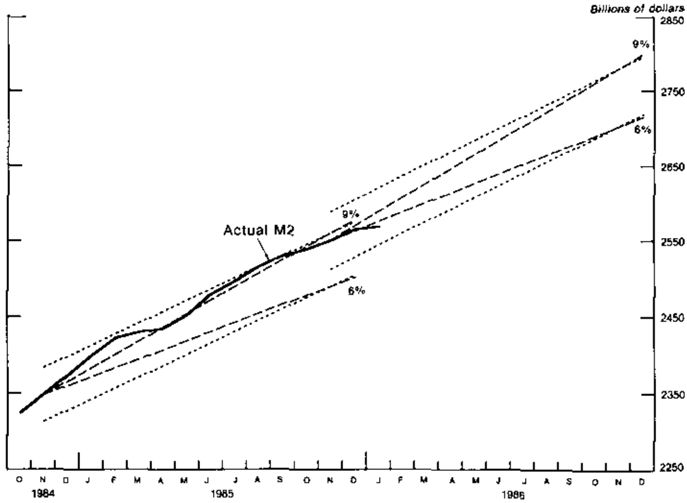

Chart III

M3 Target Ranges and Actual

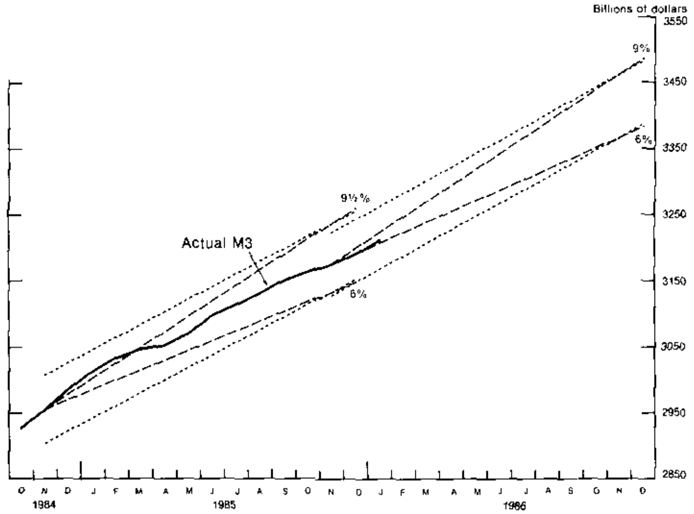

Chart IV

Ratio of Domestic Nonfinancial Sector Debt to GNP

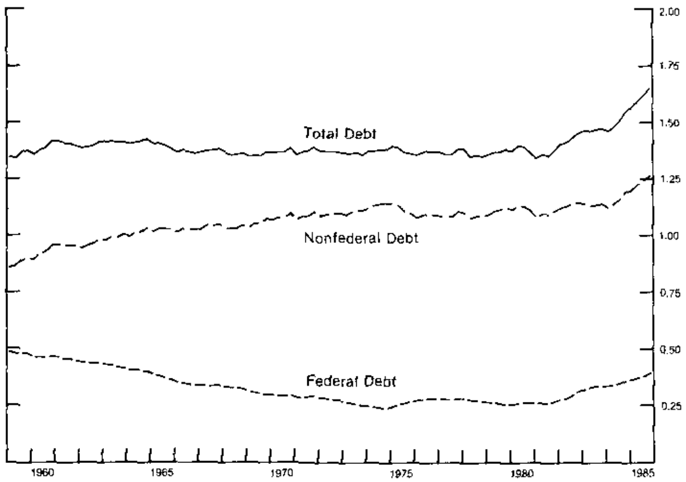

Table I

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

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

*Applied to period from second to fourth quarter.

Table II

Economic Projections for 1986

	FOMC Members and other FRB Presidents		Admini-stration	CBO
	Range	Central Tendency		
Percent change, fourth quarter to fourth quarter:				
Nominal GNP	5 to 8-1/2	6-1/2 to 7-1/4	8.0	7.6
Real GNP	2-3/4 to 4-1/4	3 to 3-1/2	4.0	3.6
Implicit deflator for GNP	2-1/2 to 4-1/2	3 to 4	3.8	3.9
Average level in the fourth quarter, percent				
Unemployment rate	6-1/4 to 6-3/4	About 6-1/2	6.7	6.7*

*Civilian unemployment rate.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator Heinz has another meeting that he must chair at 2 o'clock, so I am going to yield to him first out of part of my initial questioning time.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I just want to emphasize something that Chairman Volcker said with respect to you, Mr. Chairman, on the work you are doing on safety and soundness, trying to make sure that our principal financial market and supervisory agencies are doing everything they can, and determining whether they need any legislation to help them do it.

You are doing a superb job on that, and I just want to echo Chairman Volcker. That is not my question, however. [Laughter.]

My question, Chairman Volcker, is basically this. You are saying that Japan isn't going to grow much. The Germans still worry more about inflation than they do about growth. The rest of Europe seems pretty much economically confused, with the possible exception of one or two places like Italy.

We all know that the decline of the dollar, which is uneven in any event with respect to specific currencies, while it makes us more competitive internationally, it is going to take a long time to do that. It works through very slowly.

We have depressed regions and industries which you and I have both touched on. Somebody actually estimated that in spite of the economic growth and job creation which we have had, there are some 30 to 35 States that actually are in depression. Now the obvious ones are the ones like Iowa, the Farm States, and some of the less known ones are areas like western Pennsylvania, which is in the midst of a 1930's type depression.

NEED FOR LOWER INTEREST RATES

You have mentioned that productivity growth has been zero. That carries with it the suggestion perhaps that the very high real interest rates that we have made make it too costly or unprofitable to get any increases in productivity.

And if you add all of that up, doesn't that suggest that we should pursue a monetary policy that is more expansive and aimed at lowering interest rates, both real and nominal, by whatever extent we possibly can relative to where we are today?

Particularly, as there is anti-inflationary assistance from lowered oil prices which is very, very helpful indeed. Given those drops in oil prices and all those other economic growth problems that I have alluded to shouldn't the Fed pursue a more growth oriented monetary policy?

Mr. VOLCKER. I think the aim of our policy is to achieve sustainable growth, and that has to be in the context of progress toward price stability; and within that framework we have to make our judgments.

I think the key to your question was with respect to interest rates. We would all like to see lower interest rates to the extent we possibly can. Well, I interpret that in the light of what is consistent with sustained growth over a period of time and what is consistent with progress toward stability.

The oil price in and of itself is certainly a factor moving in that direction so far as the market is concerned and, looking at it all by itself, in terms of the inflationary impacts so far as monetary policy is concerned. But I would also point out that the oil price decline itself releases purchasing power and is an expansionary factor for the economy without us—the Federal Reserve—doing anything.

I also have to point out there is another potentially strong force at work which offsets the favorable price effects—in a way we are fortunate they come together—and that is the exchange rate movement, and we have to look at monetary policy in the light of that factor.

Right now, we have some indicators that tend to be on the stronger side relative to the performance of last year. We obviously have to look at the rate of growth in the money supply, which has not been exactly niggardly over the past year. So a lot of factors have to go into that judgment.

PRICE STABILITY

Senator HEINZ. With the Chairman's permission, may I ask a followup question, which is this. The term "price stability" fascinates me because were we to have a policy that promoted price stability at current price levels, there are a number of things we could guarantee; cutting the number of farmers in half, cutting our manufacturing sector also in half, reducing the opportunity of many new small businesses to be created all because many price levels are too low for U.S. producers to compete—largely due to international monetary conditions, the relative strength of the dollar, people hanging on to their profit margins, and so forth.

Today's price levels are unaffordable for too many sectors. That is why we just passed a $52 billion bailout for the farmers. And all you are saying is keep prices stable and let Government make up the difference.

Mr. VOLCKER. I simply disagree with that analysis, I am afraid, and I had better be pretty clear about it, Senator. I do not agree that half of the manufacturing sector is going to disappear———

Senator HEINZ. At these prices?

Mr. VOLCKER [continuing]. At the present price level. Quite the contrary. I had a group of businessmen in my office the other day commenting about their results for the year, and I heard a little different tone from some of them that: it was yearend and they were looking at their statements.

Several of them commented, "You know, for the first time in many years we look at our yearend statements and what do we find? We haven't had any increase in costs this year. Some prices have declined. Our inventory adjustments are not necessary at the end of this year because basically our own prices haven't changed. And low and behold, we find that we can live without increasing our prices when our costs aren't up." And of course that is the truth.

Corporate profits in parts of the manufacturing sector without any question have been heavily oppressed by the foreign competition. We have had almost a 30 percent change in the relative value of the dollar in the past 12 months. They are now in a more competitive position.

Price stability does not mean that the price of every product remains the same. Farm prices have been depressed. But I certainly think we can find a solution—I not only think we can find a solution to our problems within the context of greater price stability, but I think the failure to achieve greater price stability will be destructive.

So if you were saying the opposite, I think we have a disagreement.

Senator HEINZ. Well, we may, but I don't wish to pursue it on the Chairman's time any more.

Thank you.

The CHAIRMAN. Well, you left me 2 minutes.

Senator HEINZ. I yield you my 10 minutes. [Laughter.]

The CHAIRMAN. No problem.

Senator HEINZ. Thank you, Mr. Chairman.

The CHAIRMAN. We have plenty of time. You are welcome.

Chairman Volcker, let me just pursue into a different area, the impact of oil price declines that have been so dramatic over the last few weeks.

IMPACT OF LOWER OIL PRICES

In addition to monetary responsibilities at the Fed, you also have regulatory responsibilities, and we are all very well aware of the very large loans that many of our banks have with foreign countries primarily based on much higher levels of energy prices.

Can you give us some idea of the impact of these lower prices from a regulatory standpoint, not monetary policy at the moment on some of our banks and how we are going to attempt to manage that international debt problem with the much lower oil prices.

Mr. VOLCKER. I can't give you a careful quantitative answer, and I don't think it is possible in this area. But let me make a couple of preliminary comments and then look toward the future.

First of all, as far as the foreign debt problem is concerned, there is one sense in which from the standpoint you raised the question we are better off, I think, significantly, than we were 3 or 4 years ago. Right through this period the exposure of banks to heavily indebted countries has been declining in relative terms, relative to their own capital, and this amounted to about one-third now in terms of the ratio of debt to their own capital.

It is still very large, and it is still a very important and crucial problem, but it has been somewhat diffused over these years.

I have comment somewhat in the same vein as far as domestic lending is concerned. If a price decline of this magnitude had come 3 or 4 years ago it would have had a sharper and even more disturbing impact at that time, in my judgment, because banks were in a more vulnerable position in terms of the kinds of loans they had on the books and the volume of them in the energy area.

Put another way, a lot of their weaker loans, loans on rigs, for instance, instead of production loans, have in some cases been written off or losses taken or, in some cases, loans repaid. So their vulnerability, given a particular price decline, I think is somewhat less now than it was then. That has been reflected, of course, in some continuing problems during this period, but on the other side they have had a period of profitability, by and large, so that some of those potential losses have been absorbed.

Nonetheless, it is obvious that when you have a decline, and should the oil price stay around the present level, you have got another level of strains put on the system. Do I believe that is manageable? Yes; I do. In the international area I think it adds more than an edge of urgency.

It makes even more urgent the directions that seemed appropriate before in terms of those countries restructuring their own economies so they are not so dependent upon oil and, indeed, increasing the efficiency of their oil sector. On that basis I think they can get the external financing that is necessary. I don't see anything inherently in this situation that says that it is not possible. But I also point out that it depends upon their judgment and their will in terms of the internal measures, and that is a decision that they are going to have to make.

I think the two sides are connected, because if they feel that they cannot count on some continuing access to credit in appropriate amounts from abroad, it will undercut their will to do what is necessary at home. It is a situation where they tend to give up. So I think it is very important to keep both sides of the equation together.

Now this problem, in that respect, has forced itself upon them in the space of, what, 4 weeks or something that we have had now, and I hope there can be enough patience all around to take the time to look at this situation and find a constructive solution to what is a very difficult matter.

I might also say that for some of those countries this is a net benefit and makes the job easier. You get a country like Brazil, which is a very sizable net importer. There is a relative handful, but nonetheless very important countries, that are net exporters, and it is important to them, not only because they export, but also because those countries rely upon oil revenues for a significant fraction of their internal budgetary financing. In many cases the crucial problem is their internal budgeting and not the external financing.

On the internal side, obviously, we and the other supervisors and regulators will be looking and following the situation with more than ordinary interest, but I do think this is a situation that can be dealt with for these banks through the tools that we have in the Federal Reserve and elsewhere for handling those points of strain.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Volcker, this morning the New York Times had a front page story indicating that economists, particularly the Congressional Budget Office economists had revised their forecast of the deficit.

CBO'S REVISED FORECAST

They indicated that whereas last year it projected that the baseline deficit, if we didn't do anything about it and didn't make cuts, would be perhaps $260 billion in 1990. Now they say it will be around $100 billion, a remarkable change, and the Office of Management and Budget has made a similar modification.

Now the heart of this is they assumed that the baseline will mean expenditures pretty much stable for defense and they estimate that costs will not rise very much.

How about that notion? Is the budget deficit, last year's problem, can we solve this thing if we go along with a baseline?

Mr. VOLCKER. I don't think it is last year's problem. It is very much with us. One lesson I think could be drawn from those changes in estimates is how fragile 5-year estimates of a budgetary situation can be. But I think those more optimistic estimates basically reflect a projection of very constrained expenditure growth relative to what they were assuming last year, and that in turn, of course, reflects the congressional actions.

But there is a difference between assuming that, even in the light of congressional actions, and seeing it develop over the next 5 years or whatever the forecast horizon is.

And I am very conscious of the fact that turning that kind of assumption into a reality is going to continue to involve very hard choices on the part of the Congress and the administration, because relative to past trends, those are very confined expenditure figures. I hope they come about. And if they come about, I think the general tendency will be more favorable, but it takes time and it takes action.

Senator PROXMIRE. You feel it does take action and it won't happen on the basis of a baseline status quo——

Mr. VOLCKER. There is no question. It is not going to happen because OMB or the Congressional Budget Office projects it. It is going to happen because you people do it.

Senator PROXMIRE. I would like to assume the posture of a Gallup pollster asking you a question, and you are somebody that has been called on the phone. You know these fellows often read a series of statements to a person and ask which statement most nearly describes his or her views. Sometimes it is useful in eliciting opinions that might otherwise be obscure.

With that in mind, I am going to read you three statements and ask you which one most nearly describes current Fed monetary policy. [Laughter.]

Mr. VOLCKER. I think I just want to describe it and not most nearly describe it. [Laughter.]

Senator PROXMIRE. All right, let me give you the three alternatives.

No. 1, in setting its monetary targets for 1986, the Federal Reserve anticipates that Congress and the President will achieve the deficit reduction goals specified in Gramm-Rudman. Any slippage will necessarily require a tighter monetary policy. That is No. 1.

No. 2, the Federal Reserve wants to wait and see what the Congress and the President will actually do under Gramm-Rudman. If the deficits are actually reduced on schedule, monetary policy can then be loosened.

Then, No. 3, the Federal Reserve's monetary targets were determined more or less independent of Gramm-Rudman and will not be directly affected by what Congress or the President does.

Now which is it, No. 1, 2, or 3?

Mr. VOLCKER. I am not sure I want to——

Senator PROXMIRE. It is a computer and you have to, to answer No. 1, 2, or 3.

Mr. VOLCKER. I can plead the fifth amendment to something I guess.

Senator PROXMIRE. The fifth wasn't here. I just had three questions. [Laughter.]

MONETARY TARGETS

Mr. VOLCKER. Let me answer your question, but without making a firm choice, No. 1, 2, or 3. I think there is a sense in which the monetary targets are broadly appropriate within at least a variety of budgetary outcomes. Looking at those targets already allows some margin, as you know.

There is nothing inherent that says that you get a different rate of growth of the money supply with a change in the budget, within some limits anyway.

So I would say there is some validity to that view and that those targets allow for different tactics and different judgment as the year progresses against the light of the budget and other factors.

I think it is fair to say that members of the Open Market Committee, in making their economic forecasts and therefore in arriving at the judgment of the monetary targets, did assume that the budget deficit will reflect, if not all, a significant part of the scheduled reductions that we would expect to see, with the budget deficit on a declining trend as the year wears on, not necessarily immediately. It is still running very high, but as the calendar year wears on, yes, a decline. So that was certainly in the background of thinking.

Senator PROXMIRE. Well, that seemed to imply No. 1. That is interesting to hear.

On page 20 of your statement you say that several Board members and Reserve Bank presidents anticipated real growth in the 4 percent area as projected by the administration rather than the Fed forecast between 3 and 3½ percent. Of course that makes a big difference on the level of the deficit, unemployment, and so forth.

Did these 4 percenters also press for more expansive monetary policy to accommodate what they regard as a higher growth potential?

