967

THE DOLLAR, INFLATION, AND U.S. MONETARY POLICY

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BEFORE THE

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WEDNESDAY, OCTOBER 17, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 11 a.m., in room 1114, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Javits, and Jepsen; and Representatives Brown and Wylie.

Also present: John M. Albertine, executive director; Lloyd C. Atkinson, William R. Buechner, Kent H. Hughes, and L. Douglas Lee, professional staff members; Katie MacArthur, press assistant; Mark Borchelt, administrative assistant; and Carol A. Corcoran and Stephen J. Entin, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. The hearing will come to order.

Mr. Secretary, we appreciate your appearing this morning. Considering the demands on your time, we will try not to hold you too long. Thus, we will limit questioning to 5 minutes per member with the idea that the members may submit questions if they feel that they have further questions to ask.

Mr. Secretary, I don't know any other time in my adult life that I have been more concerned about the long-term economic outlook for the American economy. The economic outlook for the American economy, and for the world economy generally, has deteriorated markedly during 1979.

Some of the things that are causing the problems are beyond our control. If one believes the economic soothsayers, things are likely to get much worse before they get better.

Inflation, as measured by the CPI, is currently roaring ahead at an annual rate of nearly 14 percent. And if the September rate of increase in the PPI is any indication of what we can expect for the CPI in the months ahead, our inflation problems can only get worse.

Moreover, although the unemployment rate dipped unexpectedly last month, I know of no one who seriously entertains any notion other than that the unemployment rate will rise—and rise sharply—over the course of the next several months.

There is considerable evidence that economic developments are deteriorating on the world front as well. World inflation has moved up sharply, and real economic growth promises to be very sluggish.

Already, there are hints that the world economy is about to be bludgeoned by yet another round of oil price increases. Among the developed nations, it has been suggested that we are in the midst of an interest rate war. All of these developments spell further problems for the dollar, an outcome that will exacerbate inflationary pressures domestically and worsen the world's financial markets.

I think the Federal Reserve has acted boldly in attempting to deal with our inflation problem at home and the dollar problem abroad. And this administration deserves credit for moving decisively as they have in this area.

I think that the fight against inflation requires a moderation in the growth rate of the supply of money. On monetary policy, I support this administration and the Federal Reserve.

The key to an effective monetary policy over the long run, however, is progress on productivity. Improved productivity is the only way we can break the lock-step relationship between rising wages and prices and begin, once again, to deliver on our economy's longstanding promise to the American worker—that hard work will pay off in a rising standard of living for the worker and his children.

If we increase productivity, we will be able to stick to a moderate monetary policy to fight inflation, and we will be able to do that without massive increases in unemployment.

In addition, one of the current concerns I have here with the tightening of credit that is taking place is that I don't want to see a repetition of what happened in 1974 and 1975, where the housing industry shouldered the major brunt of that kind of tightening of credit.

I know we have some moderating influences, but I'm not sure that that's enough. We have become a nation of demand junkies, we buy anything that we can buy using the credit card and hope that we can keep the initial price down.

I am wondering if we shouldn't try to insure that the burden of the credit restriction is more evenly shared in this country so that we don't focus so much on the housing industry. Some of the dire predictions I hear suggest that the credit squeeze will result in the slowing down of housing starts and the closing of loan commitment windows for housing. Shouldn't we look at something to get people to save a little more and make a little more initial downpayment.

I am told that in the next quarter savings may be as low as 3 percent in this country. And that's a serious thing to think about.

So I would hope that as you make your statement this morning and perhaps in some of the answers to questions, that you can deal with my concern as to how we can share the burden of credit restrictions more evenly in the country.

Senator Jepsen, do you have any comments?

Opening Statement of Senator Jepsen

Senator Jepsen. Mr. Chairman, I'd like to join you in welcoming Mr. Miller and Chairman Volcker before the Joint Economic Committee.

In my view, the Federal Reserve took a big step forward on October 6 when it announced that it was going to place greater emphasis on controlling monetary aggregates and less emphasis on controlling short-term interest rates.

I only hope that the Fed sticks with this policy.

It seems to me that we have ignored the fundamental importance of the quantity of money in causing inflation. We focus too much on day-to-day or year-to-year changes in the price of various commodities. When the price of corn or wheat or oil or steel goes up, we tend to say that this is causing inflation, when in fact, it is the consequence.

Moreover, this myopia about looking at commodity prices tends to blind us to changes in relative prices. Even in an economy with no inflation, there are going to be rising prices for some goods and falling prices for others.

Obviously, it is the ever-rising general price level we are most concerned about, and this results from too much money chasing too few goods.

Therefore, to effectively fight inflation, we should simultaneously tighten up on the money supply while encouraging productivity and the production of goods and services by reducing taxes and cutting back on Government regulations.

I realize that many people are going to criticize the Federal Reserve for causing higher interest rates, a credit crunch, and prolonging the recession. I expect that very shortly this kind of criticism is going to reach a high level, as the economy begins to slowly rid itself of an addiction to cheap money.

The fact is, however, that even the present 14-percent prime interest rate is not high when compared to a 13-percent inflation rate. And we are only fooling ourselves if we believe that we can turn the printing presses back on to save ourselves from a little temporary pain, because the interest will inevitably be higher inflation, higher unemployment, higher interest rates, and a deeper recession later on.

If you do not believe this, all you need to do is look at the peaks and troughs of the recessions and economic slowdowns we have suffered in the last 15 years or so.

At each trough, unemployment is higher than at the previous one, inflation is higher, and the subsequent rate of real economic growth is slower.

At some point, we must get off this cyclical bandwagon, stop trying to fine tune the economy, and adopt steady, consistent, moderate monetary and fiscal policies.

And I believe that if we announce such a policy to the American people and prove to them that we mean it, the economy will quickly readjust and the discomfort caused by a gradual withdrawal of stimulus will be relatively slight.

Lastly, I will just say that I understand completely that the Federal Reserve cannot stop inflation by itself. The Congress must also do its share by reducing deficit spending, which itself is a prime cause of present high interest rates.

Moreover, we must do something to reduce the regulatory burden on the economy, which also helps to push up prices. I pledge to do my part and I hope that the Fed and the administration do theirs.

Thank you, Mr. Chairman.

Senator BENTSEN. Representative Brown.

Opening Statement of Representative Brown

Representative Brown. Thank you very much.

Mr. Secretary, good morning. Let me say that I think the action that Mr. Volcker took was perhaps the only action he could take to cure what was clearly a deteriorating situation. The situation had begun to develop into a psychological crisis that needed to be allayed.

However, I am concerned that it may become necessary for him in the future to take similar serious steps, which will necessarily have to be greater, in order to make the required impact, and more devastating, in terms of what may happen to the recession in which we find ourselves now, or into which we find ourselves now sliding.

My guess is that the steps that he has taken will have made that recession a little bit more severe. The necessity for these steps, it seems to me, arises from the fact that there was a sharp increase in the money supply prior to Mr. Volcker's becoming the Chairman of the Federal Reserve Board. That increase began sometime in the spring. Before that, there had been a tightening, under your leadership, in the Federal Reserve Board's approach to the money supply. That tightening was necessitated by the dollar crisis of almost a year ago.

My concern is that in the near future there will be pressure on Mr. Volcker, as the recessionary situation develops and unemployment increases, to once again ease up on the money supply.

So we're getting into sort of a rhythmic, and always a higher or or more stimulative development of the money supply, which leaves the economy literally quite chaotic.

The Joint Economic Committee in the 1979 Annual Report, and in the 2 preceding years, in the minority's views, suggested that what we need in terms of monetary affairs is a steady-as-you-go policy.

What we really need, in addition, is a new fiscal approach. What we needed then—and we would be better off now if we had done it—was an effort to stimulate the supply side of the economy; that is, to try to reduce taxes on savings and investment to get the capital needed for expansion in this country which will strengthen our economy generally.

It seems to me that now, more than in any other time, we still need that capital expansion, because we will soon have a depression or recession in the consumption area as a result of the steps that you are taking.

I praise Mr. Volcker for taking those steps. But at the same time, I have grave concerns that we will not take the necessary fiscal steps, and that Mr. Volcker will not keep a steady-as-you-go course.

I hope that I am not right.

Thank you.

Senator Bentsen. Thank you very much.

Mr. Secretary, we are delighted to have you here and look forward to your testimony.

