1218

S. HRG. 98-609

THIRD QUARTER GNP

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

FIRST SESSION

OCTOBER 20, 1983

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

30-461 O WASHINGTON : 1984

81-C1

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Congress)

CONTENTS

WITNESSES AND STATEMENTS

THURSDAY, OCTOBER 20, 1983

SUBMISSIONS FOR THE RECORD

THURSDAY, OCTOBER 20, 1983

THIRD QUARTER GNP

THURSDAY, OCTOBER 20, 1983

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

The committee met, pursuant to notice, at 10:30 a.m., in room 562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen and Sarbanes; and Representatives Hamilton, Scheuer, Wylie, Holt, and Snowe.

Also present: Bruce R. Bartlett, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Paul B. Manchester, Sandra Masur, William R. Buechner, Mary E. Eccles, and Christopher J. Frenze, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The committee will come to order.

Mr. Volcker, we welcome you to this Joint Economic Committee hearing. We meet in an atmosphere of continued optimism. A half hour ago the Commerce Department released its estimate of growth of real gross national product for the third quarter. The news is good. The economy still is growing very strongly at a 7.9-percent annual rate. That's not quite as fast as the 9.7-percent growth recorded in the second quarter, but it's much stronger than most economists expected.

This economic recovery continues to confound the experts. They keep glooming and dooming, but the economy just keeps booming.

Consumers are confident and they're buying. Factories are gearing up their production. Millions of the unemployed have gone back to work. In fact, Americans are working in record numbers and unemployment is falling.

Perhaps best of all, we've achieved strong, stable economic growth without reigniting inflation. That means more job opportunities for the unemployed and rising living standards for those who are employed.

We note with relief that money supply aggregates are within target ranges. This is indeed good news and gives us confidence that inflation will not rear its ugly head and do serious damage to the economy this year or next. We congratulate you on your role in this important accomplishment. We are aware that you are walking a tight rope between inflation and recession, and we pray you will have the wisdom of Solomon to steer a steady course.

Mr. Volcker, you and your Board will have a lot to do with whether we have an enduring period of economic growth and rising living standards or whether the recovery will slow or even abort. You are not the only game in town but there is none more important. We are anxious to have your assessment of the sustainability of the recovery. And we want to know what you and your Board will do to help it along. We will also welcome your suggestions as to what the Congress can do to help the cause.

Now at this time I would ask if Congresswoman Holt has any remarks.

Representative HOLT. No, Mr. Chairman, I have no remarks except to welcome the Chairman today. It is always a pleasure to have him as a witness and certainly I share your enthusiasm for the economic growth that we are seeing and I am glad to have you, Mr. Volcker.

Senator JEPSEN. Does our distinguished vice chairman have any remarks?

Representative HAMILTON. Thank you very much, Mr. Chairman. No comments. We welcome the Chairman and look forward to his testimony.

Senator JEPSEN. Thank you. And I would advise Chairman Volcker that your prepared statement will be entered into the record as if read and you may then proceed in any way you so desire.

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

Mr. VOLCKER. I appreciate your comments, Mr. Chairman, particularly your recognizing that the Federal Reserve is not the only game in town, at least potentially.

My prepared statement does review recent economic developments somewhat along the lines that you indicated. We have had a more rapid period of growth than was anticipated by virtually everyone at the beginning of the year, and so far that has been combined with, I think, a better record on the price numbers than has been generally anticipated.

In that sense, there is a lot of good news. I would point out, in connection with the price developments, that one element in that situation is a fairly sizable decline in wage costs, a combination of both nominal wage trends and productivity growth. We have had, on the average, quite a striking decrease in nominal wage increases, although that pattern has been a very mixed one among industries and among firms. The average wage cost is declining, although individual sectors have not declined all that much.

At the same time, we have had a growth in productivity. You normally have a big rise in productivity during the early stages of a cyclical recovery, and we have one. But put together with what happened last year, when we had some productivity increases in the midst of the recession, there is some evidence that the very poor and sluggish performance we had on productivity in the late 1970's may be changing in a favorable direction; that would be terribly important if verified from subsequent information.