Mr. VOLCKER. I would have to look at precisely who projected those higher numbers, but I would not think so. I would think it is at least equally likely that they would have been on the more restrained side expecting a stronger economy, but I don't know, and I can't answer the question specifically, because I don't remember which ones.

Senator PROXMIRE. Could you do that for the record?

Mr. VOLCKER. In general terms. You know, it also involves some judgment about what they were in your terms pressing for at the committee. I will look at it and see whether I can give you an intelligent reply.

[Chairman Volcker subsequently submitted the following for the record of the hearing:]

In general, those projecting more rapid growth did not find that inconsistent with the longer run ranges adopted.

Senator PROXMIRE. Were any votes taken on the Fed's targets and, if so, what were the results?

Mr. VOLCKER. On the annual targets it was unanimous.

Senator PROXMIRE. Can you identify the 4 percenters by name?

Mr. VOLCKER. No; I can't at this point.

Senator PROXMIRE. I didn't think you would.

Mr. VOLCKER. And I don't think I should adopt that precedent in any event.

Senator PROXMIRE. You have been able to read the assumptions behind the administration's 4 percent economic forecast as outlined in the President's Economic Report. What are the areas of the economy where you anticipate less growth compared to the administration?

Mr. VOLCKER. I haven't looked at it in detail in terms of sectors of the economy, and I am not sure they put forward that projection in those terms.

I did note in my statement one logical conclusion of the differing estimates, that to get the unemployment rate that they are projecting, which is higher than our central tendency, with a higher rate of growth they must be assuming a higher rate of productivity. In fact, that is explicit, I know, in the CBO's forecast. I am not sure about the administration's, but I think it is explicit there, too. They are assuming more optimism on the productivity side, but I can't speak to the particular sectors of the economy.

VALUE OF THE DOLLAR

Senator PROXMIRE. Now the sensational nature of your testimony yesterday was with respect to the value of the dollar. On page 4 of your testimony you say that the decline in the value of the dollar since September places our industries in a stronger competitive position. But on page 5 you express concern that the dollar's decline could have an inflationary impact and also make foreigners less willing to provide the capital needed to finance our budget deficit.

I notice that Secretary Baker said Tuesday he would not be displeased if the dollar declined further. Mr. Yuetter, the President's special trade representative, last week called for an additional 15- to 20-percent drop in the dollar exchange rate.

Are you in agreement with Baker and Yuetter, or do you see more dangers than blessing in the continued decline.

Mr. VOLCKER. I suppose I am not in agreement with Mr. Yuetter because I don't know how he knows, but I know I don't know just what the appropriate level for the dollar is.

Senator PROXMIRE. You say you don't know what the appropriate level of the dollar is?

Mr. VOLCKER. I don't know with that level of precision certainly.

Senator PROXMIRE. Well I thought you indicated that you felt the dollar had declined enough.

Mr. VOLCKER. That is a different question. [Laughter.]

Senator PROXMIRE. Why is it different?

Mr. VOLCKER. I am expressing concern over a cumulative, continuing decline in the dollar that might be inconsistent with maintenance of an attitude toward the dollar that is consistent with that capital inflow that you spoke about. I don't think I have to reach a judgment as to what the appropriate level of the dollar is 2 years from now to express some concern about the possibility of a kind of cumulative overshoot.

Senator PROXMIRE. All right. Then you are saying that the present momentum and the rate of decline of the dollar concerns you rather than necessarily the level that the dollar might have 6 months from now or 1 year from now?

Mr. VOLCKER. That is right. I am not smart enough to know precisely what the level of the dollar will be or should be 1 year from now. I do know we have had a lot of experience in the world, and the world is littered with the debris of countries that have tried to escape their problems by devaluation and found out it only added to their problems by forming a kind of cumulative inflation and more devaluation.

Senator PROXMIRE. So your position relates to the short term of 3, or 4, or 5 months that the situation may change or the situation may continue. Whatever it is, you might feel that a decline of the dollar later on would——

Mr. VOLCKER. I am not ruling or pronouncing on precisely what the appropriate level of the dollar is over time.

Senator PROXMIRE. You are described in the current issue of Newsweek as, you know, you have been described——

Mr. VOLCKER. If I may just add to the question.

Senator PROXMIRE. Yes, sir; I am sorry.

Mr. VOLCKER. If I may just add to that. I would be concerned about too much emphasis on the value of the dollar in curing our trade problems. It is going to take more than that to cure our trade problem.

Senator PROXMIRE. It will take more than that, but it would be very helpful if the dollar declined somewhat more, right?

Mr. VOLCKER. It may or may not be. I would say right how, as I said before, an important element in the equation is the rate of growth in other countries. A net result of a decline in the dollar is to impair that growth prospect, and it may not, on balance in the near term, whatever the long-range competitive position, be desirable.

Senator PROXMIRE. Well, I can understand that, but I think it is a novel theory that the decline of the dollar would be somewhat helpful certainly in some areas, all other things being reasonably equal.

Mr. VOLCKER. OK. All other things being equal is not a world in which I live. [Laughter.]

Senator PROXMIRE. Well, we know the decline of the dollar, like every other economic development, has more than one effect.

Mr. VOLCKER. That is right.

Senator PROXMIRE. It is good to have you point that out to us but, nevertheless, we have certainly been terribly, terribly handicapped and hurt over the last few years and still are.

Mr. VOLCKER. That is when the dollar got very, very high and impaired our competitive position.

Senator PROXMIRE. My time is up, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Chairman Volcker, referring back to Senator Heinz' original question, the discount rate has remained the same since last spring when it was reduced from 8 to 7½ percent.

In light of the recent fall in the prices of oil and other commodities, what is the justification for maintaining the discount rate at its present level, and aren't we really saying—or are you really saying that the Board has already factored in current and projected price drops in oil and the decline in the dollar's value and determined not to lower that rate?

POSSIBLE DROP IN THE DISCOUNT RATE

Mr. VOLCKER. We have determined not to lower it to date. I think that is obvious or we would have lowered it if we had determined to lower it. In reaching that judgment, we took into account all of those factors.

Senator D'AMATO. Am I mistaken in indicating that it was last spring when the rate was last reduced?

Mr. VOLCKER. It was reduced last spring.

Senator D'AMATO. It was reduced last spring from 8 to 7½. Are you saying now that you determined at that time or that the——

Mr. VOLCKER. Of course not.

Senator D'AMATO. OK. If you didn't determine it at that time, did you factor in the kind of drop that has taken place just in the energy area, the stability that has taken place since, the decline in the dollar and why wouldn't you at this time consider dropping that discount rate?

Mr. VOLCKER. We did not factor in either of those considerations, certainly very actively last spring.

Senator D'AMATO. Well, what about now? Haven't the changes in the economic environment last spring been significant enough to precipitate a drop in the discount rate?

Mr. VOLCKER. Right now we certainly do. You have an oil price change which is certainly in the direction, assuming it stays of reducing prices. You have an exchange rate decline of 30 percent, which is certainly in the direction of increasing prices and increasing economic activity, and the oil price change also goes in the direction of increasing economic activity.

You have also had a congressional action on the budget during this period, which is not reducing the overall budget deficit appreciably at the moment, but has the prospect of doing that some quarters down the road. That is some time off yet. Yes; all these factors are taken into account.

Senator D'AMATO. So you will be taking those factors into account.

Mr. VOLCKER. We will continue to take those factors into account.

Senator D'AMATO. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Do you think there is any possibility that we could get a free fall in the dollar here, that it could go down, not in a managed way, but in a nonmanaged way? Is that possible?

Mr. VOLCKER. I suppose anything is possible, but what I am saying is that that is not what the doctor ordered in terms of our situation.

Senator RIEGLE. In other words, you would be very concerned about that happening.

Mr. VOLCKER. I would be concerned, yes.

Senator RIEGLE. I am just wondering if as you watch what is taking place here, you feel some apprehension about the possibility of that happening?

Mr. VOLCKER. I am simply saying we have had a lot of experience collectively with a cumulative decline in the currency passing a point of being constructive and becoming destructive.

APPROACHING DANGER ZONE

Senator RIEGLE. Are we at that point now, do you think?

Mr. VOLCKER. I think we could possibly be kind of approaching a danger zone——

Senator RIEGLE. Approaching, I am sorry? I couldn't hear your word. You said approaching a——

Mr. VOLCKER. A danger zone.

Senator RIEGLE. What would be the kinds of things that might cause the dollar to continue to drop? In other words, when you think about it as an economist, what are the factors, at this point, that might cause it to continue to go down?

Mr. VOLCKER. I won't think of it as an economist. I will think of it as a trader. If they expect it to go down, it goes down. In terms of more persisting factors, the most fundamental thing is, I think, maintaining confidence in our overall economic policy and approach and not accepting, for instance, the premise that you can escape economic problems through inflation. You only build up more. I think that is the most fundamental factor over a period of time to maintain the kind of confidence in the currency that I am talking about.

That is somewhat independent of the particular level of the dollar, if I can make that distinction again. It is a question of the degree of confidence the people have with an effective management of the economy over a period of time, and certainly we have some things going on that assist that.

The Congress' action on the budget moves in the right direction, in my opinion, in terms of maintaining that very basic sense of confidence, but you are starting from a level in which the deficit is very high. Other factors that contribute to further improvement in the price outlook are obviously crucially important.

Senator RIEGLE. If to go back to what you said a minute ago is right, if we are approaching a danger zone in terms of maybe too great a fall in the dollar if it were to continue for it to create other problems, I guess I should infer from that that these policy issues that you now raise become all the more important for us to handle properly.

Mr. VOLCKER. Yes, that is my message.

Senator RIEGLE. I would like to just stay with that 1 more minute, and that is we are going to do everything we can to make the right policy decision so that we don't end up with these consequences that we don't want.

If the dollar were to continue to drop or, if because of trading pressures or whatever, we went more in that direction and went into that danger zone and even deeply into it, what are the serious implications that we would have to then anticipate or worry about and what are the consequences if we were to see that happen and not get our job done?

Mr. VOLCKER. There are two related dangers, I think. There is the directly inflationary impact and there is the possibility that in those circumstances—I don't think this has happened and it is what I want to avoid happening, and I think happily it has not happened—that people may want to, in effect, get out of the dollar.

They don't want to invest in the dollar, at least they don't want to invest at current or lower interest rates in the dollar, and that would be damaging, obviously, to the economy when we are relying on the fact that we have to borrow. We are going to have to borrow; that is not a question. What the question is, is the terms and conditions under which you borrow.

Senator RIEGLE. You know, I have been wondering about that because as rates have come down and as we continue to rely on foreign credit to buy a lot of the debt instruments that we are issuing as a government, as the yields fall, as they have, and as interest rates have come down and the yields have come down, if you have in addition a currency value risk that a lender has to take into account the possibility that the dollar might fall further, if they don't have much of an interest rate premium on the front end and if they end up losing more value in terms of a further fall in the value of the dollar over the term of the time that they hold the debt instrument, I would think that you could really run the risk that the psychology could swing the other way and people would not want to lend this money.

Mr. VOLCKER. My point very simply is we don't want to run that risk.

Senator RIEGLE. But is that the key risk that you see here?

Mr. VOLCKER. That is one part of the risk, yes.

Senator RIEGLE. Now last week——

Mr. VOLCKER. I might say, I think we have had a continuing, ample availability of money from abroad, and I think that is a very good sign.

MEXICO'S FINANCIAL SITUATION

Senator RIEGLE. Last week Mexican financial officials told the creditor banks in New York, as you know, that they are going to need to borrow about $9 billion this year to keep the economy there afloat, because of the sharp decline in oil prices. And as I understand it, that is about twice what the Mexican officials told the bankers that they would need last December. So this is quite a swing in circumstance as might be expected because of the oil.

I am wondering if the Federal Reserve Board and/or the administration is thinking, or talking, or in the process of mounting any kind of a rescue package for Mexico similar to the one that we did in 1982 when they came close to defaulting, or at least there was concern that they might?

Also, am I right in believing that the cash balances Mexico has are so low that this is a problem of some immediacy?

Mr. VOLCKER. They have more cash balances now than they had in 1982, but certainly it is a large problem and it is somewhat fluid in terms of judging what their needs might be. I would not take as written in stone the particular figure that you mentioned. This is indeed a changing situation.

Senator RIEGLE. In other words, the $9 billion.

Mr. VOLCKER. The $9 billion.

Senator RIEGLE. It could be higher or lower I take it?

Mr. VOLCKER. I would hope that it isn't that high, but that depends upon the oil market and the oil price and how much oil they can sell.

But in any event, whatever that need is, it will need to be covered or we will have a real problem. This is a judgment for Mexico and not for us. What will their internal response be to this very severe challenge? If they take actions that promise to deal with the problem effectively over a period of time, then I think you have one kind of setting, and it is a very constructive setting and a setting that I think is in their own interests and in which those external needs can be met.

Senator RIEGLE. I am wondering, where is this money likely to come from? Are the U.S. banks going to have to provide most of it?

Mr. VOLCKER. I think the world banking community that is exposed in Mexico already, as in the past, would have to provide a very significant part of it. But entirely consistent with the Baker initiative, you would certainly look to the multilateral development institutions to provide a significant fraction, as well to support programs that they undertake to improve their own economy.

Senator RIEGLE. Is the burden on the United States likely to be in the order of coming up with half of the money or 60 percent of the money? What kind of proportional share are we looking at, because I have a related question in terms of our capacity?

Mr. VOLCKER. I don't remember the exact share of American bank lending in the total. My memory is it is something like 40 percent in the case of Mexico, less than half.

To the extent it is done through multilateral institutions, it depends in a sense upon our share of the multilateral institutions.

Senator RIEGLE. That is exactly right.

Mr. VOLCKER. It will not require, in my judgment, increased capital for those institutions in the short run. They have enough money with what has already been pledged to them or guaranteed to them by governments.

Senator RIEGLE. You mean the multinational organizations, some of which comes from us.

Mr. VOLCKER. Some of which comes from us, but the World Bank in particular has ample commitment authority and ample cash to meet these needs for a year or two.

Senator RIEGLE. I have a hard time understanding the Baker initiative on the one hand of asking U.S. banks to come up with some additional money, and it is going to be a lot of money that is required here not just to Mexico.

Mr. VOLCKER. For some countries it will be less as a result of the oil situation.

Senator RIEGLE. Well, it will, but in terms if you start with Mexico and the ones that have the larger needs, we are talking about a lot of money. We are talking about several billions of dollars and probably something more than $10 billion, and I don't know how much higher it is if you take the lending requirements that are going to have to be met around the world.

On the one hand, you have that pressing need that is mounting and, yes, you get some offsets in places where oil is helping, but they don't seem to me to be in equal amounts. I mean the lending problem is getting bigger.

Mr. VOLCKER. Before oil, or without assuming the impact of this oil situation, if I remember correctly, the Baker initiative contemplated something like $40 billion of flows to the collectivity of countries over a 3-year period from commercial banks and from the international development institutions, and more than that on a gross basis.

So even before this the amounts involved are quite substantial relative to the needs, and then you have these offsets. Brazil should benefit from two directions, and maybe three. They benefit from the oil price. If the net result is faster growth in the developed world, they will have better markets. And, they may benefit some from the depreciation of the dollar given the nature of their markets.

BANKS ARE STRUGGLING

Senator RIEGLE. Well, you know, we have got a lot of problems and time is short here, but with the FSLIC and the FDIC, we have some regional credit problems in terms of agricultural loans, oil and gas loans, and commercial real estate loans impacting now in certain areas of the country that are quite hard hit. You have a lot of financial institutions and banks that are really struggling.

The Bank of America is in the news in that capacity and stories about the progress is slow with Continental Illinois. Up and down the banking scale from large to small you have real problems here, and now it seems to me we have some new credit requirements, and I gather some considerable reluctance on the part of bankers to want to necessarily extend this. There is talk about having to improve the balance sheet standing and credit reserves by banks just to put them in more of a safety and soundness position.

I guess what I am wondering here is if we are going to be able to produce all this additional lending strength to go to these Third World countries with Mexico sort of at the top of the list, in a sense, because of its peculiar and immediate problems. It looks to me as if this is a surge of additional pressure.

Do you have any apprehension about this?

Mr. VOLCKER. Nobody ever said it was going to be easy, and there are problems in accomplishing the result. But if you asked me for an overall judgment, I think it can be done in a context of effective action by the borrowing countries themselves. If you don't have that, then it can't be done.

Senator RIEGLE. Well in the case of Mexico I get the feeling, and I will just finish here, that they have tightened things down to quite a degree within their domestic economy. I have heard others say that if they try to go much further in that direction they are going to have problems and we are going to get a lot of new people sort of walking across the border coming up here.

Mr. VOLCKER. A couple of points. It is not just the question of tightening down, to use your phrase, the domestic economy, although oil is an important industry in Mexico. And if the price is $10 lower than it was last year, that is a real loss of income to Mexico that they are going to have to adjust to somehow. That is just the fact of the matter if the price stays down.

