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ABC NEWS

ISSUES AND ANSWERS

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Chairman of the Board of Governors
Federal Reserve

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ANNOUNCER: From New York City, ABC News brings you ISSUES AND ANSWERS.

MR. DONALDSON: Paul Volcker, the Chairman of the Federal Reserve Board, the man in charge of the tight money policy. Interest rates are high and consumer prices are soaring. New housing constructions are down 17 percent. Mortgage rates are up to a staggering 17 percent. Thousands of automobile dealers have closed down and 150,000 automobile workers are out of work. Eighty percent of the savings and loan associations are operating in the red and many are in danger of failing.

Along with the bad news about climbing consumer prices, the stock market has fallen more than a hundred points in two months. The issue is, how long can the United States suffer high interest rates in the name of fighting inflation without sliding into a recession?

I'm Sam Donaldson, ABC News Chief White House Correspondent, and with me is ABC News Economics Editor Dan Cordtz. We'll be back with our interview with Chairman of the Federal Reserve Board Paul Volcker after this message.

(Announcements)

MR. DONALDSON: Our guest is Chairman of the Federal Reserve Board Paul Volcker. Welcome Mr. Volcker and let me begin by saying that President Reagan last week said that high interest rates are hurting his administration and what he is trying to do with the economy as much as it is hurting everyone else. Your Board is responsible, to a great extent, by keeping money tight for those

high interest rates. So my question is, are you going to let up or are you going to keep it up?

MR. VOLCKER: Well, first of all, I would not say that we are responsible for the high interest rates. In a fundamental sense, inflation is responsible for the high interest rates. We have, as you well know, a very difficult problem in this country. We, for the first time in our history, really, have had an inflation that has persisted over a decade. The longer people have come to expect that inflation, among other things, lenders and borrowers have come to expect the inflation, so they go ahead and borrow a lot of money, lenders want to get a fair return on their money, and you have a problem, a very real problem, in the market of high interest rates.

Among other things, the United States Government itself is preempting a lot of that credit that's available, through big budgetary deficits. So we have a culmination here of a good many problems that have been developing over a good many years and we are not going to deal with that interest rate problem, in my opinion, without dealing with the inflation. And, of course, that's what we are trying to do.

We are restraining the supply of money and credit. There's a lot of demand for money and credit. At the moment that means high interest rates. But it is a symptom of the inflationary situation.

MR. DONALDSON: But the Secretary of the Treasury Donald Regan says that if you don't let up he fears we may have a very deep recession.

MR. VOLCKER: I don't think there is any disagreement here and I don't know as he expressed concern about a very deep recession. We have a policy of restraint on money and credit. We have a kind of collision in the markets between very heavy demands for money and credit and the restraint which I believe is necessary to bring the inflation rate down.

It's not a pleasant situation. It's not a happy situation. All I would claim is it is part of the process by which eventually inflation is going to be dealt with and we can see some signs of that already. We can see some more hopeful signs and fundamentally that points toward a healthier economy in the future. But we have a rough period to go through here.

MR. CORDTZ: You said there isn't any basic disagreement but there are some economists who contend that there is a sort of a basic incompatibility between Reaganomics and a tight money policy, that is, that the supply side economic approach is supposed to stimulate the economy whereas you at the Fed are involved in trying to dampen it down. What do you think about that?

MR. VOLCKER: Well, I think there is, putting the point another way, a very heavy burden on monetary policy now in terms of the inflationary situation, which is fundamental. So much of the responsibility for curtailing inflation falls back on monetary policy and that gets reflected among other things and higher interest rates.

Now, you say an incompatibility in the policies. I would say that's true if we don't go ahead and do what I believe is

necessary on the spending side. We just had a big tax cut. Part of the justification of that tax cut was to put pressure, quite directly, on the Congress, the American public, to reduce expenditures, to bring expenditures down from an accelerating curve that they've been on for some time. Now the tax cut is passed, it has passed with widespread support. It will bring benefits, I think, in incentives. It will bring benefits in reducing costs, if we accept the corollary which is to keep expenditures under control.

I think that was stated at the time and it is a very large challenge, to get the expenditure side of the budget now down to match the tax receipts side.