STATEMENT OF HON. G. WILLIAM MILLER, SECRETARY OF THE TREASURY

Secretary Miller. Thank you very much. I have filed a very brief prepared statement and if I might just take a moment to both hit the high points of that prepared statement and perhaps respond to some of the opening statements that you have made, Mr. Chairman, Senator Jepsen, and Congressman Brown.

The greatest problem that this Nation faces is inflation. And looking back, it seems to me that the Government's problem, at least in my experience for some year and 7 months in Washington, has been one of completing and expanding a comprehensive strategy to deal with inflation, to contain it, and then wring it out of our system.

And this has meant a series of new directions which have been hammered out and are being hammered out by the Government in all of its functions—executive and legislative—over the past couple of years.

And I would like to touch on some of the elements of that program and how they fit in.

One is that we certainly agree—and I am a strong believer—that one of the fundamental policies we must pursue is fiscal discipline. The fiscal discipline is represented in our spending and taxing policies and is very much involved with the Congress.

In the last 3 years, as a result of a new attitude that has been developing, and one for which I think the Congress deserves commendation, the Federal deficit has been reduced relative to the GNP.

Three years ago, the deficit was running 4 percent of our gross national product. This year, the year we just closed, September 30, we had a deficit of about 1 percent.

And even more important, during this period of time we saw total Federal expenditures declining in their relative role in the economy from some 22½ percent of GNP down toward 21 percent.

Now, the purpose of mentioning those figures and talking about a new direction, regardless of the outlook for business cycles, shows a discipline in this area I think which is encouraging and we must contine to pursue.

The second important policy, if we are to attack the fundamentals of inflation and not just treat their symptoms, is monetary policy. Monetary policy has already been mentioned—and the efforts there must be, and must continue to be, to progressively reduce the rate of growth in money and credit so that we starve out inflation.

And this is a fundamental objective that has not changed.

When I became the Chairman of the Federal Reserve, that was certainly our policy and it has continued. In the first year of my responsibilities as Chairman, the rate of growth of the money aggregates did slow from the prior 12 months; and in the 12 months prior to my assuming my new role, the rate of growth of the money aggregates was lower than in the prior year.

It might be worth recalling that the ranges for the growth of the monetary aggregates are established under the Full Employment and Balanced Growth Act.

And I reported on these ranges both last January and in July to both the Senate and the House Banking Committees.

When I testified in July, the rate of growth of money was still well within the ranges that were consistent with the slower rate of growth of the economy and restraints on inflationary forces that we were endeavoring to accomplish.

In the summertime, the money rate began to grow more rapidly for a number of reasons. And part of the reason that the monetary actions of the Federal Reserve recently taken are both desirable and appropriate is that it was necessary to move forcefully against that tendency for the aggregates to begin to grow more rapidly than was consistent with our economic objectives.

The things that the Federal Reserve did included a commitment to emphasize more of the particular rates of growth of aggregates as distinguished from interest rates, to pay more attention to them and make sure that they stayed within the channels of growth that had been established.

I point that out because there may be some misconceptions. There is no intention, as I understand the Federal Reserve action, to bring about a crunch and to deny and really eradicate the growth of money and therefore, bring the economy into a deep recession.

I think, rather, there is an intention to maintain the moderate growth rate that had been persisting through the earlier part of the year and make sure that we don't feed an inflationary force later.

And that should be borne in mind because in talking about whether or not this particular action would cause a deeper recession, that depends on where one starts from. If one starts from the fact that the money growth ranges have been established for a certain economy and all we're doing is saying it stays in that area, then we're not changing the outlook when we establish the arrangment.

So I think that this is not a new range; it is not a new level of money growth. It is making sure that we meet the targets that were originally established previously.

Now, the third area that I would like to mention is the one of wage and price policies.

Obviously, one of the difficulties in our war against inflation is that for some 12, 13 years, there was a tendency in this country to deal with the symptoms of inflation, to look at short-term conditions, and not to attack the fundamentals when we began to change direction on fiscal policy and on monetary policy, and began to meet our commitment as to budget levels and spending levels and our commitments to the rate of growth of money.

When we begin to do that, we will have a powerful effect on inflation. But there is a lag, and because there is a lag, it is necessary to do some bridging actions to avoid ratcheting the inflation that we are now experiencing into our fundamental levels of inflation and aggravate our problem in the future.

The wage and price program is one that seeks the cooperation of employers and employees in the context of a complex economy and in which there needs to be flexibility as to areas of the country, particular industries and particular companies, but which overall accomplishes the restraints.

Our program has been successful in the first 12 months. Both price and wage increases were substantially lower in the areas subject to the program.

So there was a holding back of wage and price increases. And now, in the second year of the program, as time goes on, there is always the possibility of greater inequities building up in such a program.

The wage-price program has been modified in order to have greater participation from business and from labor leaders in trying to deal with these problems of adjustment.

This morning, a pay committee made up of 18 members, 6 from the public sector, 6 from labor leadership, and 6 from business, are meeting in the White House to begin to inaugurate their program.

I think that the degree of participation and cooperation will give us the opportunity to continue that kind of restraint.

The fourth important economic policy that has been fundamental to inflation and would be fundamental to the solution has to do with energy.

And I will not take the time to describe the history of the energy policy in this Nation, but it is apparent that we must rapidly reduce our dependence on the use of oil as a source of energy and we must reduce our dependence on imported oil.

The dependence we have had has created conditions which have added significantly to inflation. During this decade, we have had a tenfold increase in oil prices and a greater dependency. And we must reverse that.

And I think this committee well knows that steps are being taken on a comprehensive basis to deal with priorities of conservation, priorities of developing domestic sources of conventional energy—oil, gas, and coal—priorities in developing renewable resources of energy, and priorities in developing unconventional sources of energy which will, in combination, address our short-term, intermediate-term, and long-term problems in making a major transition in the face of our economic development and growth and its dependence upon various forms of energy.

This program that is now before the Congress and steps taken earlier, when finally in place, will reduce the importation of oil some 50 percent below our current levels to some 4 or 5 million barrels.

But more importantly, will reduce it even further some 8 or 9 million barrels below what it would be if we had continued on the patterns of the recent years.

So it's very critical that this program come into place as part of our fight against inflation.

Now, I have been talking about what might be described as domestic economic policies—fiscal discipline, monetary discipline, wage and price restraints, and energy programs. But those have their relation to our international position. They do interrelate with another important policy, and that is one in which we put our international accounts into balance and where we maintain a sound and stable dollar. Without that, we are going to again aggravate our problems of inflation and contribute to it and continue to suffer the structural rounds of inflationary increases.

The situation as to our international accounts is encouraging. We have made significant progress. We have done it through a series of actions of slowing our economy, expanding our exports, and increasing our service income from abroad. As a result of that, the deficit which we had last year in our current account, of some $14 billion, will this year be reduced to just a few billion dollars; and next year we will be in surplus.

Now, the reduction from last year's deficit to this year's modest deficit is after taking account of a $16 billion increase in the cost of imported oil. So, there has been significant progress in that regard, and that will be a fundamental factor in improving the situation as to the dollar and assuring we have a sound and stable dollar.

Now, the dollar itself is critical, and we not only look at it on an average basis, but we look at it against various currencies. On an average basis, the dollar has done quite well. In the past year, since—we actually took last November 1—on a trade-weighted basis, the dollar is up about 7 percent in a year. If you look at it from a point of view of OPEC countries, what they spend currencies for to import into their nation, the dollar has actually appreciated 10 percent against the currencies that OPEC uses itself. And so, the dollar, on an average, has done well.

But perhaps the most dramatic change of the dollar in a year has been against the Japanese yen. The dollar has appreciated against the yen by some 30 percent.

Now, despite all of that, since June, the dollar was showing some weakness against the deutsche mark, and that was of concern to us, and we moved to take action to counter that. We carried on discussions at the highest level with German authorities, and we improved our coordination, and we have taken other steps, supported by the recent monetary actions which are improving the conditions for the dollar. And the dollar now is showing a firmer tone and is behaving, I think, consistent with the general trends that we have expected.

Now, let's add to all of these policies the one that the Chair has just mentioned, and I think Congressman Brown also. We need to continue these policies, and the supplementary policies of reducing cost-raising actions of Government, reducing the burden of Government regulations. But more than that, we need to intensify our efforts to create conditions for more emphasis on investment and more concern with productivity, because even if we arrested the inflation that comes from excess Government spending, even if we arrest the inflation that comes from excess expansion of money, even if we moderate wages and prices, even if we put our energy house in order, we still have the problem of increasing our productivity, which is the basis for the expectation of real increases in income in coming years.