But it is not just a question of screwing down on the valves. It is a question of restructuring the economy so they can grow better. I don't want to pose as a great expert on Mexico or any of these countries, but I think there is a sense which is reflected in those countries that there is a lot that can be done to make their economies more efficient.

Now that in itself runs into a different set of political and other problems. Restructuring is always a difficult problem, and you have a lot of existing interests that resist change. But I think the potential for change is also enormous and it is in a very positive direction in terms of the long-term growth of those economies whether or not you had this crisis, but this makes it all the more pressing.

Senator RIEGLE. My time is up. I appreciate your responses.

The CHAIRMAN. Senator Sasser.

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

PREDICTIONS COMING UP ROSES

Chairman Volcker, it is not even springtime yet and everything seems to be coming up roses as far as economic predictions are concerned, and I am delighted to see that at least you have sounded a note of caution here.

The other day the Congressional Budget Office released their economic projections and they were very good, almost as good as the administration's.

But when you peeled it back, you found that they were basing these projections on assumptions of no real growth in defense expenditures in the short term, on taking the budget deficit reduction targets in Gramm-Rudman-Hollings as a fact, on the fact that the stock and bond markets were healthy and going up; and finally came to what appeared to be a solid basing for making an economic projection, and that is that oil prices are low. I presume they will continue to be low as long as the Saudis continue to dump about 2½ million barrels of excess oil a day on the market.

My question to you is this: How solid, in your judgment, are these predictions for satisfactory and even excellent economic growth in the coming year, and what happens to these predictions if Gramm-Rudman-Hollings and its deficit reduction targets are not met, if Gramm-Rudman-Hollings is indeed thrown into the trash can, which I suspect it could be if the Supreme Court sustains the lower court holding, and what happens if we get back in the old gridlock of the President demanding his defense increases and the Congress refusing to make the spending cuts that are necessary? What happens to the economic projections in that scenario?

Mr. VOLCKER. All economic projections are contingent. You can give me a variety of hypotheses that would make the outlook much less favorable, and I agree with that. That is why I called attention to the thorns among the roses. I think the basic outlook has some quite favorable indications in it and some very important things are happening that could be enormously favorable to our prospects.

If we deal with these contingencies, of which you have emphasized one, I share that optimistic outlook, but I think we have to deal with the contingencies.

Senator SASSER. But at least on the question of Gramm-Rudman-Hollings, Mr. Chairman, as I read the Wall Street Journal report of your testimony yesterday, you are not optimistic enough about that yet to start taking the Gramm-Rudman-Hollings deficit reduction numbers into account in making your economic projections.

Mr. VOLCKER. We certainly take some account of the fact that the basic budgetary outlook looks better, but the major impact of that is still quite a few months off, and we are aware of other important changes going on in the economy at the same time.

Senator SASSER. What, in your judgment, is the most serious threat to our economic health at the present time? Would it be a rapid deflation in the value of the dollar?

RAPID DEFLATION COULD BE A THREAT

Mr. VOLCKER. An overly rapid deflation in any event would, in my judgment, be a threat. But I might point out that—and all these things are interrelated—that particular outlook for an improved budgetary position helps to reduce that threat, and it is a very important factor in helping to reduce that threat.

So I come back to the fact that the budgetary outlook is still an uncertainty. In its most general terms of course I would take the position that a resurgence of inflation is in a kind of underlying way the biggest threat that we have. We have financial pressures, we have these LDC problems that I think have to be dealt with in a constructive way.

Senator SASSER. But in the main, Mr. Chairman, judging by the projections that are made by the Fed, I gather that you yourself are optimistic about the economy and optimistic about economic growth in the coming year.

Mr. VOLCKER. I am optimistic, but I want to call your attention to these threats.

Senator SASSER. You are optimistic but realistic.

Mr. VOLCKER. Yes.

Senator SASSER. All right. On one recent report, I want to ask you a question sort of like Senator Proxmire's a moment ago, although I won't try to do it by way of a Galley Poll on the telephone. As I read the Newsweek article about your apartment, it may be so austere there is no telephone there or maybe even a pay phone. [Laughter.]

And I did enjoy the article. It was very good.

One recent report estimated that the average taxpayer works 1½ weeks to pay the interest on the national debt. Now that is $699.23 of the average $3,537 in Federal income taxes that the average taxpayer pays.

It is well established that your first choice, and always has been as I understand it, in dealing with the problem of the deficit is to cut spending. And your second choice, as I have listened to you over the years, a reluctant second choice, is to raise taxes to try to reduce the deficit.

OMB estimates that every 1 point drop in interest rates would reduce the deficit by $5.1 billion. Now you can't cut spending from where you sit and you can't raise taxes from where you sit. But do you see yourself having a role in deficit reduction through the third option, and that might be cutting interest rates?

Mr. VOLCKER. To the extent that is consistent with balanced economic growth and keeping control over inflation, I would love to see that happen, but it has got to be consistent with those factors.

Senator SASSER. I am not sure that is a world in which we politicians live, Mr. Chairman.

Mr. VOLCKER. Well I agree, we sometimes have different perspectives on that. But obviously the danger always is that in an attempt to reduce interest rates artificially, if I may use that word, you end up with higher interest rates rather than lower.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Chairman Volcker, it is always a pleasure to be with you and to listen to you. Your testimony always is lucid and worthwhile for all of us.

Just a couple of points. You have really covered a lot of the bases here. Obviously we take advantage of your presence here to extend the parameters of what you are here for, monetary policy for 1986, to get into some other areas as well. So I hope you are not in any way offended by all of that.

Just to follow up a little bit on what Jim Sasser was raising, I am sure the Fed has done some analysis to the House-passed tax bill. Would you care to comment at all on that? I realize we ask you all the time to comment on things that we are involved in up here, but we value your opinion tremendously.

COMMENTS ON H.R. 3838

Mr. VOLCKER. Well, I really can't comment on that in general. I know there are some controversial sections, and this is a narrow section of the bill, but from my perspective not unimportant, that affects the bad debt reserves of banks in particular. From my perspective we, of course, want to encourage the active buildup of the bad debt reserves, and I detect some obvious incentives arising out of that bill which concern me in my banking regulatory supervisory capacity.

Senator DODD. How about investment tax credits? I am trying to get at the economic growth questions which we are dealing with here. Do you see anything in that bill which is counterproductive?

Mr. VOLCKER. I just can't get into the details, but a lot of investment incentives have been removed and the level of corporate taxation is certainly increased and the effect of that kind of thing can only be judged in an overall balance of the bill.

Certainly I can recognize, without trying to get into it, that maybe we have gone a little incentive happy in tax provisions as a whole, and I know just from the financial implications in the real estate area, for instance, it seems to me we derive a lot of economically bad decisions because of particular tax incentives when they get too big, or too liberal, or are not well designed.

So I don't think dealing with all those tax incentives is necessarily bad, but you have to look at the balance as a whole and what weight you are putting on investment. I think, in a fundamental sense, and particularly the way we treat interest or equity, whichever way you want to look at it in the Tax Code, it creates a kind of balance against investment and against savings, and I am not sure that that bill goes any distance toward correcting that and it may be the reverse.

Senator DODD. I appreciate your comment on that. You note in your testimony, at page 10 of your testimony, you talked about how hard it is to explain the fact that in 1985 there was virtually no growth in the nonfarm business sector. You have suggested today, and it is hard to explain, and I am going to ask you in a second to try to give us some idea of where you think the center of the problem is.

Obviously the strength of the dollar, and obviously the trade deficit have had a profound influence on that. I would ask you, and I will put it in the form of a statement that maybe if some of the uncertainties about the tax bill itself with some of the retroactive dates may have had some chilling effect on business activity. And then, last, obviously the Federal deficit, the problem we face that you have alluded to in terms of how we cope with Gramm-Rudman-Hollings and the like.

Of all of those factors, do some bear more weight than others in that?

Mr. VOLCKER.You know, it is an illusive problem, and I think all the factors that you have mentioned could bear particularly upon the level of investment, which in turn is related to productivity. But what you find in these figures is that manufacturing productivity—I am tempted to say isn't doing too badly—is not doing as well as you would conclude from listening to a lot of businessmen and what they are doing in terms of increasing productivity. So there is a bit of a mystery there.

The hopeful thing is that for a lot of those efforts that have been made within industry, and particularly the manufacturing industry, the payoff still lies ahead rather than in the last year, particularly given that manufacturing was not growing much last year.

I think the real mystery is in the other part of the economy, and it is just very obscure. The whole service end of the economy is getting larger and larger and it has been growing quite rapidly, but you don't see much in the productivity figures.

One of the recent mysteries is why employment in retail trade, a type of service I suppose, is increasing more rapidly than you would think the retail trade figures themselves justify, more than in proportion to the increase in retail trade. Are we suddenly getting so inefficient in selling goods that we now need more employees per real dollar of sales? I don't know. Maybe we are, but it seems strange.

So you begin wondering whether there are very difficult problems in measuring output, and they are extremely difficult if you get into the medical service area. Just to take an extreme example, how do you measure the output of medical services? You know a lot more people are employed there and you hope a lot more people are getting well, but how do you measure just what service they are getting in quantity or in quality? It is almost an impossible task for the poor statisticians that have to make up these figures, sometimes they assume no increase in productivity. So naturally the figures don't show it.

WILL THE DROP IN OIL PRICES BE PROLONGED?

Senator DODD. Let me ask you about the oil question. You accurately point out that this is—and I don't know whether you mention it in your testimony, but it is almost tantamount to a tax cut I suppose and maybe more so, the drop. In fact, it may provide some justification for looking at some revenues.

How certain are you that this is going to be prolonged, whether or not it continues to drop or stabilize at a vastly reduced price than what people anticipated a few years ago?

My understanding is that the Saudis are doing this because they are producing a barrel of oil at about $2 a barrel whereas for the British and others it is $10 or $12 a barrel to produce that same barrel, and that they are putting the squeeze on these other OPEC partners because of what they consider, the Saudis consider to be a violation of agreements. But as soon as the other partners begin to squeal then we will see those prices start to go back up again and that this thing will not be as long lived as some are anticipating. Is that an accurate——

Mr. VOLCKER. I will be as enlightening to you as the experts are to me when I consult them. The answer is they don't know. [Laughter.]

I would make the judgment that given the market situation at the moment and given the worldwide potential supply situation and demand situation, I would not assume that the prices are going to go up in the next year or two to where they were.

Senator DODD. That is not in the $30 range.

Mr. VOLCKER. Even something substantially less than that. Now I think one of the longer range dangers, if you look into the 1990's, let's say, is that you set up a force here that reduces conservation on one side and reduces exploration on the other side; you set up a dynamic that produces a snap back, but in a longer time perspective.

I think markets tend to run to extremes when you have lags. It is somewhat analogous to the exchange rate situation where you don't get instantaneous responses in consumption or production, just as you don't on the trade side, and your market keeps pressing and pressing to one extreme or another and then it snaps back the other way. But I suspect that phenomenon would take years to work out.

Senator DODD. One of the things that is being discussed is a revenue source, not just in terms of deficit reduction, but even the President indicated every so slightly the other day that an oil import fee is something that he has not rejected out of hand as a way of paying for some of the provisions in the House-passed tax bill to reopen some of those. At least that is some of the chatter that you hear around here.

Would you care to comment on the wisdom of an oil import fee or a gasoline tax in light of the present drop in oil prices and what is it apt to do in terms of the economic growth and so forth in the area of manufacturing and the like?

Mr. VOLCKER. I got that question yesterday and I will make the same preface that I don't want to pose as any special expert in this area. But as I look at an oil import fee in the present situation, it seems to me we could only reasonably think of that in terms of, frankly, exempting some of our closest trading partners in oil; and once you look at it that way, Mexico, Canada, and so forth, it is not much of a revenue producer because you are excluding so much of the supply.

Senator DODD. And that is not to mention the exemptions, and you would probably have to do rebates on home heating oil and——

Mr. VOLCKER. You get into all those administrative complications, which are enormous. So it reduces itself to a question as to whether you forego some of the gains from the price decrease.

Basically, on the analysis that you were just giving about the long-term conservation and exploration results, one could imagine I suppose a price that seemed so low and so damaging in its longer term consequences that you could justify it as a kind of conservation supplement and exploration incentive. But I don't think that says you look at it very quickly.

Senator DODD. It is not a great revenue gainer.

Mr. VOLCKER. Right, it is not a revenue gainer. Now if you look at an energy tax across the board——

Senator DODD. A gasoline tax.

Mr. VOLCKER [continuing]. Or a gasoline tax, that can be a big revenue gainer. It also tends to hit consumption, and you can begin to make an argument that if you had to turn to the revenue side, that is something to look at.

Senator DODD. That makes more sense. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, U.S. News & World Report polled a number of prominent Americans for several years and they consistently say that you are the second most powerful man in Government. And, as you know, Newsweek put you on the cover and said the same thing.

Mr. VOLCKER. I think they basically poll businessmen and get a rather biased result.

Senator PROXMIRE. I think most thoughtful and informed people would agree that you are a powerhouse. [Laughter.]

At any rate, when I saw the cover on Newsweek I felt that Don Regan must be gnashing his teeth because [laughter] because that means that President Reagan is only the third most important man. [Laughter.]

Senator DODD. I expect to see fruit boxes in Regan's office, too.

MEETINGS WITH THE PRESIDENT

Senator PROXMIRE. Well one fascinating tidbit from the article is that you meet secretly with the President five or six times a year. You told us in the past that you meet with the President occasionally, but this is the first time I have seen that five or six times secretly.

Do you meet with the President from time to time and, if so, why is the existence of the meeting secret?

Mr. VOLCKER. I meet with him from time to time. Five to six times a year at an annual rate as economists talk would be somewhat of an exaggeration recently. I don't think of it particularly as being secret. It often is not publicized. [Laughter.]

Senator PROXMIRE. You mean nobody asks? The second and third most powerful men in Government meet and the press hasn't enough initiative to find out whether you fellows met and what you talked about?

Mr. VOLCKER. It is not very frequent, but I sometimes think it is more convenient and I think he thinks it is more——

Senator PROXMIRE. More what?

Mr. VOLCKER. It is more convenient sometimes to not make a bigger deal out of it than it is.

Senator PROXMIRE. But you do meet with him. When was the last time you met with him?

Mr. VOLCKER. I don't honestly remember. It hasn't been for some time.

Senator PROXMIRE. You can't remember?

Mr. VOLCKER. No; which tells you it hasn't been at an annual rate of five or six times a year. [Laughter.]

Senator PROXMIRE. Did you meet with him in 1985?

Mr. VOLCKER. In 1985, yes, I am sure I met with him in 1985, but I can't tell you offhand how many times.

Senator PROXMIRE. But you can't remember when?

Mr. VOLCKER. I honestly don't remember. I should have looked that up knowing that you would ask [laughter] but I am unprepared.

Senator PROXMIRE. I would think that would be a memorable occasion. [Laughter.]

Mr. VOLCKER. They are memorable occasions, but I don't remember the date.

Senator PROXMIRE. Mr. Chairman, given the wide range, and it is a wide range in your monetary target of a 3- to 8-percent increase in the M1, it is difficult for the Congress and the public to know what the Federal Reserve policy really is.

I remember when we first adopted the requirement that you report your monetary target in 1975, Chairman Burns pleaded that he be allowed to report a range and not a specific single number. But 3 to 8 percent means they could either be quite tight or rather permissive. And, moreover, even the outer limits of your monetary targets don't mean very much as we saw in 1985.

In describing monetary policy for last year, you say on page 24 of your report, and I quote, "Throughout the year the monetary policy remained generally accommodative to emerging demands for money."

MONETARY GOALS FOR 1986

If the phrase "generally accommodative" is an accurate description of monetary policy in 1985, how would you characterize monetary goals in 1986? Would you say that about the same degree of accommodations as in 1985, somewhat more accommodation or somewhat less accommodation?

Mr. VOLCKER. Obviously that is kind of a jargon word, but I can't think of a more descriptive one. It depends on what the demand for money is, how fast the economy is growing and all the rest, rather than a particular number for the increase in the money supply.

We were "accommodative" in the sense, and I think I tried to describe it a bit in the statement, that rather large demands for M1 were being met consistent with staying within the targets on M2 and M3 and consistent with declining interest rates during the year.

Now you put all those things together and I think that can be fairly described as an accommodative policy. You might have a different economic environment with the same economic growth rate, but because the economy is demanding so much money, you would describe the policy as restrictive in some cases. What would be the symptoms? Interest rates would be rising, there would tend to be pressures on the credit markets and those other pieces of evidence of how comfortable people feel about the amount of money that is around.

Senator PROXMIRE. Well I just asked you to compare it with 1985. Will it be more or less accommodative in 1986?