MR. CORDTZ: Is it your judgment that what's been happening in the stock and bond market and financial community generally is a reflection of fears that this budget deficit has come out too high?

MR. VOLCKER: I think that is certainly part of it and that fear has tended to mount, I think, in recent weeks. More fundamentally there is all the doubt and uncertainty about whether we are really going to be successful in dealing with this inflation problem, as we must. So it is a combination of the two, I think, that account for the problems in the financial markets.

MR. DONALDSON: So what you are telling us, from your side, the monetary side, you're going to keep the screws on?

MR. VOLCKER: No question. We have to keep restraining the growth of money and credit.

MR. DONALDSON: And you are telling us, from the fiscal side, they are going to have to balance the budget in the sense of

finding deeper cuts. Now there is a study, two or three of them, that say that this fiscal '82 budget deficit will not be \$42-1/2 billion as the President forecasts. It will be closer to sixty. Do you agree?

MR. VOLCKER: Well, I think if there are no further expenditure cuts, there are no further efforts at reducing expenditures, the chances are that that deficit could be bigger. And I would not focus just on '82. The budget in the short run is affected, and importantly, by what is happening in the economy. But we have to look out beyond '82 and '83 and '84, as I think the Administration has done, and get the expenditures on a trend that is going to have a declining trend of deficits.

MR. DONALDSON: Clearly, if we are twenty billion over the forecast for '82, if it turns out that way, then the off-years of '83 and '84 have a rebound effect.

MR. VOLCKER: There's no question about it.

MR. DONALDSON: You couldn't possibly balance it by '84.

MR. VOLCKER: There is no question. We've got to get to work on that. We've already gotten to work, or the Administration has and the Congress has. They've already had, against our past history, a sizeable expenditure cut. I think what was clear all along and it is certainly clear now is that's a downpayment on the cuts that are going to be needed as we go ahead.

MR. DONALDSON: Now, Mr. Volcker, you know something about politics as well as about money. Where is President Reagan going to find more cuts? It is either going to be in the Defense budget

or it's going to be in the entitlement programs such as Social Security.

MR. VOLCKER: Well, you still have a \$700 billion budget. That's a lot of money to run the Government on. There's a lot of room for cutting. I have no expertise and a lot of political decisions appear in questions of where to cut. I find it hard to believe that there is no room for economies in the Defense program. And that's a big part of the budget. You are going to have to look beyond that. You're not going to find all the cuts there, consistent with the kind of Defense build-up the country seems to want.

MR. DONALDSON: Social Security?

MR. VOLCKER: I think you, you can't really start this process, in my opinion, by saying, I am going to exempt any large part of the budget. You've got to look at it all. Social Security is a problem of its own, in terms of just looking at the receipts and payments involved in the Social Security program, as one goes out. So I think it is pretty well known that things have to be looked at in that area. I don't suggest any particular area within Social Security, but that does have problems.

MR. CORDTZ: There have been some published suggestions, by columnists among others, that when President Reagan comes back he's going to want to take you to the wood shed and talk about monetary policy. Suppose he asks you to let up, what will you say to him?

MR. VOLCKER: Well, you know, I read some of these stories. We have communication with the Administration all the time and I

think in broad terms we've been on the same wave length in monetary policy and I think there's been a very healthy realization on the part of the Administration that restraint on money and credit is essential to their own programs, to their own expectations. So I don't see any conflict arising in that area.

MR. CORDTZ: In theory, these high interest rates are supposed to help bring down the inflation rate, but in last month's CPI, high interest rates played a rather large role in driving those numbers up still higher. Are we in a kind of a no-win situation?

MR. VOLCKER: No. I think those Consumer Price Index numbers, as many other index numbers, are subject to gyrations from month to month. I think the evidence in the past five or six months has been a little progress, a little turning the corner on inflation, which is a long ways from home, but it's a hopeful sign.

I think there are problems in the way the Consumer Price Index is calculated, the home buying area in particular. Almost all indications of home prices now show a slower rate of increase or an actual decline but in the Consumer Price Index the particular number used shows an increase.