And so, the administration will, as it fits into the other priorities, be coming forward with initiatives to help contribute to an environment, a climate, and help create incentives that will attack the problem of productivity and will create conditions for larger investment, greater allocation of resources to investment.

Perhaps I spent more time than you would like, Mr. Chairman, because I know you are anxious to turn to questions, and I do appreciate your attention on looking at the broader aspects.

I would be pleased to turn to your questions about credit, or I would be pleased perhaps to just pause here and see what priorities you would like to give to the questioning. Thank you.

[The prepared statement of Secretary Miller follows:]

PREPARED STATEMENT OF HON. G. WILLIAM MILLER

Mr. Chairman and members of this distinguished committee, thank you for this opportunity to appear before the whole committee. The primary focus of this hearing is on Federal Reserve monetary policy, its contribution to the fight against inflation and to the maintenance of exchange market stability. Chairman Volcker will comment in detail on monetary policy. I will briefly outline the major elements of our comprehensive strategy to deal with inflation, in which monetary policy plays a critical role.

High and persistent inflation has become deeply embedded in our economic structure and is a clear and present danger to our national well-being. It reduces real incomes and values; it inhibits job creating investment and threatens our ability to provide employment opportunities; it impedes productivity; it breeds recession; and it bears most heavily on those least able to afford it.

Containment of inflation is fundamental to restoration of sound economic growth. It is our top priority.

The causes of inflation are many, and the war against inflation must be dealt with on a broad front. We have a comprehensive, integrated strategy. All economic policies are being directed toward a total war against inflation.

First, the Administration is pursuing a disciplined fiscal policy. We are determined to reverse the trend of expanding federal deficits and expanding federal claims on the national economy. Progress has been made, both in reducing the deficit and in reducing the relative role of federal expenditures in the economy. We intend to make further progress. The net result over time will be to reduce the demands of the federal government on the economy and to release substantial resources to the private sector.

Monetary policy represents the second major weapon in the attack on inflation. The objective is to reduce progressively the rate of growth of money and credit in order to starve out inflation. Again, progress has been made. But in recent months monetary growth has accelerated. Earlier this month, the Federal Reserve announced a series of forceful actions that should serve to contain growth in the monetary aggregates and dampen inflationary pressures. These steps were needed and appropriate.

Third, fiscal and monetary restraints are being supplemented by the voluntary program to moderate pay and price increases. Widespread cooperation during the first year brought smaller price and pay increases than would otherwise have been recorded. We are providing for greater participation by management and labor in establishing and applying pay standards during the second year, which should help avoid inequities that could otherwise develop over time. A broadly representative pay committee, to be chaired by John Dunlop, will have as its first task the development of pay standards for the period ahead. The Administration has developed a National Accord with labor leadership in support of the war against inflation, and providing for labor involvement in the pay-price program.

Fourth is energy. The ten-fold increase in world oil prices has been a principal contributor to the acceleration of inflation during this decade. Constraints on energy supply pose important questions about the prospects for real economic progress worldwide.

To win the war against inflation, it is essential that we reduce our dependence on imported oil and that we reduce our dependence on oil itself as a source of energy.

For 2½ years, President Carter has sought support for a broad and comprehensive program to achieve these objectives. The diversity of individual circumstances and interests in our vast country has made it exceedingly difficult to hammer out a national energy program. Some important parts of the program have already been put into place. The President has recently taken two major steps—on decontrol of domestic crude prices and on limiting oil imports—under his own powers and his own initiative. Remaining critical elements are now under active review by the Congress.

The priorities for our energy program are clear. We must conserve. We must increase the development and use of conventional domestic energy sources. We must increase the use of renewable energy sources. And we must rigorously develop unconditional domestic energy sources. Fully in place, our national energy program is expected to cut oil imports by about 50 percent—4 to 5 million barrels per day—from present levels and by about 8 to 9 million barrels per day from levels that would have been reached without a comprehensive energy plan.

Also of major importance for the longer run, we are attacking unnecessary cost-raising government regulation. Much has been done to reduce regulatory barriers to efficiency and competition, and to reduce the administrative burdens on business in complying with excessive regulation. But much regulation is founded in statute. Administratively, we can clarify and simplify. But we will frequently need legislation to achieve real reductions in burden.

These domestic policies—our efforts to wring out inflation, secure sufficient independence and restore efficiency and vitality to the U.S. economy—are also the policies needed to assure a strong external position, and a sound, stable dollar. Indeed, maintenance of exchange market stability is essential in the fight against inflation and forms an important part of our comprehensive attack on inflation.

Despite the massive buildup in our oil import bill, the effort to strengthen the United States balance of payments has made significant progress. In 1978, the U.S. current account was in deficit by $14 billion. This year, even though the recent oil price increases are imposing a $16 billion rise in the cost of our imports, we anticipate a deficit of only a few billion dollars. Next year the U.S. current account will be in substantial surplus. This major positive shift in our balance of payments—together with our concerted attack on inflation—provide the fundamental basis for dollar strength and stability.

Action on the fundamentals is being supplemented forcefully with action to deal with unwarranted exchange market pressures. The Committee is familiar with the program announced last November 1, nearly a year ago. Since that time, the dollar has strengthened by over 6½ percent against other currencies used in our trade, and by nearly 10 percent from the viewpoint of the oil exporting nations in relation to the other major currencies they use to purchase their imports.

We are not, of course, interested only in averages. We are concerned about the dollar's value in terms of major individual currencies. The dollar is now about 30 percent higher against the Japanese yen than it was a year ago, reflecting in part the dramatic—and welcome—moderation of the large Japanese balance of payments surplus. But the dollar has also been somewhat lower in relation to the German mark at times since mid-June, and this movement has attracted market interest and speculative pressure. We have therefore given this situation special attention in our exchange market operations, and have consulted closely with German officials at the highest levels to assure that our joint techniques and resources are adequate and effective.

We are determined to maintain a sound and stable dollar. This is in the interests of our own domestic economic stability, and consonant with our broader world interests and responsibilities. Our basic economic policies are headed in a direction that will ensure that result. Our external position is strengthening sharply. And cooperative arrangements with other major countries are in place to deal with unwarranted exchange market pressures.

In sum, we are pursuing a comprehensive strategy to deal with U.S. economic problems, internal and external. Inflation is central to all aspects of those problems. Our domestic and international objectives are closely related by the overriding importance of controlling the inflationary pressures affecting our economy.

Senator BENTSEN. Thank you, Mr. Secretary.

We have a vote in the House, and the House Members have had to leave, but I will ask a question later for Congressman Brown, that expresses his concern.

Mr. Secretary, what we are seeing now in the way of money restraints and monetary policy, with some modest changes, is pretty much a replay of what we have seen other times in the past in trying to deal with demand. What concerns me is that it focuses so much on the housing industry, and I have had economists telling me that the housing industry could have as low as 900,000 starts in 1980, down from the 2 million starts now.

Now, in 1975, we saw housing starts fall to a disastrous level. They went to 1.2 million. I don't know that I would agree that they are going to 900,000 in 1980. I certainly hope not. But I would like to find a way to spread this credit restraint more evenly.

All the time television is showing us these things—credit cards with our own names punched out on them—we are told that we can buy things for, in effect, nothing down, taking years to pay.

Now, there ought to be a way that we can slow down the move toward our Nation becoming one of demand junkies. And I would like to see if there isn't a way to apply a regulation W, so we can say to people that they ought to save a little before they try to buy. I saw in the first quarter of this year that our savings rate was 4.6 percent; in contrast, the Japanese rate was about 22 percent. And I'm told now that ours is down to 3 percent. That's just unacceptable.

Isn't there a way that we can slow down consumer demand? I see consumer demand at a level that is much higher than in the past. What can we do in an evenhanded approach to try to cool this thing off, rather than focusing so much on the housing industry?

Secretary MILLER. Mr. Chairman, you raise a very broad subject. Let me give you a few responses.

Since 1966, because of interest rate ceilings on savings, we have experienced in every economic cycle a peculiar and undue burden on housing. We have had conditions with interest rate ceilings in every business cycle with increasing demand and tightening markets and increasing interest rates that has caused a flight of savings from thrift institutions to money markets or other instruments, leaving relatively little capital available for housing. The result, as in every business cycle since 1966, as the cycle ended was, a shutdown of credit to housing, a drop of housing, which dragged other activities behind it and eventually slowed the whole economy and pulled us into a recession.