Mr. VOLCKER. I can't project it through 1986 because it depends upon those other factors.

Senator PROXMIRE. Well what is your present disposition?

Mr. VOLCKER. I think we are essentially in the same posture now that we were in throughout 1985.

I might say in terms of those target ranges and the width of them in trying to describe monetary policy, it means something that the range is as wide as it is. It means that in fact we have some uncertainty as to what developments in velocity will be and that we would want to take that into account in the most technical terms in an appropriate growth in M1 in 1986.

I would hope that is more useful, that explanation, than sticking down a single figure when we don't know whether it would be appropriate or not in the light of changes in velocity, just to be technical about it.

Senator PROXMIRE. Well let me ask you about some of the constraints that limit the Fed's flexibility. For example, the Fed might wish to do a more restrictive policy, but be hampered by the fragility of the banking or financial system. As you look down the road is the job of the Fed becoming harder and harder because of these practical constraints and, if so, what we can do to strengthen the ability of the Fed to keep inflation under check?

Mr. VOLCKER. I hope it doesn't become harder and harder. The first line of defense on that kind of problem is not monetary policy, but supervisory policy, regulatory policy, extensions of credit through the discount window where they are necessary, which can be offset through open market operations in terms of their aggregate effect on the market supply and on the economy.

One looks at financial strains or the lack thereof in the economy as a factor that might have to be taken into account at times in the design of general monetary policy, but it is not the first thing you think of.

Senator PROXMIRE. Now there are some monetarist economists who believe that a 13-percent money growth in 1985 has laid the groundwork for a resurgence of inflation in 1986. They say the principal danger facing the economy is not a slowing of the economic expansion, but rather a resumption of inflation.

Do you share to any degree that moderist view of the economic outlook?

Mr. VOLCKER. I don't share it on balance, or presumably at least my personal voice would have been on the side of a tighter policy.

Senator PROXMIRE. Why do you think they are wrong?

Mr. VOLCKER. Because they think we are seeing unusual developments in velocity. Now if you say that it doesn't give me pause to see the money supply rise that rapidly, obviously it does, but on balance I gave you my judgment. I think they are wrong because we have seen unusual developments in velocity and, based upon what other portents we have of prices and economic activity, I don't share that alarm.

CORPORATE DEBT EXPLOSION

Senator PROXMIRE. You have had what I think is a very good and rather rare concern with the debt, the debt creation in this country and the implications of greater leveraging and the potential of the financial fragility of our institutions and so forth. But there are some theoreticians in the Reagan administration who are essentially saying not to worry.

They point out that corporate debt equity ratios are still below their peak reached in the early seventies. They even see a silver lining in all that corporate debt and they argue that corporate managers must work a lot harder to pay off all that extra debt. As a result, companies are becoming more efficient they say.

What is your response to that benign view of the corporate debt explosion?

Mr. VOLCKER. I would readily admit that it is hard to draw certain conclusions from the overall statistics, but I do know that this rapidity of increasing debt relative to the economy is quite an unusual phenomenon and I do think that it does add up to more leveraging whether you think of it in business terms or more leveraging of the consumer for that matter.

Some of that has been offset. Indeed, for the consumers it has been largely offset for the past year, if you look at the overall balance sheet, by the rise in stock prices. And of course interest rates are down in terms of their cash flow and financial wealth, but I don't think you can count on stock prices going up every year the way they have been going up. Sometimes they go down as well as up. That is a more lasting phenomenon. So I think there is cause for concern here overall.

I get concerned when I see businesses retiring $100 billion of equity in a year by borrowing, because I don't think the economy is suffering from any excess of equity relative to debt.

In fact, there are particular instances where some of these corporate reorganizations, some leveraged buyout or some case where the management of a division of a company will take that division private, so to speak, where I suspect in some it does add up to better management and more flexibility for that particular division. So it is hard to generalize across the board.

But when you look at the overall trends, I think it is somewhat disquieting in terms of a persistence of those trends. And you give me a chance to make a favorite point.

I think a lot of this must ultimately reflect, as I was saying to Senator Dodd, the way we tax equity relative to debt. A corporate manager when he looks at that choice, which he has to look at all the time, has an enormous financial incentive to leverage simply because of the difference in tax treatment involved, and I would hope that some day the Congress will look at that seriously. It is only touched on in a kind of glancing way in the current tax reform bill.

REFORM IN THE BANKING INDUSTRY

Senator PROXMIRE. As you know, Mr. Chairman, there are a number of important banking issues that are before the committee, closing the nonbank bank loophole, closing the nonthrift thrift loophole, providing new powers for bank holding companies, relaxing restrictions on interstate banking, strengthening our deposit insurance systems and so forth.

As you see it, what are the most important issues that the Congress should deal with this year, and what advice can you give us as a committee?

Mr. VOLCKER. I have the same list that you do, and my advice would be to proceed with all the energy that you can on the list that you have in front of you.

Now you get into questions of legislative tactics where you are the experts and not I. But let me say that——

Senator PROXMIRE. Would you give us your priorities in this list?

Mr. VOLCKER. The priority in one sense is dealing with what I see as the philosophical underpinnings of the whole thing. What is the role of banks, and as a complement, what is the role of nonbanks in the financial system and in the economy. Unless you resolve that kind of underlying issue, it is hard to know where else to proceed. And in very specific terms that comes down to this so-called nonbank bank issue and the nonthrift thrift issue.

But that in itself is not resolving this whole set of problems. I think it is at the background of a lot of these problems, but I would urge you to clear that up—and my views on it are well known—and on that base then deal with the problems of what are the appropriate powers for a bank holding company and what are the limits. I think this is particularly important and relevant currently: What are the limits on the authorities provided by State banking law or thrift law where it is more pressing that may be inconsistent with the Federal safety net and the safety and soundness of the whole system?

So if you deal with those three areas, you would have gone a long ways toward dealing with this situation. You have this whole series of insurance questions that you touched upon, and I think there are very real serious questions in my mind partly because they are so difficult. They are pressing, but maybe they do not have the same degree of legislative priority, in my opinion, simply because it is not quite so clear what directions to go in.

I would also say, and maybe less sweepingly, but quite important and a matter of priority in the current environment—and a matter you are going to have to deal with anyway because the present law expires—are the provisions in the Garn-St Germain Act for failed institutions to be taken over by an out-of-State institution. This has been very useful in some instances and still, I think, is too narrowly written to deal with all the problems that we have today.

One aspect of that is the problem of agricultural banks that are individually very small but are very important in terms of the local community. You may not have a market for that bank, and you have a question of the banking services for that community.

So I think some liberalization in that area in terms of dealing with very current problems is very important.

LOGJAM ON BANKING BILL

Senator PROXMIRE. Now as you know, in 1984 under the leadership of Senator Garn, the chairman of the committee, the Senate did pass by an overwhelming margin a bill 89 to 5, and the problem here is a very practical problem. We can't seem to get action by the two Houses together and you can't even work out some kind of a compromise.

Suppose we can't get agreement on moving forward with a comprehensive banking bill providing banks with new powers, should we move forward on a bill just to close the nonbank and nonthrift thrift loopholes, or should we defer action on these issues unless and until Congress is prepared to grant new powers to banks and bank holding companies?

Mr. VOLCKER. I think the only way I can answer that question at present is that I retain that hope, which I confess is under some strain, that you can move forward by some device or another with a more comprehensive result than just the nonbank bank issue.

The nonbank bank alone is clearly too narrow even on its own terms. You cannot sensibly I think deal with that problem without dealing with the nonthrift thrift problem, because there is too much substitution between them. But I would certainly be hopeful. I don't know how you get the legislative process started.

The CHAIRMAN. We could have a unicameral legislative body and that would solve the problem.

Mr. VOLCKER. Given the two houses and the different views on how to proceed and all the rest. But I would be hopeful that somehow that gets unlocked and that the net result is a broader package than H.R. 20 in the House. But maybe that is a good starting point, looking at it from the House's perspective. I think it may be an essential starting point from that perspective.

Senator PROXMIRE. Attorney General Meese in a speech before the American Bar Association argued that the so-called independent regulatory agencies, including the Federal Reserve Board are really unconstitutional and that the President has the power under the Constitution to hire and fire the members of the independent commissions, the same way he can hire and fire members of his Cabinet.

That issue was raised again in the recent decision of the court on the Gramm-Rudman law, and the court came down on the side of Meese. It is also before the court in a matter involving the Federal Trade Commission.

If the Attorney General is right, what are the implications for the ability of the Federal Reserve to conduct an independent monetary policy, and does the Federal Reserve have any plans to intervene in the FTC case?

Mr. VOLCKER. We haven't got any plans to intervene in that case, but obviously if you are talking about by one device or another, ending the independence of the Federal Reserve and the current status of the Federal Reserve, I think that would have very serious repercussions——

Senator PROXMIRE. Why would you not intervene in that case? It seems to me you would have a great deal at stake?

Mr. VOLCKER. It hadn't even occurred to me. So maybe we ought to consider that and we will consider that. It hadn't occurred to me until you raised the issue.

Let me say that——

Senator PROXMIRE. Is it your understanding that you have the legal authority to intervene?

Mr. VOLCKER. I don't know. We just have not considered the issue at all, and I don't know whether that would be appropriate. So I pronounce no judgment on that. I am aware that the Federal Reserve itself has been in existence for 70 years without anybody challenging its constitutionality, and some other independent agencies have been in existence longer than we have. It seems to me it has in some large sense, without trying to play lawyer, become part of the American system of government. I am talking about the role of independent agencies in general and not just talking about the Federal Reserve. But it would be a very large change in the way things have been looked at for a very long period of time.

Senator PROXMIRE. Should the Fed be given the authority to file its own brief with the courts without getting permission from Justice?

Mr. VOLCKER. I rather like that idea, yes. [Laughter.] I would not oppose it.

The CHAIRMAN. Senator Cranston.

TAX ON OIL IMPORTS

Senator CRANSTON. I wanted to ask you your view on one matter at this point. With the decline of oil and energy prices as reflected in the cost of living and other indexes, what is your view of a tax on imported oil and/or a tax on domestic energy as a way to cope with the deficit?

Mr. VOLCKER. Those were two different questions that arose, I think, with Senator Dodd shortly before you came in, Senator, and to try to summarize my answer, I think I would look at an oil import fee in the light of whether that is necessary and desirable as a conservation measure or as an exploration support measure rather than as a tax generating measure. I don't think it is a very efficient way to raise revenues, and simply as a tax measure there are an awful lot of complications when you begin singling out one source product for taxation with all the exemptions and allocations and everything else that that might involve.

So if you are looking at it as a revenue raising measure—and against the background of any revenue raising measure being a second choice, economically, to spending reduction measures—I would look more toward a direct tax on gasoline or energy more widely.

Senator CRANSTON. On another topic, and I was just talking with one of the representatives of one of the largest banks in our country who is no longer concerned about inflation, but deflation with oil prices going down and with the farm economy and the difficulty it is in which he suspects may trend on into real estate values plummeting.

Do you see anything that would cause concern on the front of deflation in contrast to inflation?

Mr. VOLCKER. Given my understanding of the word "deflation," there are pockets of deflation and there are sectoral deflations in the economy. Overall, there is still obviously inflation at a much lower rate but nonetheless still there. I suppose this might be typical of a period more broadly described as disinflation.

We were on a bit of a binge and prices were accelerating, and now we are adjusting to a much more stable situation and I think that is favorable. Particularly the areas that were over-extended in the past have elements of deflation in them now, and you see that in some commodity prices, and you certainly see it in the agricultural area, and you see it in some other areas.

The challenge during this period is to contain those problems in a way that isn't inconsistent with working toward stability overall, and there are risks involved in that process. There is no doubt about it.

Senator CRANSTON. I know that inflation has been one of your major concerns and you have been a staunch advocate of a greater responsibility by Congress on the budget deficits and so forth.

How do you feel about the timetable in Gramm-Rudman-Hollings getting down to $144 billion by October in the deficit and down to zero by 1991? Do you have any concerns about that being such a drag on the economy under any perspective circumstances that it would cause any serious recession?

Mr. VOLCKER. When you add "under any prospective circumstances," that is a big statement.

Senator CRANSTON. Yes; I meant it to be that way.

Mr. VOLCKER. I am not concerned about the broad direction and the pace of that effort. I think it is quite a challenge to achieve it. Nor do I think success rests upon any precise numerical target that we set 5 years in advance of the event. But the overall thrust of the effort, I think, is constructive.

Senator CRANSTON. One final question. Would you support any special assistance to farm banks that are suffering from what you call disinflation?

Mr. VOLCKER. That is an issue which we will shortly be writing the chairman about. He has asked us about it in particular, and you will have your reply, Mr. Chairman, very shortly. There are certainly elements of what I would call special attention at least, if not special assistance. We have tried to be very careful in our examination processes, and I think the other supervisors look at it similarly, so that we don't aggravate their problems through overly heavy-handed reactions or overreactions in the supervisory process.

We have been very fortunate in this situation. There are very grave problems out there, but we have been very fortunate that the mass of agricultural banks, and there are a great many of them, have been among our most strongly capitalized institutions and historically among the most profitable. So they have had some considerable financial strength to withstand some of these strains.

And in that process, certainly speaking for the Federal Reserve, if their capital is depleted temporarily below our guidelines, the capital is there to be depleted or used at least in part in times of strain. We would have to approach that, obviously, on a case-by-case basis, but with some recognition that temporarily capital ratios might fall below standards we otherwise think are appropriate.

There are questions that arise that we will address in terms of changing accounting practices and net worth certificates. We resist those approaches because we don't think they are good in the long run and any application of them ought to be quite limited, but our view will not be strongly supportive of those particular approaches.

I mentioned earlier the structural factor, which is at least as much a matter for State legislatures as the Congress, but there are elements that affect the Congress. And when you have States that permit no branching or, in some cases, no affiliations among banks—although that is diminishing—it is more difficult to deal with some of these failing situations, because there is no other bank that can step into the shoes of the failing institution.

Now that is a matter of changing some of those laws if, indeed, it is important to preserve banking services as it sometimes is in those local communities.

The CHAIRMAN. Senator Proxmire.

BAD DEBT RESERVE DEDUCTION

Senator PROXMIRE. Mr. Chairman, when this committee held oversight hearings on the House tax reform bill, it was argued that the elimination of the bad debt reserve deduction will have an adverse effect on the safety and soundness of the banking system. That is, without the bad debt reserve deduction banks will have less incentive to establish their bad debt reserves. And since these bad debt reserves are counted as capital for regulatory purposes, the overall capital position of the banking system will decline.

I don't want to get into the issue of whether the bad debt reserve deduction should or should not be repealed because that question is outside of this committee's jurisdiction. But in looking at the issue just from a bank regulatory point of view here, just from that point of view, what authority do the bank regulators have to offset any adverse effects of the tax bill?

If regulators thought that banks were inadequately capitalized, why couldn't they have simply raised capital requirements? Why should banks need to have tax incentives to comply with bank safety regulations?

Mr. VOLCKER. We could raise capital requirements, but I think the issue that is raised is how expensive that becomes. If we raise capital requirements and the taxes on that additional capital are, in effect, increased because of the elimination of the bad debt reserves, it comes more costly and more difficult.

Senator PROXMIRE. Have you had anybody in the Fed take a look at the taxes paid by the banks, how much do they pay?

Mr. VOLCKER. I know that——

Senator PROXMIRE. The big banks pay practically nothing.

Mr. VOLCKER. I am aware of that. Now that doesn't end the story entirely because of two reasons. Some of the things they do to avoid the taxes don't necessarily fall into their pockets. Their customers, in effect, are taking advantage of some tax incentives. They finance it and it shows up on their books, but the customer is getting credit, which was the purpose of tax incentive in the first place.

So you have that kind of situation where the tax savings do not translate into net profits for the financial institution, and you do have this contrasting need, in the current circumstances, certainly more than earlier when the bad debt reserve——

Senator PROXMIRE. Well, why can't you as a regulator just say you ought to have 10 percent capital?

Mr. VOLCKER. Pardon me?

Senator PROXMIRE. Why can't you as a regulator simply say you ought to increase the capital ratio from 8 to 10 percent?

Mr. VOLCKER. Where are they going to get it from?

Senator PROXMIRE. I know you are doing that, but why wouldn't that be adequate?

Mr. VOLCKER. That would be increasing the capital ratio, but the question that always arises is where are you going to get the capital from. All we can issue is a UKASE to raise the capital ratio. They have to raise the capital, and how difficult or feasible that is is what we are talking about.

Senator PROXMIRE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, thank you very much. I have no more additional questions for you.

I do expect you will have the usual number for your response in writing.

Thank you very much.

The committee is adjourned.

[Whereupon, at 3:28 p.m., the committee adjourned, subject to the call of the Chair.]