MR. DONALDSON: Mr. Volcker, that's true, but we are in a very sluggish period in our economy, just kind of on the edge, many economists feel, of a recession, de jure type recession, as the two-quarter definition is given. Do you think we will go into a recession before we come out of this trough?

MR. VOLCKER: I think there are many more predictions of recession in the past three or four years than recessions that

have actually happened. I don't exclude the possibility. You could have a decline in the gross national product for a quarter or two. We had a decline in the second quarter. But I don't think we can conduct policy on guesses, which is all they are, about whether you may have a recession in the next quarter or two.

Most of those guesses have been wrong in the past. And our major problem is dealing with the inflation. We're going to have more recessions over a period of time and a worse economic performance. I'm not talking about 1982. I am talking about 1983, 1984, the rest of the 1980s, if we don't deal with this inflation problem.

There has been, I think, a significant correlation, unfortunately, between rising levels of inflation in the past decade and poorer economic performance.

MR. DONALDSON: Well, now, you talk about, we can't do it on guesses. Howard Baker, who is the Senate Majority Leader, a Republican, a very good, a strong supporter of President Reagan, calls Reagan economics a riverboat gamble, and many of Mr. Reagan's advisors will say approximately the same thing. Do you think it is a gamble? Do you think we are gambling with the economic future of this country?

MR. VOLCKER: Well, I suppose what he may have had in mind is the fact that, for the first time in recent years, anyway, we put in a big tax reduction.

MR. DONALDSON: And indexed it.

MR. VOLCKER: And indexed it so that it doesn't generate inflationary tax revenues in the future. That has been done, in my

opinion, and I presume in Senator Baker's opinion, without yet having in place all the expenditure reductions that are the complement of that tax reduction. So in that sense, I suppose it is fair to say -- I don't like to use the word "gambling" -- but we have to wait for those expenditure cuts. We have to make good on the implicit pledge that the expenditure cuts will come in.

MR. DONALDSON: When you and Dan referred to that a moment ago, is that why Wall Street isn't backing the Reagan program?

MR. VOLCKER: I think it is one -- I don't know whether I would phrase it or not "backing the program" -- I think there are doubts on that score.

MR. DONALDSON: Well, how much longer will these doubts persist? Will the stock market just keep going down?

MR. VOLCKER: I think after years of disappointment, disappointment in pledges to balance the budget, after years of disappointment and hoping that inflation would come down and seeing programs to bring inflation down, they didn't see that happen. So there's a certain natural skepticism out there and we've got to work through that skepticism. I don't happen to think that skepticism is justified but nobody's word is going to do it. They're going to have to see results over a period of time.

MR. DONALDSON: Before we take a break, let me ask one more time, will the stock market keep going down?

MR. VOLCKER: Markets never keep going down.

MR. DONALDSON: The bears and bulls trade off.

On that note, we will take a break. We'll be back in a

moment with more ISSUES AND ANSWERS.

(Announcements)

MR. DONALDSON: Our guest is Chairman of the Federal Reserve Board Paul Volcker and we resume our questioning of Mr. Volcker today with ABC Economics Editor Dan Corätz.

MR. CORDTZ: Mr. Volcker, some people have suggested that even if the Fed loosened up on the purse strings and let the money supply go that it would disillusion so many bond buyers and others that interest rates would shoot up again rather than come down. Are you in a hopeless situation here?

MR. VOLCKER: Well, I don't think it is at all hopeless. I think that situation reflects an understanding that the basic sickness, the basic ill, in the bond markets, the basic ill in the economy is inflation. So people in the bond market certainly don't welcome action that they interpret as permitting inflation to persist or increase and they would react to that adversely. I think there is an element of truth, there is an element of reality in that story.

MR. CORDTZ: Well, at the moment, lenders are demanding and getting a premium over and above the inflation rate that is absolutely unprecedented. How do you explain that?

MR. VOLCKER: Well, it's not unprecedented. If you go back into history, over long periods of history, you will find other periods of high real interest rates of this sort. And of course we have never had, looking at the whole sweep of history, such high tax rates that impinge upon the reality of these interest rates.