Actually, in the last recession, which was the most severe recession since the Great Depression, if you look back at the figures and see how housing led into that recession, you will find that in the fourth quarter of 1972, as I recall, housing was running at nearly 2½ million starts a year in that quarter. And by the fourth quarter of 1974, it was running at a rate of only about 1 million starts.

You are correct in the total for the year, but that involved nearly a 60-percent drop in a fairly short period of time in housing, which is, of course, one of the reasons we have high prices for housing now. It is an industry that, since 1966, has been highly cyclical. How can we expect permanent investments in building supply when the industry doesn't know what their market is going to be?

Senator BENTSEN. And causes instability in the labor force.

Secretary MILLER. The labor force, too. And so all those who sell supplies in housing expect premium prices in good times because they have to absorb the costs. And labor expects to be paid more because it will be laid off so often.

So we have moved in recent years to change that and to create, as you mentioned, new instruments that address the problem by at least creating flows of capital into those areas through money market certificates, in particular, and nongovernment sources of funds.

Before the Congress now is a proposal to phase out the interest rate ceilings and get rid of that situation and create a more even, balanced availability of credit for housing. And I urge the Congress to look with favor on that reform and to pass that legislation. It is supported by the administration and the Federal Reserve, and all of us have supported it as a necessary reform.

But let me go beyond housing to the more generalized questions you asked.

In the present situation, of course, housing is nervous because of the Federal Reserve's action and an increase in short-term interest rates. The theory is that there will be a shortage of capital.

I might say, without trying to be optimistic, or in any way departing from reality, that if the Federal Reserve action is successful in demonstrating that money growth is going to be contained within its channel and therefore inflationary expectations are dampened, then we have a chance for a more favorable relationship. If we can do that rapidly enough and forcefully enough, then I think housing does not have to go into a tailspin, because the correction process will take place sooner.

On the broader issue of excess credit and excess consuming, I couldn't agree with you more. This Nation for too long has emphasized consumption and demand management as a way to handle its economy.

And I think we must place more emphasis on investment and savings and productivity if we are to solve our problems, which means indeed we must change our habits somewhat.

I was particularly concerned about a year ago when debt in relation to household income had risen to the point where the service of that debt, the payment of interest, principal, on the debt, had risen close to 23 percent of disposable income. This was a historic high and was potentially alarming. Well, the restraint we have put on since then has had some impact. So at least we reversed the trend toward rapid expansion of credit, and I do believe that reversal will continue with the restraints that now exist.

I think lenders are now going to sort out and make less credit available for nonproductive purchases. And I think that will help.

Let me say a little bit about saving and credit, again just to put it into context, because I agree with everything you say. But in the United States it is sometimes a little difficult to compare our savings rate directly with other nations' because we have the highest percentage of homeownership of any major nation. And part of American savings goes into building an equity in homes. You have to make a little correction.

But even if you make that correction, we are saving too little. So your point is well taken.

As to whether we should apply further controls, direct controls on consumer credit, I don't want to foreclose that possibility. But it seems to me that under the directions we are now taking and the actions now being taken, it seems to me unlikely that that would be necessary. We will be able to dampen excessive consumer credit and excess spending without going to direct controls, with all of their problems, because, as you know, one of the problems of direct controls is we have a very complex society. And while we can control credit through official channels, there are many ways to get around those controls by operating in barter markets and operating in different ways.

So I think that that's a kind of medicine that is one of last resort. And I think because of the actions we have taken—I don't think it will be necessary. Some of the use of credit in the country is perhaps a little overstated, too, because credit cards are not—all plastic cards aren't all credit cards. Some of them are user cards.

The numbers get into credit, but they are only a way of charging the bills and paying them at the end of the month. We used to do that at our store, and it wasn't in the credit. But now with the charge cards, it gets into the credit numbers and somewhat overstates them.

And I don't mean to divert from the primary thrust of your worry, because it's a worry of mine. It's a worry I have had for a long time, and I think we should continue to monitor it, and if there is not an abatement, that we should look at alternatives.

Senator BENTSEN. Mr. Secretary, you have used up my time.

Senator Jepsen.

Senator JEPSEN. Mr. Secretary, I am pleased to hear you repeatedly refer to the total picture of savings and productivity, because that's what the Joint Economic Committee is saying in their reports this year—that we are for restrictive monetary policy, but we then have to have some specific low-cost tax changes to keep the economy moving forward while we curtail money. It seems to me that people have a right to form a public opinion on these facts and to get action from the administration.

I am pleased to see you address yourself to all these things.

Have you considered a specific tax rearrangement program to get this productivity going?

Secretary MILLER. Well, Senator Jepsen, I do have some priorities and I think the administration has some priorities on how we do so.

Let me put that in the context of where we are on our strategy, because we must be faithful to the total strategy, and one of the important accomplishments we must achieve is to have a permanent attitude about fiscal discipline and get it really embedded in our process. We have been too big of spenders in Washington. Therefore, I must suggest that we forgo some of our desired initiatives until we have demonstrated that we can control spending and control the deficit. Any such program has a short-term immediate impact that increases the deficit and increases inflation pressures. To move before we have brought our house in order seems to me to be unwise.

I believe we are on the verge of bringing our house into order, and as we do so, I think that the preferences we would offer in terms of investment incentives would be to look to liberalize depreciation as one of the techniques that would be most efficient and at the same time look at the savings side in terms of regulation Q elimination, or any other way that both saving can be made more attractive and at the same time make investing more attractive. Because, unless we match them up, we will create a higher demand and end up with the investment, maybe, but with inflationary pressures going with it.

And I believe that there's a good consensus of Congress to move on those fronts. I think the question before the Senate and the House now is the timing to do that, and I believe it's a little premature to launch a new effort until we dampen the pressures that are now upon us.

Senator JEPSEN. Thank you. You said "consensus." And it's not only the consensus of the Congressmen. I think too long—far too long—the Washingtonian, so to speak, or the Potomac people here have forgotten about the consensus of the American people. I think if we give the people the facts, their collective judgment and commonsense and wisdom will tell them to come up with the right decision and support the right decision.

Therefore, doing everything we can to get the consensus and the support of the American people for these policies would be an answer. Their concern, such as Senator Bentsen has talked about earlier regarding the housing industry, will have a tendency to create the discipline that you desire to continue and keep and have, so anything we can do in that area is very helpful.

Thank you. My time is up, Mr. Chairman.

Senator BENTSEN. Mr. Secretary, we are very appreciative of having you this morning. I have many other questions, but due to the limitations of time I think it best to defer them. I have one I promised to ask for Congressman Brown.

He says, if we have a restrictive monetary policy, why can we not have a specific low-cost tax change to keep the economy moving forward?

Secretary MILLER. I think it's a question of timing and I do think it's a question of making sure that we—you see, there's no way to solve our problem by trying to, trying to restrain money growth on one end and pump out in spending on the other. We have to get them in harness, and that's what I think is a good aspect of the close coordination between the administration and the monetary authorities.

Thank you very much.

Senator BENTSEN. Thank you very much, Mr. Secretary.

Our next witness is Mr. Paul Volcker, Chairman of the Federal Reserve.

Mr. Volcker, we have a great many House Members absent. They have a vote on the House side, and they tell me they will be back at 10 minutes of 12. But in the interest of trying to reserve your time, you may proceed with your testimony.

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

Mr. VOLCKER. Thank you, Senator. First of all, this is the first time in a number of years that I have been back before this committee, and my first time appearing in my new capacity. But I note that there has been a good deal of continuity on the committee in my absence, and I do want to acknowledge the special role that this committee has played, under your leadership and that of others, in carrying forward the dialog in economic policy and the discussions of economic policy toward increasing economic understanding. And, as you alluded to earlier, I think you have had in your deliberations some impact upon the conduct of monetary policy itself in its emphasis on the money supply numbers and in other ways.

Senator BENTSEN. Thank you very much, Mr. Volcker.

Mr. VOLCKER. I belabor the obvious when I say we face some unpleasant economic circumstances and that none of our choices are risk free or pain free. At the same time, the clear and widespread public perception that the problems are difficult, but that the time has come to deal with them provides us with an important opportunity to put in place and sustain forceful and appropriate policies.

I note monetary policies can only be a part of the overall framework. But I do believe they are an essential part.

I'm not going to recite all of the history of how we got where we are. I would note that in recent weeks and months we have seen rather clear evidence of the influence that rising inflation and inflationary expectations can have on the orderly function of financial and commodity markets and on the value of the dollar internationally. Over a long period of time, as seems to me apparent, uncertainties and distortions inherent in inflation have had a debilitating effect on investment, productivity, and growth.