[Response to written questions of Senators Garn, Heinz, Gorton, Mattingly, Proxmire, and Riegle with additional material supplied for the record follow:]

Chairman Volcker subsequently submitted the following in response to written questions from Chairman Garn in connection with the hearing held before the Senate Banking Committee on February 20, 1986:

Question: In his State of the Union address, the President directed the Secretary of the Treasury to study possible modifications in our international monetary system.

One alternative, of course, would be increased official intervention to bring more stability to rates.

Do you believe that foreign exchange market intervention can be effective if it is "sterilized" and not allowed to affect domestic money supplies?

If intervention cannot be sterilized and remain effective, do you believe that exchange rate stability should be an explicit objective of monetary policy along with the domestic objective of low-inflation and high real growth?

Answer: I believe that sterilized intervention can at times play a useful role in helping to stabilize exchange rates and, perhaps, even to correct serious exchange rate misalignments. For example, intervention following the G-5 announcement last September may have reinforced and made more credible the statement that policymakers thought non-dollar currencies should move somewhat higher, and thus may have accelerated the decline in the dollar that had begun earlier in the year. However, experience over the years shows that unless intervention is complemented by appropriate policies, its effect is likely to be fairly small and transitory.

Changes in the exchange rate have an important impact on our economy, and on the world economy. They cannot be ignored in the formulation of policy. Indeed, as we have noted on many occasions, the Federal Reserve in recent years has been giving explicit consideration to exchange rates, among other factors, in its policy decisions.

Question: How and to what extent should monetary policy be adjusted to compensate for recent declines in the price of oil?

The Federal Reserve has argued that it needs to have a role in bank regulation to be adequately sensitive to the impact of monetary policy on financial institutions. Does monetary policy need to be adjusted in light of the impact of oil-price declines on banks with large loans to the energy industry or oil-exporting countries?

How and to what extent should monetary policy be adjusted to compensate for Gramm-Rudman-Hollings?

How and to what extent should monetary policy be adjusted to compensate for the decline in the value of the dollar during 1985?

Answer: Your question enumerates a number of key elements in the economic outlook, illustrating the variety of considerations that must be taken into account in conducting monetary policy. The effects of any of these developments are very difficult to predict in advance, and they may interact in complex ways. Some have quite different and potentially offsetting impacts. Oil price declines and dollar depreciation have offsetting effects on inflation rates. While budgetary restraint reduces demands for goods and services, the behavior of the dollar and oil prices increases them. But the magnitude of the oil price decline, the extent of dollar depreciation, and the exact amount of budgetary restraint are all subject to some uncertainty, as is the timing of their various effects on economic activity and prices. Conditions to date, with this lagged potential for the year ahead, were considered by the FOMC in establishing its objectives for money and credit growth for the coming year. However, actual developments will need to be monitored carefully as the year progresses in assessing the implementation of policy and whether the monetary ranges continue to be appropriate relative to our overall goals of fostering sustained economic expansion consistent with progress over time toward price stability.

Question: The Federal Reserve's guidelines on daylight overdrafts become effective in March. Apparently some banks are planning to charge their corporate customers for creating daylight overdrafts.

Do you expect this to cause corporations to significantly increase their working demand deposit balances, and if so, do you expect this to be an important downward pressure on monetary velocity?

Answer: It is not anticipated that the implementation of the initial Federal Reserve policy to limit daylight overdrafts will raise corporate demand deposit balances to the extent that M1 or its velocity would be significantly affected. Corporate payments and funds transfers are not the only source of daylight overdrafts of reserve balances. A very substantial portion reflects the morning return of overnight Federal Funds borrowings before the receipt of newly-negotiated borrowings in the afternoon. Depository institutions have alternative means of reducing daylight overdrafts--such as entering into longer term federal funds transactions or returning borrowed federal funds later in the day--which are the approaches likely to prove more significant. It is true that some depository institutions have reviewed their corporate payments policies in light of the Board's efforts to focus banks' attention on the risk exposures associated with daylight overdrafts. But, our information suggests that relatively few of the many thousands of depository institutions are likely to need to make substantive changes to their payments patterns in order to meet the initial limits on daylight overdrafts to be implemented in March. Thus corporate demand deposit balances are not expected to be greatly affected by the Federal Reserve's guidelines on daylight overdrafts, as presently set out. As overdraft limits are adjusted further, some limited and gradual effects on the aggregates may occur. While, as noted, no measurable impact on the aggregates is likely to occur in 1986, the Federal Reserve will continue to monitor depository institutions and corporate cash management in order to detect any reaction that could alter the interpretation of the monetary aggregates.

Question: The 1986 Economic Report of the President examines monetary policy over the last three years and finds that "each of the major shifts in monetary policy appears to (have been) a reaction to contemporaneous economic activity." The Report concludes that, "real growth has been the primary target of monetary policy."

Has the Federal Reserve, in fact, been trying to target a desired level of real growth over the last three years?

Answer: The Federal Reserve does not "target" a particular rate of real economic growth. Clearly, sustained expansion of the economy over time at a rate close to its potential is a basic goal of monetary policy, and along with continuing progress toward price stability, are fundamental objectives. Ranges for growth in money and credit are chosen by the FOMC consistent with these objectives, and other policy adjustments are undertaken in that basic framework. However, looking at a longer time frame, the Federal Reserve does not control growth in the labor force and productivity, which are the key determinants of the nation's growth potential. The higher productivity, the more rapid will be the long-run growth potential and Federal Reserve policy would accommodate policy to that as it emerges over time.

In periods of economic slack, the Federal Reserve does seek to encourage a revival of economic activity consistent with the economy's capacity and containment of inflationary pressures. In the second half of 1982 and again in 1985--two of the "major shifts in monetary policy" identified by the Report--incoming information about economic activity and prices suggested that, in light of strong demands for liquidity and associated declines in velocity, rapid growth of M1 above its ranges would not have inflationary consequences, and indeed was needed to foster satisfactory performance of the economy--in the first case, recovery from a deep recession, and in the second, continued expansion. However, we do not aim at precise growth targets from quarter to quarter or even year to year, partly because that is not reasonably feasible with the tools at our command and the lags involved, and also because other considerations (including prices) bear upon the sustainability of growth.

Question: The House-passed tax bill, H.R. 3838, would no longer allow banks or bank holding companies with more than $500 million in assets to take a tax deduction for contributions to loan loss reserves. In addition, the bill would require these larger banks to pay taxes on their previous years' deduction, as existing reserves would have to be "recaptured" into income over a five-year period.

Do you believe it would have an impact on the safety and soundness of the banking industry to deny deductions for contributions to loan loss reserves?

Do safety and soundness considerations justify discriminatory treatment of banks with over $500 million in assets in their ability to take deductions for contributions to loan loss reserves?

Answer: Bank regulators have generally required banks to maintain adequate loan loss reserves to promote accuracy in their financial statements. In particular the objective has been to encourage banks to recognize potential future losses inherent in their loan portfolios and thus avoid overstating earnings and their true equity positions in their current financial reports.

I would note that, in addition to bank regulators, the reserve method of accounting for loan losses has long been recognized as appropriate by the accounting profession and is currently prescribed by generally accepted accounting principles. I would further note that the great majority of banks, in complying with these principles, have made contributions to their loan loss reserves that have substantially exceeded what they have been able to deduct for tax purposes.

The proposed repeal of the reserve method for tax purposes would make it more costly for banks with over $500 million in assets to maintain loan loss reserves for financial reporting purposes. These costs would be particularly high during the proposed five-year recapture period for 1985 tax reserves. In short, these provisions of the bill obviously would tend to discourage banks from maintaining as large loan loss reserves as otherwise, at some risk in terms of safety and soundness criteria.

I also note that the Report of the House Ways and Means Committee on H.R. 3838 states that the bill retained the reserve method for smaller banks because "the committee is concerned that the repeal of the reserve method for smaller banks may have some potential adverse impact." I believe that larger banks would be affected in much the same way as smaller institutions if the proposed loan loss reserve approach were adopted.

As a regulator, I am strongly inclined toward measures that will encourage banks to build up and maintain adequate loan loss reserves because I think this will help to promote their safety and soundness. Thus, viewed from this perspective alone, I would not favor adoption of the proposed tax treatment.

Question: In your statement, you say that improvement in the United States' trade balance will require faster economic growth by our trading partners. You also note that the decline in oil prices will stimulate the economies of many of our trading partners in Europe and Japan.

Your statement is unclear, however, on whether the United States should encourage our trading partners in Europe and Japan to undertake even more fiscal and/or monetary policy stimulation of their economies.

Should we press them to stimulate more at this time?

Answer. My public statements for more than a year have, in fact, consistently suggested the need for more "home grown" expansion in key foreign countries and raised the question of whether that did not justify some changes in policy and policy emphasis.

Question: Given the good outlook on the inflation front and given the prospect of reduced fiscal stimulus to the economy in the years ahead, some analysts apparently expected the Federal Open Market Committee to vote last week to ease monetary policy.

This apparently did not occur. Why not?

Answer: Consideration of the appropriate stance of the Federal Reserve in supplying reserves is made against the backdrop of a number of factors affecting the economy and financial markets, not all of which pointed in the direction of the need for further ease through open market operations when the FOMC met in early February. The growth of money and credit generally was rapid in the latter part of 1985, and the economy showed some signs of strengthening around year end. Fiscal policy, though moving toward budget balance over time, remains relatively expansionary for the near-term and is subject to uncertainties as Gramm-Rudman-Hollings is challenged in the courts; the decline in oil prices, while bringing down inflation for a time, also will serve to stimulate real spending and economic activity. Moreover the dollar had been declining fairly rapidly on foreign exchange markets, and it was likely under the circumstances that a significant easing through open market operations would risk a cumulative decline. In the weeks following the meeting, however, the central banks of Germany and Japan, and a few other key countries, lowered their official rates. In that environment--and given declines in U.S. market rates, relatively constrained growth of the aggregates early in the year, and further declines in oil prices that enhanced prospects for improved price performance--the Federal Reserve Board on March 7 approved a cut in the discount rate from 7-1/2 to 7 percent.

Question: In your statement, you indicate that one of the reasons for recent declines in measured velocity has been that domestic demand has been growing faster than domestic output. The declining exchange rate of the dollar should reduce the drain from domestic demand into imports.

Has monetary velocity become highly dependent on changes in the value of the dollar on foreign exchange markets?

Are we likely to see upward pressure on velocity this year coming from the declines that already have occurred in the value of the dollar?

Answer: In my view, the more rapid growth in domestic demands than in output--the counterpart to our burgeoning trade deficit last year--probably contributed to the measured decline in GNP velocity in 1985. Such a divergence in growth rates would contribute to a decline in measured velocity to the extent that demands for money and credit are related to domestic spending as well as to domestic output and income, which is conventionally used to calculate velocity. However, the bulk of the substantial decrease in M1 velocity last year appeared to be related to the combined effects of the downward movement of interest and inflation rates and deposit rate deregulation on the public's desires to hold money balances, rather than to the more rapid expansion of spending than income. Only rarely would I expect domestic demand and domestic output to diverge so widely as to have any measurable effect on velocity. For instance, even with the recent sharp decline in the dollar, the trade balance is likely to improve only moderately this year.

Question: In a paper submitted to this Committee, John Makin emphasized the importance to monetary policy of being alert to a resumption of velocity growth.

Mr. Makin suggested that a likely sign would be a decline in nominal interest rates associated with a weakening of the dollar on foreign exchange markets.

His argument is that the weakening dollar would signal rising inflationary expectations, and this would mean that the nominal interest rate decline reflected a decline in the real interest rate.

Do you agree that this would be a good way to anticipate resumed growth in velocity?

Answer: Declines in both the dollar and nominal interest rates could indicate that velocity was increasing, but only under certain specific circumstances. Usually when interest rates decline, velocity grows less than trend or decline. It might rise, however, if, as Mr. Makin suggests, the exchange value of the dollar were confirming a drop in real interest rates and if the lower real market rates were consistent with a decision by the public to increase its spending out of existing money holdings because, for instance, inflationary expectations were rising. But it is not clear that a decline in dollar exchange rates can always be interpreted as signalling a rise of inflationary expectations. The exchange rate can be influenced by a number of factors in addition to short-run movements in U.S. real interest rates, including interest rates and growth prospects abroad, the international competitive position of U.S. producers, and concerns about the safety of investments abroad.

The difficulty in interpreting the implications of movements in interest and exchange rates for velocity surely could not be better illustrated than in 1985. Dollar exchange rates declined considerably from early March on, while nominal short-term interest rates edged off and long-term rates fell more substantially. However, the falling exchange rate appeared to reflect a growing realization that a realignment in the foreign exchange value of the dollar would be necessary at some time to restore long-term balance in our nation's external accounts as much as it did a reduction in real interest rates. Moreover, it was accompanied by a steep decline in velocity, rather than an increase. It seems evident that the Federal Reserve will have to continue to look at movements in interest or exchange rates in the context of information about the economy and financial markets in judging the likely course of velocity and the appropriate stance of monetary policy.

Question: In a paper submitted to this Committee, John Makin of the American Enterprise Institute concluded that the United States should not seek international agreement to pursue more exchange rate stability while Gramm-Rudman-Hollings is being implemented.

Mr. Makin's argument is that more exchange rate stability would reduce the flexibility of monetary policy and that more flexibility, not less, will be needed as Gramm-Rudman-Hollings is implemented.

Do you agree?

Answer: I have supported the President's call for an exploration of steps to achieve and maintain greater exchange rate stability. Maintenance of reasonable exchange rate stability does imply a greater need for disciplined and complementary policies among nations. In my view, Gramm-Rudman-Hollings is an important step in that direction. By helping to close the gap between domestic investment and saving, it will foster better balance in our international transactions--a necessary precondition for greater stability of exchange rates.

At the same time, major shifts in fiscal policy--particularly if they entailed a divergence between policies pursued in the U.S. and our major trading partners--might imply the need for changes in exchange rates to maintain satisfactory performance of the economy and inflation. If monetary policy had to defend the existing exchange rate level in such circumstances, its use to achieve domestic objectives would be constrained. I would think that any system for achieving greater stability in exchange rates would have to retain elements of flexibility to allow adjustment to fundamental changes in underlying economic conditions or policy mix. However, the extreme volatility of recent years often has seemed unrelated to economic fundamentals, and it is the means to reduce this sort of exchange rate volatility that appear to me worth looking at.

Chairman Volcker subsequently submitted the following in response to written questions from Senator Heinz in connection with the hearing held before the Senate Banking Committee on February 20, 1986:

Question: With regard to debt, you give credit to the Baker Plan's recognition of the need to deal directly with the policy and financing problems of countries suffering from continuing debt problems, especially those such as Mexico, Venezuela and Nigeria that are affected by falling oil prices. These countries are claiming that nothing short of interest rate concessions will resolve their problems, calling into question the value of current bank loans and making prospects for further loans problematic. Do you believe the Baker Plan is workable under these conditions? Should the commercial banks increase their lending to fill a widening capital gap in these countries when they are seeking loan concessions?

Answer: The Baker Plan is workable today, and the basic approach Secretary Baker outlined in Seoul is still valid: the adoption of stabilization and structural policies by the borrowing countries to promote sustained growth; support of those policies by the IMF, the World Bank, and the other multilateral development banks; and additional lending in this context by commercial banks to provide the necessary margins of external financing. This cooperative effort will be more difficult to the extent that the borrowing countries insist upon "loan concessions" as a substitute for the adoption of more fundamental economic reforms.

Question: A number of legislative provisions related to U.S. monetary policy are pending in Congress. Many are premised on the view that the level of the dollar exchange rate has not been an explicit goal of U.S. economic or monetary policy, with damaging effect on the U.S. economy. Is this criticism of U.S. monetary policy valid? You have noted concern with and monitoring of the exchange rate in your recent reports; how has the exchange rate factored into your 1986 monetary targets?

Answer: The exchange rate as it affects the outlook for economic activity and prices inevitably enters into our deliberations, along with other economic and financial circumstances--such as fiscal policy, the wage-price nexus, and conditions in domestic and international credit markets. Thus, implications of the sharp drop in the dollar that had already occurred were assessed. It was a factor exerting upward pressure on prices but at the same time stimulating growth. Over the year ahead, though, it was generally considered that the drop in oil prices would offset the price effects, and the monetary targets set would be consistent with continued constraint on inflationary pressure while encouraging real growth.

Question: The Administration seems increasingly taken with the idea of reform of the world monetary system, as most recently indicated in the President's State of the Union address. Various proposals in the Congress call for similar discussions. Do you see a need for fundamental reform of the system? What changes, if any, are needed?

Answer: As I have noted in the statement that I submitted to the Committee, I welcome the call by President Reagan to consider what steps might be desirable to achieve and maintain greater exchange-rate stability. We have had enough experience with the distorting effects of extreme exchange-rate volatility to justify a reexamination of the functioning of the international monetary system. One should not, however, underestimate the complexity of the task of achieving intellectual and operational consensus about modifying the currency international monetary arrangements. Still, while I do not have a blueprint for international monetary reform, we ought to be prepared to examine various ways to achieve greater exchange-rate stability.