We are very much aware that while the news looking backwards is good, the recovery is still short, and the question of its sustainability over time is the key question, as you suggested.

As I indicated in my prepared statement, there are obvious potential obstacles in the path to sustained progress. Most importantly, the current prospect that Federal budget deficits will remain exceptionally large into the indefinite future is a major factor propping up interest rates and continues to pose a serious risk to the stability of financial markets in the future, threatening the balance and ultimate sustainability of the recovery itself. The economic and financial problems of many developing countries—aggravated by the high level of dollar interest rates—remain a dark cloud over the international financial system, and, unless contained, those problems could jeopardize our own economy. And finally, despite our substantial progress against inflation, doubts about the sustainability of that progress, and temptations to revert to attitudes and behavior characteristics of the 1970's, could undermine prospects for continuing economic expansion. In all those respects, we are in a period of testing.

I believe it is well within our capacity to pass those tests. But it will take a positive approach, not a wait-and-see attitude. I review the budgetary situation in my prepared statement today—as I have done on many occasions, Mr. Chairman—and suggest once again that a relaxed attitude in this area is not justified.

A year ago there seemed to be a sense of growing commitment that the Congress would address the problems. I feel that some of that sense of urgency may have been dissipated and there may be a temptation to try to live with historically unprecedented peacetime deficits; I emphasize that that course does imply great hazards.

We are coming out of a period where private credit demands, particularly in the business area, were slack as they typically are in a recession and in the early parts of recovery. There has been an improving cash flow in the business sector. But we cannot expect weak credit demands to remain indefinitely in the face of a good expansion of economic activity and rising investment.

We have a situation, I believe, where the underlying inflation situation potentially would justify substantially lower interest rates, but the deficits move in the opposite direction—with all the potential implications that that has for investment, for housing, for other interest rate sensitive areas of the economy.

I think it's also a factor in our deteriorating trade situation. That is one area of the economy that has clearly been out of keeping with the general expansion we have had. Our exports are doing very poorly. Our trade balance has reached, and is reaching, historically high and, I believe, unsustainable levels over a period of time. At the same time, we're getting huge capital inflow—a growing capital inflow—and those two phenomena are related. The money comes in, indirectly helping to finance our budget deficit, but it also keeps the dollar high relative to our competitive position, and is connected with that big current account and trade deficit through that mechanism.

I point out also that this situation, both in its exchange rate impacts and its interest rate impacts, greatly complicates the problem of dealing with the international indebtedness problem. The debt—I cite the figures in my prepared statement—is essentially denominated in dollars, most of it at floating interest rates, and it puts a very heavy burden on the debt servicing capacity of the borrowing countries. That situation has been contained through a large degree of cooperation among borrowers and private creditors and national authorities and international organizations. Its success here rests upon the borrowing nations themselves undertaking strong adjustment measures to restore financial stability, to increase and improve their debt servicing capacity, and to maintain their creditworthiness. There also needs to be an effort on the other side of the equation, from the lending banks and from governments.

I do emphasize in my prepared statement the key role in this process of the International Monetary Fund. I do not see how this situation can be managed or contained without support to the International Monetary Fund. The irony is, of course, that this is in question now in the U.S. Congress, in terms of the quota and related funding being requested by the administration for the Fund as part of a worldwide effort. It seems to me that a positive response is essential to containing this situation. It's a necessary investment in our own prosperity and growth, because if that situation is not contained, it's just going to feed back on our own markets, our own interest rates, our own financial institutions, and impair the prospects for recovery.

A final point deals with, perhaps, a less tangible area in the sense that it deals with expectation, psychology, and attitudes, although it has very tangible results: and that is, the attitudes toward wage and pricing behavior as the economy expands, as markets improve, as employment increases.

I mention that we have overall, on the average, a good record on wages and prices looking backwards, but it's also a mixed record. In some areas of the economy and particularly those areas that have been under heavy economic pressure there has been, I think, a lot of restraint and a lot of effort to improve efficiency. In some other areas of the economy, where the pressures may be less direct, less evident, responses to the observed decline in inflation have been less obvious and wage trends and prices, while improved, remain closer to earlier patterns.