I think there is an overwhelming feeling in the Nation that we have to come to grips with that problem and that feeling does reflect the solid commonsense of the American people.

At this particular point in time, of course, we have to recognize that after long periods of expansion there are very widespread anticipations of inventory adjustments and a downturn in economic activity; so we do have to deal with this very troublesome inflationary situation in a manner that recognizes the short-term concerns but, most importantly, does promise over a period of time to restore a solid basis for sustained growth and stability.

Now, we hear a lot about what's wrong with the economy. Mr. Chairman, I recite some examples in my text of the strength of the economy. We are not in a situation where we have nothing upon which to build. We have had a very long period of expansion by normal cyclical standards. We do look forward to a reduction in the rate of increase in energy prices. That is, of course, partly dependent on OPEC actions and other actions. But I think it is a reasonable expectation that we get some reasonable relief, in relative terms, on that side of the equation. Energy prices have been an enormously important factor, swelling the rate of overall consumer prices or producer prices in recent months.

We have a pretty good level of investment at the present time—not as high as I would like to see, but one that has risen over this expansion, despite all the inhibitions we have put on investment, including regulations and tax policies, as well, I believe.

And finally, the balance-of-payments picture, as Secretary Miller has suggested, promises to come into better balance next year. The export performance has been quite strong and growth abroad is reasonably strong.

Now, I don't view those kinds of development within complacency, because I think all those achievements, actual and prospective, will be jeopardized if we don't deal with the inflationary problem. And that inflationary problem has led to speculative distortions. It does undermine our ability to deal with both cyclical problems and the longer run problem of stability both in the United States and abroad.

It's in that setting that the recent actions by the Federal Reserve were designed to deal with the clear danger of a renewed outburst of destabilizing and inflationary speculative pressures—a development that could only complicate and distort the present process of economic adjustment—and at the same time to establish a stronger foundation for orderly and sustained growth. In one sense, the Federal Reserve actions announced on October 6 were part of a continuing effort to maintain control over money and credit expansion. Our basic targets were not changed; but the new measures—which involve, among other things, a change in operating procedures—should provide added assurance that those objectives will be reached. Above all, the new measures should make abundantly clear our unwillingness to finance a continuing inflationary process.

I won't describe the measures in detail. We can get into that in discussion, if you would like.

Mr. Chairman, I would like to emphasize several points. First, as I have already suggested, our immediate objective is to forestall speculative excesses and anticipations of a new inflationary outburst that could only complicate and ultimately make more severe the process of economic adjustment that is underway. By doing so, I believe that our recent actions can hasten, not postpone, the day when interest rates can decline and more stable conditions can be restored to credit and capital markets, thus providing part of the framework for renewed and stable economic growth.

In the meantime, these actions are not intended to, and will not, cut off the supply of money and credit to the economy. We are conscious of the fact that there are important areas of the economy—homebuilding, smaller businesses, and others—that are particularly dependent on a continuing flow of credit. In that connection, we have asked the banks to take special care to avoid lending to support speculative activity, while giving particular attention to the continuing needs of their established customers for funds to maintain normal business operations.

Second, doubts about the dollar in exchange markets in recent months have been one factor increasing uncertainties faced by businessmen and consumers alike. Given the dollar's central position in the international financial system, we must recognize that its external value is particularly sensitive to perceptions and expectations about economic policy, and especially to concern about our ability to deal with inflation.

I see no fundamental conflict—indeed, no meaningful tradeoff—between our domestic and international economic objectives in this respect. We continue on a day-to-day basis to monitor developments in foreign exchange markets, and if and when intervention is necessary, our actions will be closely coordinated with those of monetary authorities abroad.

Third, the recent Federal Reserve actions offer the promise that more effective control can be exercised over the money aggregates, but they are not an automatic solution to all our difficulties. The new technique for conducting open market operations is not a panacea. The definition of money itself needs refinement, and redefinition of the monetary aggregates is currently a major Federal Reserve objective. We will be monitoring financial markets and the flow of credit and monetary growth as this committee and some others have urged for so long.

Finally, we should not rely on monetary policy alone—critical as disciplined monetary policy is—to solve our economic problems. We also need a sustained, disciplined fiscal policy. We need an effective energy policy, commanding the support of all segments of our society, that will put us more surely in control of our destiny. We need regulatory and tax policies that will help stimulate investments, cut costs, and increase productivity. And we need international cooperation and understanding.

At the IMF-World Bank meeting recently held in Belgrade, I was impressed again by the general understanding that rising real energy prices will require significant and painful economic adjustments, and by the consensus on the need under current circumstances for virtually every country to attach high priority to the fight on inflation.

As has been amply reported, the atmosphere at those meetings was restrained, skeptical, and uneasy. Therein lies a danger. I am convinced that forceful and effective policies to deal with the evident problems can be successful. Those policies will need the support of concerned citizens who recognize the need for hard decisions, for restraint, and even for sacrifice. Pessimism and cynicism can only erode that process.

We are passing through a period beset with exceptional economic problems. Let us recognize there are risks, but that those risks will only increase if we fail to act forcibly against inflation now, and if we fail to sustain the effort. That is the context in which the Federal Reserve has acted. I am convinced those actions, as part of a determined national effort, can help establish the essential conditions for a more prosperous and productive America, a strong dollar, and a sense of stability and coherence in the world economy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Volcker follows:]

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

I appreciate the opportunity to appear again before this Committee in my still-new capacity. Some years have passed since I had the privilege of appearing, with some frequency as an official of the Treasury. I note with pleasure the continuity of membership on the Committee. I know in some cases that membership spans decades, and the Committee has played a prominent role through the years, in enhancing economic understanding and policy-making. The Federal Reserve, as so many others, has benefitted from the dialogue.

I belabor the obvious when I say we face unpleasant economic circumstances, and that none of our choices is risk-free or pain-free. At the same time, the clear and widespread public perception that the problems are difficult, but that the time has come to deal with them, provides us with an important opportunity to put in place and sustain forceful and appropriate policies.

Monetary policies can only be a part of the overall framework. But they are an essential part.

It is not necessary to recite all the details of the long series of events that have culminated in the serious inflationary environment that we are now experiencing. An entire generation of young adults has grown up since the mid-1960's knowing only inflation, indeed an inflation that has seemed to accelerate inexorably. In the circumstances, it is hardly surprising that many citizens have begun to wonder whether it is realistic to anticipate a return to general price stability, and have begun to change their behavior accordingly. Inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations.

We have recently seen clear evidence of the pervasive influence of inflation and inflationary expectations on the orderly functioning of financial and commodity markets, and on the value of the dollar internationally. Over a longer period of time, the uncertainties and distortions inherent in inflation have had a debilitating influence on investment, productivity and growth. In the circumstances, the overwhelming feeling in the nation—that we must come to grips with the problem—reflects the common sense of the American people. At the same time, we have to recognize that, after more than four years of expansion, there are widespread anticipations of inventory adjustments and a downturn in economic activity. The challenge is to deal with this troublesome situation in a manner that promises, over a period of time, to restore a solid base for sustained growth and stability.

In approaching that challenge, and in our preoccupation with what is wrong with the economy, we should not lose sight of the positive aspects of the current situation.

The U.S. economy has enjoyed a long and relatively strong economic recovery; more people are employed than ever before, over 10 million more than five years ago.

In the face of unprecedented inflation, and enormous new increases in energy prices, wage trends overall have not appreciably accelerated this year, reflecting, despite some disturbing exceptions, the discipline and good sense of Americans in general in accepting the need for restraint.

As the rate of increase of energy prices moderates—and it should, with responsible pricing behavior by producers in coming months—there is a reasonable prospect that the overall inflation rate will soon decline.

Investment activity, while restrained by uncertainties of inflation and by tax and regulatory constraints, has been relatively well maintained, even though it appears lower than consistent with our long-term needs.

Economic activity abroad is being sustained; this should support the recent trend of substantial growth in U.S. exports and help to improve the overall U.S. current account position.

More generally, the sizable imbalances among industrialized countries are being reduced; the substantial reduction—even elimination—of Japanese and German current account surpluses is particularly noteworthy.