Chairman Volcker subsequently submitted the following in response to written questions from Senator Gorton in connection with the hearing held before the Senate Banking Committee on February 20, 1986:

One line of questioning which I think would be useful has to do with the Fed's policy in light of the deficit reduction effort and Gramm-Rudman:

Question:

1) Can "fine tuning" of monetary policy offset the contractionary fiscal policy that Congress will undertake in compliance with the Gramm-Rudman-Hollings Act?

Answer: I do not believe monetary policy can be "fine-tuned" to offset the effects of one particular factor affecting the economy. "Fine tuning" implies an ability to predict with precision and confidence the size and timing of the effects of both the factor in question and of any changes in monetary policy to offset it. In any event, the economic impact of Gramm-Rudman-Hollings is subject to substantial uncertainties, including the effect of court rulings on its implementation and the extent of offsetting increases in private spending as the drop in government credit demands reduces pressures on interest rates and frees saving to be channelled to private investment. Moreover, a number of other important factors in addition to fiscal policy are likely to be affecting the economy over coming years. Oil price developments and the lagged impacts of the readjustment in exchange rates are two of the more important.

In general, in establishing ranges for money and credit growth, the FOMC necessarily looks at all the developments that could be influencing the economy and the relationship of those aggregates to economic performance. In implementing policy as the year progresses, the behavior of the aggregates is assessed against that of the economy, inflation, and developments in credit and foreign exchange markets. If a major change in one or more important factors--including but not limited to, fiscal policy--seemed to suggest that the FOMC's policy objectives were not consistent with progress toward national economic goals of sustained growth and price stability, the FOMC would of course reassess its overall policy stance.

Question:

2) Mr. Volcker, you have been quoted in today's papers as saying that "the dollar has fallen enough". Given that there may still be some room for the value of the dollar to fall further, at what point do you think that the Fed will have to act to prevent a further decline?

Answer: That statement was made in the context of the size and rapidity of the decline of the dollar in recent months, not as an expression of a conviction that I knew, or could know, that the dollar had reached an appropriate "equilibrium" level that should be maintained over time. That sense was, I believe, clear in the total context of my comments.

I know of no reliable way of determining ex ante or hypothetically at what point the dollar might have fallen too far, and I do not take the view that some further adjustment may not be necessary over time. However, we know from experience that changes can develop a momentum of their own unrelated to lasting influences, as apparently happened for a period when the dollar was so strong. At some point, particularly if inflationary risks were high, such an event could influence Federal Reserve, as well as other, policies. If that point is ever reached, more than action by the Federal Reserve alone is likely to be required to reverse the slide. The precise actions would depend on the circumstances.

Question:

3) Which is more important--to ease monetary policy in the face of contractionary fiscal policy, or to prevent the dollar from depreciating too far?

Answer: I cannot intelligently answer the question in the abstract, and absent other assumptions. Even the two factors you mention have offsetting effects on economic activity--one contractionary and the other expansive. In other words, in that setting, it is possible there would be no net contractionary effect.

Question:

4) Mr. Volcker, we have recently heard a great deal about Secretary Baker's initiatives to stabilize exchange rates by coordinating monetary and fiscal policy among the Group of Five nations. What is the Fed's role in these efforts?

Answer: We have participated in international discussions and have intervened, along with the Treasury, in exchange markets. Our basic monetary policy thrust is, of course, set independently by the Federal Open Market Committee and the Board of Governors; it remains one of encouraging sustainable economic growth and progress toward reasonable price stability. In policy implementation we have made an effort to adapt certain policy instruments, such as the discount rate, in light of conditions in exchange markets and policy actions abroad as well as underlying economic and financial conditions here.

Question:

5) It appears that although our deficit problems are now coming under control, there is still a great deal of work that must be done by Congress and the Administration in the way of deficit reduction. This effort will continue for several years. In the face of a long-term contractionary phase of U.S. fiscal policy, what would be the effect of resorting to a fixed exchange rate regime on your ability to conduct discretionary monetary policy?

Answer: Under our present exchange rate system, a long-term reduction in the federal budget deficit would tend to reduce domestic interest rates and the exchange rate for the dollar, as current and expected future pressures on domestic financial markets would be eased. There is already some evidence of this process at work in the wake of the Gramm-Rudman legislation.

The movements in interest rates and the exchange rate would help to correct the internal and external imbalances that had been generated by the budget deficit. The tendency for interest rates to decline would also boost domestic expenditure, offsetting the contractionary impact of the reduction in the budget deficit.

If, instead, we were operating under a fixed exchange rate regime, downward pressure on exchange rates would need to be restrained in part perhaps by interest rate movements here or abroad depending on the extent to which exchange rate tendencies were or were not buffered by changes in international reserves. Whether this would represent a practical constraint on monetary policy, relative to current conditions, would depend on the degree of exchange market pressure, the "give" in a fixed rate system, actions of other countries, and the availability of international reserve movements or intervention to moderate exchange rate tendencies.

One last question you might ask has to do with the relationship between the trends in the price of oil and the value of the dollar vis-a-vis inflation:

Question:

6) As we all know, the price of oil has fallen far more sharply than anyone foresaw even as recently as a few weeks ago. Is the falling price of oil offsetting the inflationary effects of the falling dollar?

Answer: The fall in oil prices in recent weeks, if sustained, will exert a significant downward impact on U.S. inflation that could for a period of time tend to offset the inflationary effects of the decline in the dollar. Lower oil prices are likely to begin to affect consumer prices fairly quickly, over the next few months. In contrast, the fall in the dollar, which has been taking place for twelve months now, has only just begun to show up in higher import prices. The relative timing of these effects suggests that the recent decline in oil prices is likely to contribute to a continued favorable performance of prices over the course of this year. However, as the effects of the dollar decline are passed through increasingly into import prices, inflation could begin to pick up.

Chairman Volcker subsequently submitted the following in response to written questions from Senator Mattingly in connection with the hearing held before the Senate Banking Committee on February 20, 1986:

Question: As you know, Gramm-Rudman-Hollings calls for substantial across the board budget reductions in the event Congress fails to meet required deficit ceilings ($144 billion for the next fiscal year). Assuming Congress makes no progress on deficit reduction, and $30 to $40 billion of across the board cuts are required, what would be the effect on the economy? Would the Federal Reserve be accommodating in order to prevent dislocation and the possibility of recession?

Answer: There is no question that fiscal action of the $30 to $40 billion magnitude you cite is significant, and that--all other things equal--it would have a restraining effect in the short run on the expansion of demand for goods and services in the economy. But I must underscore that phrase "all other things equal," for the fact is that the prevailing economic environment would have a major influence on whether the effect of the fiscal restraint would be a cause for concern. However, federal spending would reduce demand on credit markets and lower interest rates; the net effect on spending would depend on the degree to which private businesses and spenders came to replace federal. Moreover, in the period ahead we may also be experiencing a stimulative effect on the economy from the drop in oil prices and in the dollar on exchange markets. Thus, the extent to which Federal Reserve policy would need to adjust to maintain satisfactory growth in the face of deficit reductions--and of course maintenance of growth along with attainment of price stability are basic objectives--would depend on other circumstances at the time spending cuts were being put in place. In that context, the prospect of deficit reduction itself yields the positive result of helping to relieve the stresses and imbalances that have continued to plague our economy and represent a threat to the continuity of expansion.

Question: Oil prices have fallen substantially in recent weeks. Obviously, many regional banks hold large percentages of their portfolio in energy-related assets. Without mentioning any particular institution, at what level would prices have to fall before the Fed becomes concerned about a large bank holding company failing? If Congress provides assistance for banks with large concentrations of agriculture-related loans, should Congress also consider applying similar aid to institutions with a commitment to energy projects?

Answer: The recent fall in energy prices has obviously placed additional pressures on borrowers whose income is derived from the exploration and production of oil and gas and on borrowers who provide services in support of these activities. This, in turn, has no doubt had adverse repercussions on the loan portfolios of banking organizations with exposure to the oil and gas industry.

While the general direction of these effects are beyond dispute, the impacts on particular institutions will vary depending on a number of factors. These include the quality of an institution's energy loans and of other assets in its portfolio, the volume of its earnings (or lack thereof) obtained outside the energy area, the adequacy of its capital and loan loss reserves, and the capability of its management to establish policies and practices that will enable a bank to weather a difficult situation. Another critical element that is perhaps most difficult to gauge is how these factors will be perceived by financial market participants, a consideration of obvious importance for banks that must depend on market confidence for their funding.

The Federal Reserve is currently conducting--on behalf of ourselves, the FDIC and the OCC--special targeted inspections of large bank holding companies with significant energy exposure. I do not believe at this point there is a need for financial assistance for agricultural or energy banks beyond the normal resources and policies of the Federal Reserve and the FDIC. There is, in my judgment, an urgent need to review and make more flexible certain emergency provisions of law that would facilitate, with minimal disruption, failed or failing banks. The regulatory agencies have also reviewed accounting for restructured loans and policies toward capital forbearance that can be applied to both energy and agricultural banks.

Question: Yesterday, I received a Federal Reserve press release dated February 14, 1986 which reads, in part, as follows:

> "The Federal Reserve Board and the Federal Open Market Committee today released the attached record of policy actions taken by the Federal Open Market Committee at its meeting on December 16-17, 1985."

What justification can be given for withholding such important economic data for two months? I intend to reintroduce legislation which I have proposed in the past that will require that the FOMC minutes be released in a more timely fashion. I hope that the Fed will work with Congress on this important issue.

Answer: Decisions of the FOMC about its basic monetary policy thrust for the year are made public through a report and Congressional testimony in February and July of each year shortly after the FOMC meetings at which they are made. If the FOMC alters its basic approach to policy between these regular semi-annual reports, it is typically announced immediately or with only a short time lag. The press release to which you refer contains the policy directive and record of discussion of FOMC meetings, which is not released until after the ensuing meeting. The information withheld for a time pertains not to the basic thrust of policy, but rather to decisions concerning the implementation of open market operations over the very short-run within the announced policy framework.

Early release of these decisions risks destabilizing market speculation. The instructions of the FOMC are conditional, in that reserve provision will depend on the behavior of a number of variables over coming weeks, including the expansion of the monetary aggregates, the behavior of the economy and inflation, and conditions in credit and foreign exchange markets. As participants in credit markets protect themselves against a variety of possible outcomes, trading can be affected by a conditional decision, even if never implemented, adding to volatility in securities markets. Moreover, concern about these "announcement effects" may complicate and limit the flexibility of the FOMC's decision-making process. It would force greater consideration of the effects of the words rather than the substance of a decision and would make it more difficult to adopt and implement necessarily conditional decisions. The FOMC might be driven to meeting at shorter intervals--which itself could be an added source of uncertainty in markets.

Immediate release of the directives also would tend to focus attention on the short-run tactical decisions of the FOMC, rather than on its basic policy stance. The latter, as I noted above, is announced immediately after it is decided, and, quite properly, is the subject of extensive Congressional hearings and public scrutiny. This legitimate debate about basic policy approaches could well be obscured by the increased public discussion about the short-run implementation of policy that would accompany more rapid publication of the regular meeting directive. There is little to be gained, and potentially much to be lost, by inviting attention to the continuing "tactical" implementation of monetary policy rather than basic policy directives.

Question: A monetary policy that does not encourage a rise in U.S. interest rates obviously contributes to keeping the value of the dollar down. Assuming then that the Fed is supportive of the initial efforts of the Group of Five to lower the value of the dollar do you feel multilateral policy coordination is the next step and do you feel it is possible? France has proposed an international monetary reform plan that centers around the use of exchange rate "reference zones" (or target zones). Do you agree with France that such reference zones are a logical extension of recent Group of Five decisions? Under the French proposal, domestic monetary authorities would be pressed to relinquish "some of their autonomy" in favor of International Monetary Fund oversight. The French are vague about this shift in authority--does this represent a danger to this country's ability to set its own monetary policy?

Answer: The fortunes of all countries--including the United States--are inextricably interlocked. Meaningful progress in achieving a better functioning international economy, therefore, is enhanced by international cooperation. The initiatives by the Group of Five countries to achieve a configuration of exchange-rate relationships among the major currencies more reflective of fundamental economic conditions is a good example of such a cooperative effort.

Proposals for international monetary reform that center around the use of exchange rate "reference zones" or target zones represent, I believe, attempts to foster and formalize further cooperative efforts. We ought to be willing to examine these or other possibilities for achieving greater exchange-rate stability. The effects of exchange rates on our economy are too important to be ignored in policymaking, and exchange-market developments have increasingly been taken into account in the formulation of U.S. monetary policy.

However, major countries do not appear to be prepared to commit themselves to adjust their monetary or other policies in any automatic way in response to exchange-rate movements or movements of other economic or financial variables. Moreover, one has to be skeptical of the desirability of directing policy almost exclusively toward exchange-market considerations or of having policy exclusively subservient to external objectives. Finally, from a different perspective, any procedural device to achieve greater exchange-rate stability cannot in any way substitute for disciplined and complementary domestic policies among the leading nations.

Question: In light of recent legal setbacks to the Fed, i.e., the Dimension and Bankers Trust decisions, what is the status and likely outcome of the controversial Citicorp application concerning securities activities of bank holding companies?

Answer: The Citicorp application raises a very significant issue concerning the scope of the Glass-Steagall Act and the appropriate role of bank holding companies in the securities business. The application, including the comments of a number of interested parties, is under consideration by the Board. The Board has not yet reached a final decision and therefore it would be inappropriate for me to express an opinion as to the likely outcome.

Chairman Volcker subsequently submitted the following in response to written questions from Senator Proxmire in connection with the hearing held before the Senate Banking Committee on February 20, 1986:

Question: On February 4, 1986, Mr. George J. Clark of Citibank appeared before the Banking Committee and said certain provisions of H.R. 3838, the House passed tax bill, would doom the Baker Plan if they were enacted into law. In particular he opposed the proposed foreign tax credit charges, the elimination of the bad debt reserve, and change in the deferral of foreign-earned income. The most damaging of these to the Baker Plan, he said would the "the disallowance of the foreign tax credits on cross border loans". This provision, said Mr. Clark, would slash the supply of international credit. Do you share Mr. Clark's views that the provision of H.R. 3838 noted above would be a disaster for the Baker Plan?

Answer: The terms on outstanding cross-border claims on borrowers, in Latin America in particular, now incorporate the strong presumption that (U.S. and foreign) bank creditors will be able to claim home-country tax credits for withholding taxes paid to debtor governments. An abrupt introduction, such as provided in H.R. 3838, of a limitation on the creditability of foreign withholding taxes could significantly complicate the task of arranging for bank support of the Baker Initiative. Furthermore, there is some concern about the effect of the House bill's bad debt reserve-related provision on the capital positions of U.S. banking organizations.

Question: Should banks write-off foreign loans? Many observers of the international debt situation suggest we are just kidding ourselves in pretending the amount of debt to some of the most over-burdened countries will ever be repaid. As you know, many European banks have already written down their Latin American debt. Why shouldn't the U.S. banks be forced to do the same?

If some of the debt were written off wouldn't this make it easier for the most debt burdened countries to recover and resume their normal pattern of trade with the United States?

Answer: To my knowledge, foreign banks have not written down their claims on Latin American countries in the sense of relieving the borrowing country of the obligation to pay. Foreign banks have been encouraged in various ways, often including generous tax treatment, to increase their reserves against such loans, and where appropriate U.S. banks have received similar encouragement without the assistance of favorable tax treatment. If, however, some of the debt were written off, I would doubt that the capacity of the borrowing countries to recover and increase their imports from the United States would be enhanced by that action alone. For one thing, I would be doubtful that the country had taken the internal measures necessary to restore growth and stability. For another, banks would be hesitant to finance the country's trade if they would risk similar write offs in the future.

Question: Target zones for currencies. Recently, there has been some discussion about establishing target zones or reference zones for our major currencies. Each government would be expected to intervene in foreign exchange markets to keep its currency within the target or zone.

What do you think about this idea? Is it something we should be moving towards?

Answer: I understand the motives of those who propose target zones or similar arrangements, and we ought to be willing to examine possibilities to achieve greater exchange-rate stability. Exchange-rate movements at times contain information about the posture and compatibility of economic policies within a country and among countries. The effects of exchange rates on our economy are too important to be ignored in policymaking. In fact, exchange-market developments have increasingly been taken into account in the formulation of U.S. monetary policy. At the same time, major countries do not appear willing to commit themselves to adjust their policies in any automatic way in response to exchange-rate movements or movements of other economic or financial variables. Finally, as I noted in the statement submitted to the Committee, any procedural device to achieve greater exchange-rate stability cannot in any way substitute for disciplined and complementary domestic policies among the leading nations.