When you can deduct it from your tax payments or from your income in calculating your tax, that takes the bite out of the interest rate for a good many people and lowers the effective rate. But I think the high, relatively high real interest rate is unusual in one respect. Usually when we have inflation, in the past, real interest rates have been low. I think that reflects the fact that people have not expected the inflation to persist.

We have never had, in our history, a peacetime inflation of this sort that people expected to persist. It took them a long time to become convinced that inflation was going to continue. Now, I think they may be exaggerating the persistence of inflation, but that undoubtedly is on a lot of people's minds. So they want to protect themselves and they want to protect themselves when they lend money.

On the other hand, the borrower is apparently willing to pay the high rates, in many instances, because he has the illusion that he can pay it back in cheap dollars.

MR. CORDTZ: There have been some critics who suggested that the Fed simply hasn't been able to hold down the money supply the way it presumably wants to, that the fluctuations have been up and down and that you have't been able to stick to a target. Is there any validity in that?

MR. VOLCKER: Well, you've got a lot of fluctuations in the money supply figure on a week-to-week basis. You have about a half a trillion dollars a day of payments made in dollars around the world and all of that goes through somebody's bank account and I

think it's a little too much to expect that that money supply figure, which reflects all those bank accounts, is going to be stable on a week-to-week basis. We've had some fluctuations recently.

The trend has been quite moderate this year. I brought along a little chart if you'd like to look at it. This red line shows the week-to-week fluctuations which have been quite marked, as you can see, in the last couple of weeks. You put a trend through that, the growth in the money supply this year -- this is M-1, one of the measures of the money supply, has been between one and two percent, a very modest number. It shows no particular tendency to accelerate. And that reflects our effort -- and I think quite successful effort -- this year, to maintain moderate growth in the money supply.

MR. DONALDSON: Let's ask about interest rates that people can get. Their savings institutions which are now offering certificates and in the future -- I think October 1st for the start -- with 25 and 35 percent rates of returns. Are those good deals?

MR. VOLCKER: Well, when you see those extraordinarily high interest rates for a limited period of time, they appear to be tied in with a promise to acquire one of the so-called all savers certificates, a tax exempt certificate. I don't quite know what the rate will be because it is related to the Treasury Bill rate at the time. But some institutions are saying, we will pay you these extraordinary interest rates for a month if you promise to buy an all savers certificate from us October 1st, when they come

into force. I think there are very definite questions in my mind as to whether that particular practice, of the tie-in deal, does not really violate what the Congress had in mind in passing --

MR. DONALDSON: Are you talking about questions at the IRS?

MR. VOLCKER: Well, the IRS has raised a question about it, I see, a question in terms of enforcing the interest rate ceiling which is part of that legislation. So, I do have a very definite question on the special tie-in deals.

MR. DONALDSON: Let's go back to 1933. Or, I guess the question is, should we go back to 1933 and go back on the gold standard? A lot of people -- some of them in the Reagan Administration, Jack Kemp in Congress -- say that's exactly what we should do.

MR. VOLCKER: Well, to the extent this kind of longing or talk about the gold standard reflects a recognition that we need disciplined financial policies, and look to gold for a kind of discipline, I think one can recognize the validity in a sense of looking for some method to enforce discipline. I'm afraid there also is a large element in some of this talk, I see, of kind of wishful thinking, that somehow there is some magic pill out there that we can take and if we only go back to the gold standard or have a big tax cut or whatever the remedy is, we're going to get out of all our problems painlessly and easily. That, I think, is an illusion. Don't forget that only ten years ago, the popular

notion among almost all economists was to get off the gold standard. That was going to solve all the problems. It didn't solve all the problems either to get off the gold standard or get on the gold standard. We have very real problems. We do need discipline in financial policies and budgetary policies, in monetary policies, and I hope and expect that's what we are getting.

MR. DONALDSON: Yes, but what do you think? If the President calls you up and says, Mr. Volcker, I need your advice. Should we try and go back on the gold standard? What would you say?

MR. VOLCKER: I would not recommend going back on the gold standard at this point.

MR. DONALDSON: You would say, poppycock?

MR. VOLCKER: I wouldn't use that particular word but I would not endorse --

MR. DONALDSON: Not to put words in your mouth, what would you say to him?