I don't report these facts with any complacency. These actual and prospective achievements, and much more, will be jeopardized by a failure to come to grips with the home-grown inflationary pressures that have become so pervasive, that have led to speculative distortions, and that have undermined stability and order in the American and the world economy. Dealing with the sources of inflation and instability is central to both the domestic and international objectives of the United States; as I see it, these objectives are firmly interconnected, and we will be successful in neither unless we can begin to move toward restoring a sense of stability in our economy.

In this setting, the recent actions by the Federal Reserve were designed to deal with the clear danger of a renewed outburst of destabilizing and inflationary speculative pressures—a development that could only complicate and distort the present process of economic adjustment—and at the same time to establish a stronger foundation for orderly and sustained growth. In one sense, the Federal Reserve actions announced on October 6 were part of a continuing effort to maintain control over money and credit expansion. Our basic targets were not changed. But the new measures, which involved among other things a change in operating procedures, should provide added assurance that those objectives will be reached. Above all, the new measures should make abundantly clear our unwillingness to finance a continuing inflationary process.

Specifically, in the period ahead, more emphasis will be placed on controlling the provision of reserves to the banking system—which ultimately governs the supply of deposits and money—to keep monetary growth within our established targets. We have raised the discount rate so that restraint on bank reserves will not be offset by excessive borrowing from the Federal Reserve Banks. And we have placed a special marginal reserve requirement of 8 percent on increases in "managed liabilities" of larger banks (including U.S. agencies and branches of foreign banks) because that source of funds has financed much of the recent build-up in bank credit.

In connection with these Federal Reserve actions, I would like to emphasize several points.

First, as I suggested earlier, our immediate objective is to forestall speculative excesses and anticipations of a new inflationary outburst that could only complicate, and ultimately make more severe, the process of economic adjustment that is underway. In doing so, I believe that our recent actions can hasten, not postpone, the day when interest rates can decline and more stable conditions can be restored to credit and capital markets, thus providing part of the framework for renewed and stable economic growth. In the meantime, these actions are not intended to, and will not, cut off the supply of money and credit to the economy. Indeed, we are conscious of the fact that there are important areas of the economy—home building, smaller businesses, and others—that are particularly dependent on a continuing flow of credit. In that connection, we have asked the banks to take special care to avoid lending to support speculative activity, while giving particular attention to the continuing needs of their established customers for funds to maintain normal business operations.

Second, the doubts about the dollars in exchange markets in recent months have been one factor increasing uncertainties faced by businessmen and consumers alike. Given the dollar's central position in the international financial system, we must recognize that its external value is particularly sensitive to perceptions and expectations about economic policy, and especially to concern about our ability to deal with inflation. I see no fundamental conflict, indeed no meaningful "trade-off," between our domestic and international economic objectives in this respect. We continue, on a day-to-day basis, to monitor developments in foreign exchange markets, and if and when intervention is necessary, our actions will be closely coordinated with those of monetary authorities abroad.

Third, the recent Federal Reserve actions offer the promise that more effective control can be exercised over the growth of monetary aggregates, but they are not an automatic solution to all our difficulties. The new technique for conducting open market operations is not a panacea. The definition of money itself needs refinement, and redefinition of the monetary aggregates is currently a major Federal Reserve objective. We will be monitoring financial markets and the flow of credit closely. We will adapt our instruments to shifting needs as time passes, but we do intend to maintain the kind of restraint on monetary growth that this Committee and so many others have urged for so long.

Finally, we should not rely on monetary policy alone, critical as disciplined monetary policy is, to solve our economic problems. We also need a sustained, disciplined fiscal policy; we need an effective energy policy, commanding the support of all segments of our society, that will put us more surely in control of our destiny; we need regulatory and tax policies that will help stimulate investment, cut costs, and increase productivity; and we need international cooperation and understanding. At the IMF/World Bank meetings recently held in Belgrade, I was impressed again by the general understanding that rising real energy prices will require significant and painful economic adjustments and by the consensus on the need, under current circumstances, for virtually every country to attach high priority to the fight on inflation.

As has been amply reported, the atmosphere at those meetings was restrained, skeptical, and uneasy. Therein lies a danger. I am convinced that forceful and effective policies to deal with the evident problems can be successful. Those policies will need the support of concerned citizens who recognize the need for hard decisions, for restraint, and even for sacrifice. Pessimism and cynicism can only erode that process.

We are passing through a period beset with exceptional economic problems. Let us recognize there are risks, but that those risks will only increase if we fail to act forcibly to deal with inflation now, and if we fail to sustain the effort. That is the context in which the Federal Reserve has acted. I am convinced those actions, as part of a determined national effort, can help establish the essential conditions for a more prosperous and productive America, a strong dollar, and a sense of stability and coherence in the world economy.

Senator BENTSEN. Mr. Volcker, I certainly agree with you that we have to have both monetary and fiscal restraint. With respect to the last part of your testimony today about the calling for some sacrifices—that we may have to suffer some pain to still inflation—I interpret that to mean that we will have lengthened unemployment lines, and loss of output in our economy, in order to correct the inflationary trend.

President Carter, in a speech before the AFL-CIO, gave his assurance that he would not tackle the inflation problem by jeopardizing worker's jobs. Now, how is that possible?

Mr. VOLCKER. Let me break your question up into two points. If I may make one general point first, in terms of the need for discipline and sacrifice—a point that doesn't refer to cyclical development at all, directly.

I would point out that productivity growth in this country has actually been negative in a recent period. And, we have had higher oil prices; of course, we import 50 percent of our oil, so that the higher revenues going abroad do not go to American citizens. Under those conditions, the standard of living of the average American has declined; I don't think we can escape the effect when we're producing less with the same amount of effort, according to the statistics and we're paying high prices abroad.

Now, if we fail to recognize that, and people try to catch up with the existing standard of living or try to increase their standard of living, we get a process going that only feeds inflation, because wages move ahead of prices and then push up costs further, and up go the price levels some more.

As I suggested, I think there has been a good deal of commonsense shown on the part of the American people, all things considered—and particularly the increase in the price level recently—in restraining themselves from a big further increase in wage gains. That's one kind of sacrifice.

On the cyclical question of unemployment, there has been a lot of talk about a downturn, a recession, for months now. It looks as though a real downturn has been somewhat delayed in terms of earlier expectations. But I share the concern that there are developments in the economy—pressures on consumer spending—rather fundamentally relevant to high level of inventories, that may lead to some adjustments and some unemployment.

But let me say this was true before we acted, as well, and it is still true today, and it's not altogether clear to me that the prospects over any reasonable length of time for unemployment specifically were made worse after we acted than before, given that almost all economists were projecting sizable increases in unemployment.

There was a certain indication in the economy that might have suggested, both in the area of consumer buying and in the area of business behavior, that some expenditures were being made in anticipation of price increases. As pointed out, the savings rate was very low. Businesses have begun to build up inventory. That kind of behavior can keep the economy going for a little while, but it's also the kind of behavior that's going to give you a bigger downturn eventually.

One effect of our action is to cut off some of the speculative-type behavior. I am hopeful that the total adjustment process, which I think we're entering into and have been in, may proceed more smoothly than would otherwise be the case. But that doesn't mean we are not going to have an adjustment process.

Senator BENTSEN. Now, Mr. Volcker my other concern is the timing of a tax cut. I think there is no question we are going to have one. It's a question of when. And I am concerned about the productivity problem that you just discussed. Productivity last year increased three-tenths of 1 percent in this country. In Japan, it was 8 percent. Now we have a negative figure. I am told it's as low as 6 percent negative, and that has to be a concern to us since it will lead to a lowering of the standard of living of all of our people unless we take some corrective action.

Now, if we wait for a tax cut until we have 8 percent unemployment in the country—and most tax cuts that we have had, 1974 and 1975 being prime examples—the tax cut will be too late again. In 1974–75, it was made as we were coming out of the recession, and it didn't contribute to the solution; it contributed to the problem: later, we got more inflation.

But the pressures will be so great if we are at the 8-percent level of unemployment that it will be a very difficult thing, politically, I think, to do the things we want to do to try to increase productivity and encourage the supply side of the economy.

Would you care to comment on that?

Mr. VOLCKER. Let me say I recognize the problem and perhaps the potential political difficulties. But there isn't any easy way out of that, that I see. In a general sense I am sure you and I could sit here and develop a tax program that would help deal with those long-term productivity problems and long-term investment problems, and it's important that we do so.