Chairman Volcker subsequently submitted the following in response to written questions from Senator Riegle in connection with the hearing held before the Senate Banking Committee on February 20, 1986:

Question: Tax Reform as It Effects Banks. Two weeks ago several witnesses testified before the Banking Committee that the foreign tax credit provisions of the House passed bill are inconsistent with the Administration's "Baker Initiative." (The Baker Initiative is designed to encourage U.S. banks to participate in a program that would supply billions of dollars ($20 billion) of new funds to the lesser developed countries.)

The point they made is that on the one hand the Administration seems to be encouraging the banks to lend money to the lesser developed countries while on the other the House passed bill is taking away their foreign tax credits which will make the lending significantly more difficult.

What is your position on the foreign tax credit provisions in H.R. 3838 and on the loan loss provisions of that legislation?

Answer: The terms on outstanding cross-border claims on borrowers, in Latin America in particular, now incorporate the strong presumption that (U.S. and foreign) bank creditors will be able to claim home-country tax credits for withholding taxes paid to debtor governments. An abrupt introduction, such as provided in H.R. 3838, of a limitation on the creditability of foreign withholding taxes could significantly complicate the task of arranging for bank support of the Baker Initiative. Furthermore, there may be some concern about the effect of the House bill's bad debt reserve-related provision on the capital positions of U.S. banking organizations.

Question: State of the Union. In his State of the Union message the President directed Treasury Secretary Baker "to determine if the nations of the world should convene to discuss the role and relationship of our currencies." In so doing, the President seemed to hint that proposals to change the monetary system could follow.

What changes if any, do you think should be made to our international monetary system?

Answer: As I have noted in the statement that I submitted to the Committee, I welcome the call by President Reagan to consider what steps might be desirable to achieve and maintain greater exchange-rate stability. We have had enough experience with the distorting effects of extreme exchange-rate volatility to justify a reexamination of the functioning of the international monetary system. I share the concern about the operation of the international monetary system, but one should not underestimate the complexity of the task of achieving intellectual and operational consensus about modifying the current international monetary arrangements. While I do not have a blueprint for international monetary reform, we ought to be prepared to examine various ways to achieve greater exchange-rate stability.

Question: Japan. After conquering large segments of the world market for manufactured goods, it is my understanding that the Japanese now are on their way to being the world's bankers. I am referring to the fact that for the first time, the share of the international banking business held by Japanese banks has "clearly exceeded" the portion held by U.S. banks.

How do you account for this increase in Japanese international lending and what are the implications for American banks and our international competitiveness in the financial services industry.?

Do you see any possibility that Japan could become the new OPEC of the world financial system, sucking in money from abroad through its powerful export industries and spending even less abroad because of falling oil prices?

Answer: As long as Japan records large current account deficits it will accumulate net claims on the rest of the world. However, these claims need not be accumulated through banking channels.

The Bank of International Settlements (BIS) publishes data on the international business of banks according to nationality of ownership. Data for September 1985 show that the share (26 percent) of Japanese banks in total gross international loans for the first time exceeded that of the U.S. banks (23 percent). However, these data may be distorted somewhat by the relatively greater reliance by Japanese banks on conventional lending operations rather than on the use of other forms of financial services.

An alternative measure of the role of national banking systems in international markets constructed by the BIS shows that, on a net basis, at end-September 1985, U.S. banks ($35 billion) remain larger net suppliers of funds in international banking markets than Japanese banks ($18 billion). In fact over the first three quarters of 1985, Japanese banks reported an overall reduction in their net creditor positions. These net creditor data suggest that Japanese banks have not been the primary channel through which the large Japanese current account surpluses over recent years have been invested abroad.

Question: Japan's Challenge in the Euromarkets. It is my understanding that the Japanese stature and presence in the Euromarkets has been expanding dramatically. For example, last year 8 Japanese securities houses and banks ranked among the top 50 underwriters of Eurobond issues, playing the lead role in offerings that $15 billion. In 1984, by contrast, 6 Japanese firms ranked in the top 50, accounting for new Eurobond issues of $6.4 billion.

How do you account for Japan's success and increasing expansion in the Euromarkets?

Answer: The financial counterpart to Japan's larger current account surpluses has been very sizable accumulations of foreign bond portfolios, particularly U.S. Treasury and corporate securities. These financial stockpiles have been purchased by Japanese institutional investors and Japanese corporations through Japanese investment banks.

The expansion of the role of Japanese firms in the Euromarkets largely reflects their placing power with Japanese investors. However, the building of capabilities to service sophisticated Japanese customers has also been viewed by these financial firms as the basis for establishing new international relationships. For example, Japanese financial firms have exploited their placing capabilities by offering attractive financing packages to U.S. corporate issuers of yen-denominated securities. In this way, they have facilitated the financing of our current account deficit.

Question: Mexico. Last week Mexican financial officials told creditor banks in New York that it will need to borrow about $9 billion this year to keep its economy afloat as a result of the recent steep decline in oil prices. That is more than twice what Mexico told bankers it would need in December.

Are the Federal Reserve Board and the Administration planning -- or in the process of mounting -- another emergency financial rescue package similar to the one it spearheaded in 1982, when Mexico nearly defaulted on its foreign debt?

Is it true that without additional assistance Mexico is likely to run out of cash in the weeks ahead?

Where do you expect them to get the $9 billion from?

Answer: While Mexico's current cash balances are larger currently than they were in 1982, the recent sharp oil price decline is adding to Mexico's debt servicing difficulties. However, the situation in Mexico is fluid. The $9 billion figure that has been cited as Mexico's financial needs for this year may well be too high. It depends critically on the price of oil and the volume of oil that Mexico will sell this year. Another important consideration in assessing the prospects for Mexico is the nature of the internal response by Mexico to the new challenges facing the Mexican economy. In recent bilateral discussions with Mexican officials, U.S. officials were impressed by the constructive manner Mexican officials were addressing Mexico's economic problems, and U.S. officials have expressed their willingness to assist in finding appropriate solutions to Mexico's financial problems. With effective internal efforts by Mexico, I am confident that Mexico's external needs could be met by the international banking community and the multilateral financial organizations.

Question: Plunge in Oil Prices. It is generally believed that the plunge in oil prices is likely to bring on a recession in such states as Texas, Oklahoma and Louisiana and poses a serious threat to many banks -- large and small -- in that area.

What can you tell us about the safety and soundness of the banking industry in those areas?

Answer: Falling oil prices are causing concern about the strength of economic conditions and the fiscal health of certain states, such as Texas, Oklahoma and Louisiana, whose economic growth is relatively dependent on energy prices and production. At the same time, to the extent that banks in these states hold relatively more loans to firms engaged in oil exploration, development, production and distribution than banks in other states, falling oil prices have weakened the loan portfolios of these banks.

Lower oil prices reduce the current value of production flows and proven reserves which serve as the collateral for many energy loans, and strain the cash flow of many oil companies which have borrowed from banks in these states. In response, bankers have taken steps to bolster capital and reserves. The data on the attached sheet indicate that, overall, banks in Texas, Oklahoma and Louisiana generally have higher capital ratios and reserves than banks in the rest of the country. It is clearly prudent to strengthen capital and reserves when net loan losses and levels of nonperforming loans are rising, as they have been for banks in these states, and for banks in general, over the past few years.

While these steps are positive, they do have costs. By strengthening loan loss reserves, banks must take a direct charge against current earnings. As a result, performance ratios have declined. For example, for banks in Texas, Oklahoma and Louisiana, profitability (expressed as return on average assets) has declined since 1982.

In addition to these steps taken with respect to existing loans, bankers in these states have begun to establish more conservative lending policies and practices to better control future risk. For example, bankers are less likely to make loans secured by drilling equipment and would be more likely to rely on proven producing reserves.

The Federal Reserve is also taking steps to better evaluate and control risks in energy lending by, among other things, increasing the frequency of bank examinations and holding company inspections, promoting more direct communication with member bank and holding company directors, and issuing stronger capital guidelines.

UNIFORM BANK PERFORMANCE DATA
PEER GROUP DATA
Insured Commercial Banks in U.S.

	09/30/85	09/30/84	12/31/84	12/31/83	12/31/82
Number of Banks in U.S.	14,452	14,476	14,483	14,469	14,455
Number of Banks in Texas	1,917	1,832	1,853	1,727	1,598
Number of Banks in Oklahoma	535	534	538	525	509
Number of Banks in Louisiana	301	296	302	286	278
Net Income to Average Assets (%)					
U.S.	1.06	1.10	0.95	1.02	1.10
Texas	0.89	1.13	0.93	1.10	1.41
Oklahoma	0.92	1.00	0.71	1.02	1.41
Louisiana	0.93	1.17	0.84	1.11	1.26
Net Loan Losses to Average Total Loans and Leases (%)					
U.S.	0.74	0.50	0.76	0.65	0.57
Texas	0.79	0.63	0.89	0.80	0.62
Oklahoma	1.56	1.17	1.46	1.48	0.92
Louisiana	0.94	0.59	1.02	0.78	0.72
Loss Reserve to Total Loans and Leases (%)					
U.S.	1.21	1.05	1.09	1.03	1.00
Texas	1.26	1.07	1.10	1.02	0.99
Oklahoma	1.53	1.22	1.31	1.10	0.88
Louisiana	1.24	1.10	1.11	1.13	1.06
Nonperforming Loans and Leases to Total Loans and Leases (%)					
U.S.	2.92	2.46	2.45	2.30	2.27
Texas	2.35	1.64	1.74	1.56	N.A.
Oklahoma	4.47	3.46	3.60	2.94	N.A.
Louisiana	4.90	3.33	3.54	3.22	N.A.
Primary Capital to Average Assets (%)					
U.S.	9.44	9.37	9.17	9.05	9.03
Texas	9.39	9.36	9.16	9.01	9.17
Oklahoma	9.62	9.49	9.20	9.18	8.93
Louisiana	9.90	9.73	9.26	9.22	9.06

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

Statement

of

Beryl W. Sprinkel
Chairman
Council of Economic Advisers

Submitted for the Record

to the

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

Thursday, February 20, 1986

Chairman Garn, Senator Proxmire, distinguished Members of the Committee, I am pleased to have the opportunity to submit for the record this statement of the Administration's views on monetary policy.

Long-Term Objectives

The Administration's long-term objective for monetary policy continues to be a gradual reduction in the inflation rate until price stability is firmly established. While inflation has moderated significantly in recent years, current inflation rates of 3 to 4 percent do not constitute price stability. It would be a serious mistake to accept such inflation as satisfactory. Since most of the costs of reducing inflation have already been borne, it would be unfortunate to allow inflation to reaccelerate thereby necessitating yet another costly inflation-reducing episode in the future.

The objective of price stability can best be achieved by a gradual and predictable reduction in monetary growth. Chairman Volcker and other Federal Reserve officials have on many occasions reaffirmed their intentions to gradually reduce monetary growth in order to foster price stability. The Administration fully supports this policy. In considering growth targets for the M1 aggregate, the Administration recognizes that some uncertainty exists as to the relationship between M1 and nominal GNP. In particular, it is evident that M1 velocity has slowed from its postwar historical trend. Decreases in both inflation and interest rates are partly responsible for this decline. It is also likely that financial deregulation, by allowing interest-bearing checking accounts to be included in M1, may have contributed to this change. Since these accounts may function partially as savings, individuals may hold larger M1 balances on average thereby altering velocity growth. Accordingly, M1 growth somewhat higher than would otherwise be the case may be acceptable. Nonetheless, it is difficult to justify an indefinite continuation of the rapid M1 growth that occurred in 1985. Given the lessons we have all learned about the pernicious consequences of inflation, some slowdown in monetary growth is called for in the period ahead. Yet the slowdown should not be abrupt, since such action would likely disrupt real economic activity in the near-term. Accordingly, a gradual steady deceleration of monetary growth seems most appropriate at this time.

Despite the recent slowdown in the growth of velocity, the evidence to date is insufficient to determine precisely the nature and extent of any permanent change in velocity growth. Nevertheless, the growth rate of M1 remains one of the most reliable indicators of the stance of monetary policy. Given the well-known inadequacies of variables commonly suggested as alternatives to M1, the Administration urges the continued targeting of M1 as a primary intermediate target of monetary policy.

Near-Term Concerns of Monetary Policy

Recently, some have expressed concern about three issues confronting monetary policy in the near term: (a) Gramm-Rudman-Hollings (GRH) deficit reduction actions, (b) oil prices declines, and (c) agreements made among the G-5 members to influence exchange rates and external imbalances.

The scheduled reductions in Federal budget deficits as mandated by GRH have prompted some to suggest that reducing government spending to meet the deficit targets of GRH may bring about a recession. As a consequence, an offsetting easing of monetary policy is often recommended.

Fears that reductions in government spending will cause an economic slowdown are unjustified for several reasons. First, GRH targets can be met primarily by holding down the growth of real government spending rather than cutting its level. In fact, the only significant cut in real government spending is equivalent to about 0.5 percent of real GNP and occurs in fiscal year 1987. Six times in the past 35 years real spending cuts of this approximate relative magnitude have been made without evidence that they led to recession. Secondly, the required spendingcuts will occur at a time when economic activity is likely to be relatively strong. Thirdly, as long as the Federal Reserve maintains steady, predictable monetary growth, no serious or protracted macroeconomic disturbances should be expected from reducing the budget deficit. Accordingly, an easing of monetary policy does not appear necessary in order to offset scheduled reductions in budget deficits.

A second concern that some believe calls for a monetary policy response is the recent dramatic decline in oil prices. Specifically, it has been argued that the Federal Reserve should ease policy because the oil price decline lessens inflationary pressures and therefore provides leeway for the central bank to promote increased economic activity. Moreover, it is argued that lower interest rates will soothe heightened concerns about the fragility of certain financial institutions with sizable exposure to the energy sector.

These arguments are misleading for several reasons. First, the decline in oil prices is a decline in a relative price. As such it is a market signal indicating that current oil supply exceeds demand. An easing of monetary policy would obfuscate that market signal and thereby inhibit the functioning of market clearing forces.

Secondly, while the decline in the relative price of oil will have some distributional impacts on consumers and producers of oil, it is not expected to have significant effects on aggregate nominal economic activity as measured by nominal GNP. Nonetheless, the oil price decline should prove favorable to the real GNP/inflation mix in 1986 and perhaps somewhat longer. In particular, oil price declines will foster increased real GNP growth and lowered measured inflation in the near-term. Since other factors already at work should be providing the impetus for healthy economic growth, additional monetary stimulus is neither required nor desired.

The impact of falling oil prices on measured inflation, it should be noted however, is a one-time improvement. The Federal Reserve can take advantage of this temporary, one-time fall in prices to promote a steady deceleration in monetary growth and thereby improve the prospects that inflation and expectations of inflation will be completely eliminated and price stability firmly established.

Third, easing monetary policy is not the appropriate response to the problems of financial institutions heavily exposed to the energy sector. An expansionary policy for this purpose would only increase the risks of higher future inflation and create incentives for financial institutions to assume more risk, thereby increasing the likelihood of difficulties in the future. As long as the Federal Reserve serves as the lender of the last resort to the market and thereby prevents credit problems in some institutions from becoming systemic, monetary control as well as the soundness of the financial system will be ensured.

The G-5 Agreement

It is important to understand the relationship between the G-5 agreement in September 1985 and monetary policy. The G-5 agreement was not simply an agreement to intervene cooperatively to force down the value of the dollar. It was a recognition that the excess of domestic investment over domestic saving (i.e., the current account deficit) in the United States is mirrored by the opposite condition in the rest of the world. Consequently, the agreement recognized that policy changes across countries, not just in the United States, are essential to correct external imbalances. The agreement specified that policies designed to achieve increased convergence of economic performance, especially sustained, noninflationary growth, were the responsibility of all participants. In this regard, the United States reaffirmed its commitment to decrease the Federal government's claim on domestic spending by reducing government spending as a share of GNP, thereby reducing the budget deficit. The remaining four countries, in general, committed themselves to policies that promote increased internally-generated economic growth thereby providing increased demand for their own output as well as for U.S. exports. While the group noted and agreed that a realignment of exchange rates should play a role in resolving external imbalances, such a realignment cannot be sustained unless policies are pursued to generate more balanced economic growth. The participants in the agreement realized that exchange rate manipulation alone was not an appropriate long-term strategy to redress external imbalances.

It is not clear exactly what affect the G-5 agreement and intervention carried out under that agreement have had on the foreign exchange value of the U.S. dollar. Even though the dollar has depreciated on a trade-weighted basis by more than 14 percent since the agreement, its fall began in late February 1985, as it depreciated by more than 15 percent during the seven months preceding the agreement. Consequently, it is difficult to ascertain how much of the depreciation subsequent to the agreement may be a continuation of the process in progress at the time of the agreement and how much has been due to intervention since the agreement.