MR. VOLCKER: I would say, the gold standard has not been successful in the past, in preventing economic instability. We were on the gold standard -- as you say, go back to 1933 -- we were on the gold standard in 1933 when we got into problems. The price of gold was increased. That didn't cure the problems, but there was a popular theory at the time that that would cure the problems. There isn't going to be any, there is no laetrile to cure this problem of this inflation, this kind of -- this has been kind of a cancer on the economic scene.

Discipline policies, yes, but magic solutions, no.

MR. CORDTZ: Well, I don't want to put any words in your mouth, but you seem to be saying that we really have to suffer a great deal of economic pain to get out of this.

MR. VOLCKER: Well, I have never said that this process is a painless one. People have to change their expectations and change their behavior and that's always an uncomfortable process. Wages -- you can't have inflation coming down, being eliminated, and have wage rates which are two-thirds of cost, increasing at ten percent or so, the way they are. So, we've got to affect people's behavior, affect people's thinking, to the point that they have an incentive and a recognition that we will all be better off to conduct ourselves in a non-inflationary way.

In a sense, the pressures on financial markets push us in that direction. That's all rationality. And I think we see some signs, early yet, but some signs of improvement.

MR. DONALDSON: Yes, but, it's not just getting a smaller wage increase. A lot of people are thrown out of work. The inflation rate is certainly going to go up. How high do you think? How high can this country tolerate it?

MR. VOLCKER: I think the inflation rate, we see some signs, is coming down.

MR. DONALDSON: Why?

MR. VOLCKER: I think in large part because the Federal Reserve policy has been restrained and restrictive. I think when you look beyond all the surface things, there's been a certain amount of fortuitous developments, luck. We had some rain in the

spring when a lot of people feared that we wouldn't. We are having better crops than people expected. That helps food prices. For the moment, at least, we have more stability in energy prices. Even that may be affected to some extent by a sense of financial restriction. But let me --

MR. DONALDSON: Do you mean in the shortrun a continuation of a tight money policy and a -- cutting the Federal budget further -- would somehow in the shortrun reduce the inflation, the unemployment rate?

MR. VOLCKER: We're not playing for the shortrun. We are playing for what makes the economy solvent in 1980.

MR. DONALDSON: But people have to put food on their table every night.

MR. VOLCKER: That is right. Actually, the economy, one of the surprising things is the economy has been doing -- I don't like to say so well -- some sectors of the economy, you mentioned at the beginning of the program, are doing very poorly. They are on the whipend of this. They are more affected by credit shortages than other parts of the economy. The level of the economy as a whole is higher than almost any economist would have projected six months or nine months ago. That's a surprising thing but it is a fact, that the economy has moved better, against these very high interest rates, than most economists' expectations six or nine months ago, when there was also a lot of talk about, there was going to be another recession next quarter.

MR. CORDTZ: It seems to me that the most visible effects of the high interest rate are down on Wall Street. Is Wall Street a good guide for public policy?

MR. VOLCKER: Oh, I think Wall Street reflects the hopes and fears of people all over the country and all over the world about what the future brings. They are dealing in futures all the time. What's tomorrow going to bring? What's next year going to bring? It is also subject to exaggerated movements. But I think it is fair to say, I take it as a sign that there is still a lot of doubt, a lot of uncertainty, a lot of concern about the budgetary picture, a lot of concern about economic policy in general, concern focused on whether we are going to be successful in dealing with inflation, whether we are going to stick with it, in the simple term.

And my message there would be, yes, we intend to stick with it.

MR. DONALDSON: That's the Fed. What about the Reagan Administration?

Fifteen seconds left.

Will they stick with it? Will they make those cuts?

MR. VOLCKER: I think that --

MR. DONALDSON: They have an election in '82.

MR. VOLCKER: They have an election but they have a program and it seems to me those cuts are integral to their own program and they've said so right along, so I am hopeful that they are going to follow up the very good start they already made and push ahead.

MR. DONALDSON: Thank you, very much, Chairman Volcker,
and Dan Cordtz, for being with us today on ISSUES AND ANSWERS.

(Announcements)

ANNOUNCER: We hope you will join us next week for another
Program of ISSUES AND ANSWERS.

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