But it is not my direct responsibility; it's for you to do so. I think there is a basic need for tax reduction and—tax restructuring as a part of reduction—that will help deal with these long-term problems. But when you ask me what the right time is: when we're in the middle of a very, very critical period of dealing with inflation and inflationary expectations, I have to look at the cost of tax reduction in the short run and it's impact on the deficits and I have to conclude that this is not the time for it—desirable as tax reduction is as a basic objective, as a basic program, and as desirable as it might be in another cyclical circumstance.

It would be nice to sit here and think that we could foresee the appropriate timing—get that political process that you refer to going. I don't think we're that good. You know, most economists 6 months ago were saying we were going to be deep in a recession now, that we would be approaching the low point at this moment.

Well, we're not that good in our forecasting. It really hasn't developed that way, and we can't sit here and anticipate, in a difficult and uncertain situation, whether or not that situation may develop in the first half of next year or not.

We just don't know at this time, and I think we have no choice but to hold off—not only so that the basic case is clear, but so that the timing is clear.

Senator BENTSEN. Mr. Volcker, the appropriate timing of the tax cut is critical. Since it's going to be exceedingly difficult for the Congress to react to get it through both parties and have it signed by the President in time to seriously help, it is mandatory that we be ready to introduce it in a timely manner in the event that the recession is worse than anticipated.

Mr. VOLCKER. If I may give you one further reaction, Mr. Chairman, it does seem to me important to agree on the problem, and these discussions, I hope, will help in reaching some consensus on the general type of tax reduction that would be desirable if and when it becomes necessary in the cyclical timing sense. If it is true, as I believe, that tax reduction should be oriented toward the cost-cutting, supply-providing side as much as possible, it would be useful during that difficult political process to be able to build on an existing consensus.

That shows you, perhaps, how naive a new Chairman of the Board of Governors of the Federal Reserve System can be.

Senator BENTSEN. I don't believe that. I think he's just put the ball back in our court. I know Senator Javits has been in and out. My time has expired.

Senator JAVITS. You're an old friend and an old associate in Government, and I congratulate you on your new job and the solemnity and dispatch with which you moved into it.

I'd like to ask you for a time estimate. I realize that these are chancy things and we surround it with every caution. Looking ahead, what do you see as to the duration period for this tight money policy?

Mr. VOLCKER. Let me say first, Senator Javits, that I am very reluctant to give you—and I'm just not going to give you—a precise estimate of interest rates in the period ahead, or how long the adjustment levels of interest rates might last. I just reminded the chairman of the uncertainty of economic forecasts and interest rate forecasts—which are perhaps even more uncertain than general economic forecasts—and I don't think it's wise for me to imply a degree of certainty that doesn't exist in this world by making such estimates.

Let me say, however, that I do firmly believe that by acting forcibly now, we bring the day of lower interest rates at an equitable position in financial markets sooner rather than later, because the alternative, in some sense—if the inflation psychology kept mounting—would be to have an effect on financial markets over a longer period of time.

Conceivably, the days would come a little less aburptly, but if we are chasing an inflationary psychology, it would surely last a longer period of time and, I think, reach more extreme proportions, in the end.

So, while our actions have perhaps condensed the process, my own conviction is they make it less painful and shorter in the long run, if we can keep our eye, not just a month or two ahead but on a reasonable time perspective.

I think getting this money supply under control and the credit expansion under control is really the most important thing we can do to bring lower levels of interest rates over a reasonably short time perspective.

Senator JAVITS. What would be your criteria for establishing lower interest rates? In other words, based upon what economic indicators?

Mr. VOLCKER. Let me draw a distinction here that I think is an important one, Senator. I don't have a timetable. I don't know that I could point to any particular indicators, but I can point to the fact that if the money supply is under control, the credit expansion is under control; if we have a turnaround in inflationary expectations, we will find the market itself carrying interest rates lower and under conditions in which the supply of credit and the supply of money is moving more or less in line with our basic intention. Our basic intentions are those of restraint over a period of time, and that restraint is not at all inconsistent in particular economic circumstances with the decline in interest rates.

Let me put it much more simply. If we go through this adjustment period that everybody is talking about, if we have a recession, if inventories go under control—they're not rising, they're leveling or even declining—if credit demands will decline, then the most natural thing in the world would be to have interest rates decline. And that should not be taken as a shift in our basic policy.

Senator JAVITS. Now, the last time this kind of measure was put on, it held over for about 6 to 9 months. It's estimated that what you have done is good for about 6 months, with a soft economy. Is it a fact that your program simply gives us an opportunity to make the structural changes that we have to make, which you have yourself specified; to wit, productivity, energy, investment incentives, trade, dealing with overregulation, et cetera? Otherwise, the opportunities you have given us will be wasted.

Mr. VOLCKER. I think it's important that progress be made in those other areas. I'm not going to sit here and say our policy is predicated or dependent upon your accomplishing all those good things in a 6-month timeframe. The more progress that can be made in those directions, the easier the process will be, the quicker and more surely we can establish a base for resumed prosperity.

But, in any event, we mean to stick with it in terms of maintaining the long-term restraints on credit and the money supply that are necessary as part of this process.

Senator JAVITS. Mr. Chairman, my time is up. I don't think Mr. Volcker quite got my question. My question is this: Regardless of the time element, whether it's 6 months or 1 year or more, the only question I am asking you is whether what you have done is alone a remedy for the very ills that you describe, or does it just give us the chance to get the remedy, if we pursue these other courses? In other words, respecting inflation.

Mr. VOLCKER. Yes and no, I think would be the answer to the two parts of your question. It does help give you time, but I don't think I view what we are doing as simply a kind of holding action. Responsible and disciplined monetary policies are not just a matter of 6 months; they've got to be part of the permanent mix of policies, too. Whether or not those other things are done—and I think it's terribly important that you make as much progress as you can—is going to have a great deal to do with the performance of the American economy, but I don't think we can relax on the monetary policy side whether or not they're done.

Senator JAVITS. But that will keep the economy where you leave it, to wit, soft. In other words, unless we do something about it, it will rock along soft with the monetary restraints; isn't that right?

Mr. VOLCKER. I think you can help a great deal.

Senator JAVITS. Right or wrong?

Mr. VOLCKER. Softer than it otherwise would be. I don't want to imply the economy rocks along in recession indefinitely. I don't think that is true.

But it is true, without appropriate complementary policies, you are not going to get the potential out of the economy that there is to be gotten. And if you simply rely upon restraint and restrictive monetary policy, I think the true performance of the economy over periods of time will be nowhere near its full potential.

Senator JAVITS. Thank you, Mr. Chairman. I have intruded on your time. But I again thank you.

Senator BENTSEN. Senator Jepsen.

Senator JEPSEN. Along these lines, I would like to continue. It concerns me, if I am interpreting what I hear you saying and what I heard Secretary Miller imply in his final statement, which I didn't have a chance to ask him about before he left, that he indicated he understood depreciation on new investment would stimulate spending or demand, when it's really designed to steer spending into added capacity, to raise the supply of goods, and increase productivity, jobs, and that type of thing. That concerns me. Maybe I misunderstood him. I hope I did.

Now, I heard some comments in response to Senator Javits and Senator Bentsen to the effect that this is not a right time for a tax cut. Did I hear correctly?

Mr. VOLCKER. I didn't say there is never a right time. I don't think this is the right time.

Senator JEPSEN. Well, that's what I want to know. Is it the right time?

Mr. VOLCKER. I said this is not the right time.

Senator JEPSEN. What do you mean? Do you regard an accelerated depreciation scale as a tax cut?

Mr. VOLCKER. In the context that I was using, yes, that's a tax cut; it loses revenue.

Senator JEPSEN. And anything that loses revenue is a tax cut? So, if we attempted to give a tax credit for new savings on interest and dividends, that type of thing, this is what you would consider in the category of tax cuts?

Mr. VOLCKER. I think in the terms that I was using, a "tax cut," yes.

Senator JEPSEN. Well, respectfully——

Mr. VOLCKER. There are all kinds of tax cuts, and some obviously are more useful than others in terms of our basic problems.

Senator JEPSEN. We're talking about a total picture.

Mr. VOLCKER. That's right.

Senator JEPSEN. Talking about increasing the productivity. And this committee is very much on record, among other things, of talking about increased productivity. We have heard of a very small increase for this year, and maybe negative. We have, time and again, talked in this committee about how important that is, and we're talking about getting a handle on inflation by doing some basic mechanical things from a tax standpoint. Yet, that's the type of perspective, in my opinion as a layperson, we need to bring to the problem if we are to solve it promptly and get this consensus.