The impact of intervention and the sustainability of its impact depend critically upon whether the intervention is sterilized or unsterilized. Many researchers, including the working group on exchange market intervention established at the Versailles Summit, have concluded that sterilized intervention (intervention that does not affect domestic money supplies) has little, if any, long-run effect on nominal and, more importantly for affecting trade flows, real exchange rates. Unsterilized intervention (intervention that does affect domestic money supplies) is tantamount to conducting monetary policy in foreign exchange markets. Such intervention can affect the long-run behavior of nominal exchange rates, and perhaps also the shorter-run behavior of real exchange rates. Commitment of monetary policy to the control of exchange rates, however, interferes with its use for other important policy objectives -- most importantly, achieving price stability and avoiding money-induced fluctuations in domestic real economic activity. It appears that the Japanese economy may now be experiencing some of the contractionary effects of the tightening of monetary policy that was associated with the Bank of Japan's efforts to strengthen the yen. On the other hand, if the U.S. Federal Reserve attempted to force down the value of the dollar with unsterilized intervention, domestic money growth would increase, rekindling inflationary pressures.

In sum, the concerns relating to (a) Gramm-Rudman-Hollings, (b) oil price declines, or (c) the G-5, should not cause the monetary authority to deviate from the policy supported by this Administration; namely, that of gradually and predictably decelerating monetary growth from the rapid expansion experienced in 1985.

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The Current Status of Monetary Policy

Prepared for the
Committee on Banking, Housing and Urban Affairs
United States Senate

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The Current Status of Monetary Policy

Introduction

This commentary discusses background for setting money growth targets. A broad range of 5 to 12 percent is suggested for M1 in view of unstable M1 demand. A 6 to 9 percent range is suggested for M2. Also discussed are implications for monetary policy of tighter fiscal policy, lower oil prices, and international economic conditions. Some questions for Mr. Volcker are proposed.

The objective of an accommodative monetary policy should be to keep the money supply at a level equal, as nearly as possible, to the quantity of money demanded. Over time that objective requires money supply growth equal to projected growth of money demand.

Money demand grows at a rate equal to the growth rate of nominal GNP less the growth rate of velocity. The growth rate of velocity measures reduction in the growth of money demand relative to national income (GNP).

Setting Money Growth Targets

Any discussion of the current status of monetary policy must be made conditional on the behavior of velocity or equivalently, on the behavior of money demand which has been highly volatile during the past year. During 1985 the economy grew in current dollar terms at about 6 percent. During that same period the growth rate of the narrowest money aggregate, M1, was about 12 percent. Velocity fell at 6 percent over the year, one of the most rapid drops ever experienced. In effect, there was a sharp increase in the demand for money that probably was linked to a drop in long-run inflationary expectations. We have come through a year during which the Federal Reserve has done a remarkably good job of accommodating a shift in money demand that was not, and in general could not, have been predicted. Where we go from here depends on prospects for the behavior of money demand in 1986 and upon the Fed's ability to anticipate its behavior.

Beyond a drop in inflationary expectations, some suggest that the sharp drop in M1 velocity is a reflection of financial innovation. The result of such innovation has been to make the checkable deposits component of M1 more like a saving deposit or a traditional component of M2. Therefore, part of the shift in the demand for M1 reflects a change in the nature of M1. Indeed M2, which includes M1 plus overnight repos, Eurodollars and other deposits, grew at the top of the range set last February for 1985. Still, M2 velocity declined at about 3 percent during 1985, a significant departure from typical postwar behavior.

An important thing to bear in mind in looking ahead and setting money growth targets is the temporary, if unpredictable, effect of changes in inflationary expectations and financial innovations on the demand for M1 and M2. Once the adjustment to lower inflationary expectations has resulted in a larger stock of money in the hands of the public, the negative effect on velocity growth will disappear. Likewise, once the effect of financial innovation on holdings of M1 has been completed, the effect of that shift on M1 velocity will also disappear. The overall implication is that, barring another sharp drop in inflationary expectations, at some time in the next year or two, velocity growth may revert back toward its postwar trend level of 3 percent. In the case of M1 velocity, such a shift would represent a massive swing from -6 percent growth to a +3 percent growth per year. If such a swing occurred during 1986, zero M1 growth would be sufficient to accommodate nominal growth of 9 percent, or a combination of 4 percent in real growth and 5 percent inflation.

The most important challenge facing monetary policy today is to avoid having the intended character of monetary policy sharply altered by a sudden move in velocity growth back toward positive postwar trend levels. In the intermediate-run period of a calendar year, this requires the Federal Reserve to monitor interest rates adjusted for inflation. For example, if in the absence of a sharp drop in inflationary expectations the federal funds rate were to fall sharply over a quarter, indicating a drop in real interest rates, the result would be consistent with an unpredicted drop in money demand or, equivalently, with a rise in the growth rate of velocity. Such events would call for a slowdown in money growth rates or a reversal of last July's upward rebasing of the M1 growth targets. A good clue to whether nominal interest rate movements are reflecting real interest rate movements is to watch the behavior of exchange rates. If nominal interest rates fall while the dollar weakens, it is likely that the drop in nominal rates is largely accounted for by a drop in the real interest rate. If a drop in nominal rates is accompanied by a stable or strengthening dollar, it is likely that the drop in nominal rates is reflecting a drop in inflationary expectations.

The recent sharp drop in the dollar against major foreign currencies--the drop against the yen over the past six months has been about 20 percent--suggests that the coincident fall in interest rates has signaled a drop in real interest rates rather than a further drop in inflationary expectations. These events may presage a beginning of the return of velocity growth to higher levels and therefore suggest setting money growth targets below recently realized actual growth rates.

In view of the high level of uncertainty regarding behavior velocity over 1986, the range of money growth targets should be wide. Retaining an M2 growth target of 6 to 9 percent seems appropriate. The M1 growth target should be 5 to 12 percent in recognition of the highly volatile behavior of M1 velocity.

Impact of Fiscal Policy (Gramm-Rudman-Hollings) on Monetary Policy

A target of a zero fiscal deficit for 1991, whether it is accomplished by the Gramm-Rudman-Hollings Act or by other means, sets fiscal policy on a rigid, contractionary path. The cut in spending necessary to achieve the Gramm-Rudman target for fiscal 1987 will be between 1.5 and 2 percent of GNP, depending on the baseline from which it is assumed the cuts are made. In any case, the implication is that fiscal policy moves from an expansionary path that it has followed since 1981 to a contractionary path.

Some contraction of fiscal policy will likely have a favorable effect on the economy. An anticipated reduction in fiscal deficits and thereby in federal government demands on the credit markets should ease pressure on interest rates, particularly on real interest rates, and result in some further depreciation of the dollar. These effects will stimulate investment demand and demand for American tradable goods as an offset to the reduction in demand resulting from a slower growth path for federal spending. In my judgment cuts in federal spending and deficits at about half the rate envisioned by Gramm-Rudman would be sufficient to achieve a ratio of debt to GNP that is stable but also reduces the pressure on real interest rates. Cuts at twice that level such as are envisioned under Gramm-Rudman are likely to produce a net reduction in aggregate demand that is greater than can be accommodated by monetary policy or eased with lower real interest rates or dollar depreciation.

The suggestion that monetary policy can accommodate a tighter fiscal policy in principle has some validity, but its execution is far from simple. As noted above, the unpredictable behavior of velocity makes monetary policy an unreliable instrument at best. To place heavy demands on it, i.e., offsetting contractionary fiscal policy, may be asking too much.

In effect, monetary policy has already eased as suggested by the falling dollar and the pick-up in economic activity that began late in the fourth quarter and appears to be carrying through the first quarter of 1986. If these events signal a combination of continued rapid money growth and a higher rate of velocity growth, further easing in the form of setting higher growth rates for M1 and M2 could precipitate a sharp increase in inflation or inflationary expectations which would be signaled by a further, perhaps sharp, drop in the dollar against other currencies.

To say that the contraction of fiscal policy under Gramm-Rudman requires an accommodating monetary policy is really to assume away a very delicate problem in policy coordination. Little reliable information about the timing of the effects on major economic variables of a tighter fiscal policy and/or an easier monetary policy is known. Humility and caution are the key watchwords that should guide macroeconomic policy over the coming year.

The Effect of Recent Declines in the Price of Oil on Monetary Policy

The recent 40 percent drop in oil prices is a plus for the economy overall. Its effect on inflation, however saluatory, is temporary as is the reverse effect of a weaker dollar. The most that can be expected from lower oil prices is a slight increase in manoeuvering room for the Federal Reserve. The effect on the path of inflation expected in the United States has been largely offset by a weaker dollar.

Looking ahead, one finds that the situation confronting monetary policy is a delicate one. If money growth is set too high, especially given a resumption of velocity growth, dollar depreciation will outstrip and eventually erase most of the positive effect on inflation from lower oil prices. The result could even be some reversal in the decline of oil prices. A good rule of thumb would be to suggest that lower oil prices and a weaker dollar just about offset each other in terms of their effect on U.S. inflation. In other words, monetary policy should be set as if neither had occurred since their net effect is roughly 0.

The Impact of International Developments on U.S. Monetary Policy

With a rigid contractionary fiscal policy in place under Gramm-Rudman-Hollings or a similar constraint, a move toward pegging exchange rates or exchange rate target zones would sharply curtail the ability to use discretionary monetary policy at a time when some heavy demands might be placed on that instrument. Exchange rate targets require that money growth targets be coordinated among major industrial countries. In a formal sense a rigid fiscal policy and rigid exchange rate targets require a passive monetary policy. The quantity of money must be whatever is necessary to validate a set of predetermined exchange rate targets.

A concrete example illustrates this point. Suppose that in 1986 exchange rates are fixed at current levels. Suppose also that Germany and Japan decide to keep inflation low and set money growth targets consistent with 2 percent inflation. If the United States were committed to the exchange rate targets and to the contractionary fiscal policy, that combination would force the Federal Reserve to set money growth targets low enough to validate the exchange rate while inflation was very low in Germany and Japan. The upshot could be that the maximum growth rate for money would be well below the level required to accommodate a nominal GNP growth rate of 8 percent.

A return to fixed exchange rates or target zones constitutes another policy experiment. Such an experiment would be unadvisable for the United States to undertake at a time when a particularly delicate move to readjusting its own policy mix toward a tighter fiscal stable money configuration is underway.

Summary

An unusually high level of uncertainty colors all economic policy setting in 1986. The American economy has passed through uncharted waters over the past five years. An expansion with rising deficits, falling interest rates, and stable or falling prices is not a typical postwar experience. The degree of precision regarding the effects of changing the policy mix between monetary and fiscal measures is not high enough to simply design with confidence an accommodating path for monetary policy in the face of a rigid contractionary fiscal policy such as is implied by the Gramm-Rudman-Hollings bill.

International economic problems add to the uncertainty faced on the domestic front. A drop in the price of oil means that Mexico and other debtor countries will be unable to service debts owed to banks in the United States and other industrial countries without a significant increase in new capital inflows. It may be decided that such inflows provide negative reinforcement for bad lending and borrowing policies, but if that is the case, steps will have to be taken to protect the depositors of some major American banks. Such steps usually involve infusions of new capital and a break-up of affected banks into pieces to be purchased by other financial institutions. Given the state of the American financial system and its difficulties with energy, agriculture, and real estate loans, we may have to decide whether foreign banks, particularly Japanese banks which are currently and aggressively seeking a foothold in the American banking system, will be allowed to purchase pieces of failed American financial institutions.

Statement on Monetary Policy
Prepared for
United States Senate
Committee on Banking, Housing, and Urban Affairs
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Some General Points About Objectives and Targets of Monetary Policy

Although inflation has stabilized at an annual rate of about 3.5% to 4% during the past four years, there is no assurance that inflation will decline in the future. To the contrary, we believe that the extraordinarily high rate of monetary expansion in 1985 and the decline of the dollar on foreign exchange markets raise a serious risk that inflation will reaccelerate later in 1986 and 1987.

As Chairman Volcker suggested in his recent testimony, an inflation rate of 3.5% to 4% would not be satisfactory as a long-run goal in any case. The U.S. economy has done much better than that at times in the past and can do better in the future. Furthermore, without the favorable effects of a strong dollar and falling oil prices, inflation would have been considerably higher. We believe that inflation will remain moderate for most of this year, but prices will be rising more rapidly before the end of the year.

An increase in inflation from its current level could impose severe costs on the U.S. and world economies. Therefore, we believe it is essential that the Federal Reserve System begin at once to pursue policies designed not only to avoid a reacceleration of inflation from its recent 3.5%-4% rate, but to bring inflation down to zero within the next four or five years.

To meet this goal will require gradually reducing the rate of money growth, and making it clear that the Federal Reserve will persevere on a long-run course toward price stability. Frequent large departures from announced monetary targets and reversals of direction, such as those seen in recent years, damage the credibility of the monetary authorities, increase uncertainty in financial markets, and increase the costs of reducing inflation.

Implications of Gramm-Rudman-Hollings for Monetary Policy

Reducing the deficit would be highly desirable, if it were to be done by reducing growth of expenditures. The amount of expenditure reduction that is likely to be achieved through Grammn-Rudman-Hollings, or through any other means, would not endanger the growth of economic activity and employment in any way.

Any reduction in growth of total national employment and output that might result from a reduction in federal expenditures would be more than made up by increases of employment and output in the private sector within a year. Therefore, it would be neither necessary nor desirable for the Federal Reserve to cushion the effects of deficit reduction through an easing of monetary policy. In fact, any attempts by the Federal Reserve to offset allegedly depressing effects of deficit reduction or Federal expenditure cuts in the short run would be inflationary in the longer run.

The idea that changes in the mix of fiscal and monetary policies can be used to stimulate growth and to control inflation is a myth. There simply is no way to substitute restrictive fiscal policies for expansive monetary policies or vice versa.

The Congress need not fear that it will cut total federal expenditures too much. However, it must be concerned about which programs it decides to cut or to expand. The most useful contribution the Federal Reserve System could make to solving this difficult problem in allocating national resources would be a stable, predictable policy of gradually reducing growth of the money supply until inflation is reduced to zero.

Implications of Lower Oil Prices for Monetary Policy

Although lower oil prices will reduce income and employment in some oil-producing regions of the country and may aggravate credit-quality problems in some banks, their effects on the total economy will be highly beneficial. Lower oil prices will enable many businesses to reduce their production costs and will free up some income for consumers to spend on other goods and services. However, lower oil prices will not reduce the danger of inflation in the future; they do not mean that the Federal Reserve will now be able to follow a more expansive monetary policy than it would have if oil prices were higher.

Energy commodities (gasoline and fuel oil) comprise only 7% of the consumer price index; electricity and natural gas account for another share of less than 5%. In addition, oil prices will not continue to fall indefinitely; their major dampening effect on inflation is likely to be short-lived.

Implications of the G-5 Agreement to Seek an "Orderly Appreciation of the Main Non-Dollar Currencies Against the Dollar"

In his testimony before the House Banking Committee on March 19, Chairman Volcker warned against the dangers of deliberately depressing the dollar on exchange markets. We agree with him that trying to depreciate the dollar through monetary policy would conflict with the System's objective of reducing inflation.

If the Federal Reserve were to try to reduce the exchange value of the dollar through direct intervention in exchange markets the end result would clearly be more inflation in the United States than we would otherwise have. Direct, unsterilized intervention through Federal Reserve purchases of other currencies would increase the supply of dollars in the world in relation to the supplies of other currencies.

The monetary authorities of a country can try to stabilize the country's domestic price level, or they can try to stabilize its exchange rate. They cannot do both at the same time. Therefore, a policy of trying to reduce the dollar's value in terms of other currencies would mean accepting a higher inflation rate in the United States. Other countries have understood this for a long time, and so they generally consider a falling exchange rate to be inflationary.

This raises the further question of what the Federal Reserve can or should do if the dollar depreciates against other currrencies (i.e, the other currencies appreciate against the dollar) for reasons other than Federal Reserve actions. With or without Federal Reserve intervention, the dollar has declined by approximately16% on a trade-weighted basis since the G-5 agreement was announced last September, and by 23% from its peak monthly average in February 1985.

Some commentators have suggested that this decline in the dollar means that the Federal Reserve now could or should reduce U.S. interest rates by cutting the discount rate or by taking other actions to achieve further reductions in the dollar exchange rate. We believe, instead, that the arguments against trying to depress the exchange rate through monetary policy apply equally as well to trying to reduce interest rates. Both policies are inflationary.

We believe that the rise of the dollar in 1983 and 1984 kept the U.S. inflation rate two percentage points or more lower in 1985 than it otherwise would have been with the monetary policies followed from 1980 through 1985. With the dollar lower on foreign exchange markets now, the moderating influence of exchange rates on U.S. inflation has ended. The Federal Reserve, therefore, must now be more vigilant against reawakening inflationary pressures, not less, than it was when the exchange rate was rising. Chairman Volcker suggested as much in his testimony on February 19.

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