I think it's terribly important for the American people. Again, the American people will support anything once they have the facts. They'll come up with the right decision. But, if you're going to give a credit for savings and give accelerated depreciation, these types of things that we need to create for the American people, the American people aren't going to support it unless—I will get off my soapbox in a minute, Mr. Chairman—somebody will give them some direction.

Mr. VOLCKER. I don't disagree with the philosophy you are expressing, Senator. All I am saying is that those programs basically have to be fed into a budgetary restraint. I am not talking about any specific measure that doesn't have much revenue effect at the present time; my remarks are in the context of a substantial reduction in Government revenues. And there we have to look at the current budgetary picture; we have to look at the current inflationary picture. And that is what leads me to think that a tax reduction program could be and is desirable, in my judgment, over a period of time.

Senator JEPSEN. That's all. I don't believe that we can pursue that. And I would acquiesce in all of that type of thing. There may never be a right time. I don't think we have ever taken the first step in the right direction from the leadership in Government, because we talk about the Government people who are on Government salaries and who are in the Government bureaucracy, and you talk about the "right time to decrease tax revenue"—you'll never find the right time.

Mr. VOLCKER. I am more hopeful than that.

Senator JEPSEN. I would like to be, but it doesn't leap from what I am hearing this morning.

Mr. VOLCKER. As you well know, Senator, a lot depends on what the outlook is for expenditures; I don't think we can just deal with the tax side of the equation. In fact, it's the importance of the tax side, the importance of doing some of these structural things as part of tax reduction, that makes it so important to exercise restraint on the expenditure side. But we have to, in effect, earn the tax cut by the expenditure restraints.

Senator JEPSEN. Thank you, Mr. Volcker.

Thank you, Mr. Chairman.

Senator BENTSEN. Congressman Wylie.

Representative WYLIE. Thank you very much, Mr. Chairman.

Mr. Volcker, Secretary Miller testified yesterday that there is a considerable knowledge of impact from OPEC oil increases on inflation and on the acceleration of our inflation rates in 1979, from roughly 10 percent to roughly 13 percent in 1979, and that that can be traced back to the fact that about a 60-percent increase occurred in OPEC oil prices during that time.

Now, we see Libya and Iran increasing oil prices again, and there's some talk that very soon the other countries will be increasing their oil prices. Apparently, we will have some inflationary pressures from OPEC oil prices.

Do you agree with that?

Mr. VOLCKER. I think we have to be prepared for that. One could hope that there wouldn't be much of a significant increase, but I think we have to assess that possibility realistically.

Representative WYLIE. How does your monetary policy fit into a description of what is happening to us on the OPEC inflation front?

Mr. VOLCKER. Let me say I think it fits in the following way. There has been a big impact on price levels from past OPEC decisions and, indeed, on what is going on domestically. In one sense, the question that we face now is whether the higher levels of inflation associated, in part—and in significant part—with the oil price increases are going to be built into the rest of the economy. In my judgment, they have not yet been built into the rest of the economy. If they are built in, the whole inflation rate will be ratcheted upward again. An important part of the objective of our own policies is to try to develop an environment in which that will not happen.

Now, if there are no real important increases in imported oil prices through the end of this year, let's say, I think there is a reasonable prospect that the current levels of inflation will not be built into the economy generally and that the contrary will happen: That the general level of inflation will relapse back to the kind of structural, homebred inflation of something under 10 percent that we had, and that this in itself would be an extremely favorable development.

One of the possibilities that would put that in jeopardy is another large increase in imported oil prices during this period. Again, I think our actions—and they are certainly not the only influence, but they are one influence—on inflationary psychology in the United States and on the stability of the dollar internationally is not unimportant as one influence on the oil producers' decisions. And I would hope that it greatly weakens a case they may otherwise feel for increasing oil prices.

They have often cited the importance of the value of the dollar. I think Secretary Miller pointed out here this morning, that looked at from a reasonable time period—from their point of view—the dollar has not declined in relative value.

Now, there has been inflation in the United States; there has been inflation in other countries that export to OPEC countries. But that inflation does not justify a very large increase in the price of oil.

Representative WYLIE. If OPEC is not at all responsive to what happens to our economy—and I'm not saying that they will be or there is any hope they will be—have we any real options in making our macroeconomic policy?

Mr. VOLCKER. It is not an either/or proposition. But we need an energy policy and a prospective energy conservation and production program. Our economy is vulnerable; our security is vulnerable.

You can look at either dimension, but the fact is that the success of the anti-inflation effort, the success in making that adjustment a relatively smooth one is very much bound up in what happens to energy prices.

I think, again, our actions, to some degree, have to diminish that risk; but the risk remains.

Representative WYLIE. Yes. In responding to Senator Javits a little while ago, you said that curtailing inflation meant that interest rates would come down. I was under the impression that the discount rate was raised to 12 percent, which naturally increases interest rates to break inflation. Isn't that a little inconsistent?

Mr. VOLCKER. I think it is kind of a chicken-and-egg process. Interest rates would not be where they are if we didn't have inflation at 13 to 14 percent existing over a period of some months, with the expectation that rate may persist, or even increase. That is an invironment in which, in my judgment, it is impossible to hold interest rates down. But those rates can change, as I just suggested.

I would look forward—and I can't argue with Senator Javits—for a decline in the inflation rate of an appreciable proportion in not too many months.

Representative WYLIE. How soon do you think interest rates will start coming down?

Mr. VOLCKER. I refused to give a quantitative estimate to Senator Javits, and I can't give you any special privileges.

Representative WYLIE. I did hear his question.

Mr. VOLCKER. As soon as possible.

Representative WYLIE. That is a question being asked of me.

Mr. VOLCKER. I understand. And the only real answer I can give is that I do think the actions that we are taking will bring that day here sooner, rather than later. And how soon that day comes depends upon how the economy performs, how the inflation picture unfolds, in these months ahead.

I do not think it need be a long prolonged process.

Representative WYLIE. Thank you. My time has expired. Thank you very much.

Senator BENTSEN. Mr. Volcker, an article in the October 10 issue of the New York Times, as I recall, said that John Heimann, Comptroller of the Currency, was concerned that the increase in interest rates to very high levels and the restraints on credit could lead to several banks going under. Do you think that is possible, or probable?

Mr. VOLCKER. I talked to Mr. Heimann and he talked to me after that statement in the press, and I think he had the feeling the press had taken something he had said and blown it up into somewhat larger proportions than he had in mind.

Senator BENTSEN. It is a question I ask of you.

Mr. VOLCKER. My general judgment is that the banking system is in a stronger position now than it was in 1973–74.

Senator BENTSEN. You don't have the same amount of real estate loans now.

Mr. VOLCKER. With all due deference to the fact that sometimes we only find things out in retrospect, I'm not aware of any situation in the banking system comparable to the problem that was the focus of the difficulties at that time.

Senator BENTSEN. So you don't see the possible failure of several large banks?

Mr. VOLCKER. I do not. I definitely do not.

Senator BENTSEN. That is what I want to understand.

Now, another question: Do you think that, as a result of your October 6 actions, more banks will leave the Federal Reserve System? Does that give you concern? What do you think we ought to do about it? And doesn't that put further limitations on your ability to control the money supply?

Mr. VOLCKER. If you want to do something about it, I've got a very concrete proposal for you, Mr. Chairman.

Senator Proxmire has a bill before the Senate Finance Committee. I have an amendment or two that I would like to see attached to that bill. I think the bill is ready to pass in the sense that there is a rather widespread consensus, after years of controversy among affected industry groups, about the central provisions of that legislation.

I feel rather strongly and deeply that that bill is essentially ready to pass; it would deal with the problem that you alluded to.

Senator BENTSEN. Does that mean that more banks will be tempted to leave the Federal Reserve?

Mr. VOLCKER. I was about to say that we felt we had a new alternative. But take the actions that we took. There is no question that it adds to the feeling of member banks that they are being discriminated against. They are the ones that we have "within our clutches"—I resist saying it that way although that may be the way they put it—and while I believe actions of this sort are not lasting and reserve requirements are designed for this particular circumstance, when we have to take actions of this sort it does put a particular burden on member banks. It reminds banks—and they don't need any reminder—that they can escape by leaving the System.

There is no question that a great many banks will withdraw from membership, not just because of this action, but because of their frustration over the years.

Senator BENTSEN. Would anybody like to make further comments?

If not, the committee stands adjourned. Thank you very much.

[Whereupon, at 12:30 p.m., the committee adjourned, subject to the call of the Chair.]