I think what we're dealing here with in considerable part, Mr. Chairman, is attitudes that built up during a long period of accelerating inflation and expectations of inflation. Those attitudes are difficult to change when they are as deeply engrained as they have been. I think they have been shaken; they have changed to some degree, although probably not to the degree that I would like to see. That is partly a matter of time, and they can change further as we continue to contain and improve the inflationary situation.

But I think it is very important in terms of public policy that we continue to be in a posture—and, of course, this refers to monetary policy but not monetary policy alone—that is consistent with the idea that inflation will and can be contained. We have to take that into account in developing our own policies toward the money supply and otherwise. I think it is a factor reinforcing the need to deal with that large budgetary deficit, because that, in itself, generates a good deal of skepticism about whether inflation will be successfully contained.

I review very briefly in my statement—in response to your question, again—the reasoning behind the limited move away from accommodation toward somewhat more restriction on growth of money and credit. That process was a relatively modest one. Whether for that or other reasons, in recent months, as you noted, various money supply and credit figures have moved comfortably within our targets. We have had some reduction in interest rates in recent weeks of a rather limited character.

So I leave you with a sense of good news so far, but also with a sense of challenge and the need for action in the future in a number of important areas.

[The prepared statement of Mr. Volcker follows:]

30-461 O - 84 - 2

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

I am pleased to have the opportunity to meet with this committee to discuss the current economic situation. As you know, the Federal Reserve's most recent official monetary policy report was submitted to the Congress in mid-July. Because that report treated the economic situation in considerable detail, my remarks on the current economic and financial situation will be limited mainly to an updating. More importantly, I also would like to reemphasize a number of concerns that I expressed at the time that the midyear report was submitted to the Congress.

At that time, it was evident that the current economic recovery had gained considerable momentum and was following in many respects a typical cyclical pattern. Advances in residential construction had been large; consumer spending had registered exceptional increases in the spring; and business investment spending also was beginning to strengthen. Employment gains were substantial through the first half, and the unemployment rate -- though still high -- had moved steadily lower. By midyear, only the export sector remained a major depressant on growth of real GNP, reflecting the further widening of this country's foreign trade deficit.

By and large, the economic trends evident at midyear have continued through the third quarter. Industrial production has continued rising at a rapid pace through September. Payroll employment increased nearly two-thirds of a million during the three months ending in September, and the unemployment rate fell three-fourths of a percentage point over that same period. Preliminary indications suggest growth in real GNP remained fairly close to the exceptionally high rate in the second quarter. On the whole, I believe that the data indicate that the economy remains firmly on the path of expansion.

Moreover, the recent price information continues to underscore the gains made against inflation over the past two or three years. During the first eight months of 1983, the consumer price index rose at about a 3-1/2 percent annual rate, somewhat less than the rate achieved in 1982, and the producer price index, on balance, has showed virtually no change over that same period. This price information is better than we have experienced in a decade or more, in sharp contrast to the racheting upward of prices in the 1970's.

Because labor inputs account for about two-thirds of total GNP, an easing in growth of labor costs is crucial if our gains against inflation are to prove sustainable. On this score, we have made further progress so far this year. The rate of increase in nominal wage gains has trended down; the hourly earnings index, the most current wage measure, has risen at a rate of less than 4 percent this year. The easing of cost pressures has been reinforced by rapid productivity gains that appear to reflect not only the cyclical gains normally associated with the early stages of expansion, but also some apparent improvement in the trend rate of productivity growth. It is this kind of pattern, that sustained, can keep the underlying inflation rate moving lower -- and real wages rising.

Overall, these recent indicators of economic activity, inflation and productivity provide a strong start toward a much more satisfactory economic performance than we have seen for many years. At the same time, as I have said many times before, what counts is not the rate of economic growth over a short time span of a few months, or even a few quarters, but rather the performance of the economy over time. The current expansion, though more robust than generally expected at the beginning of the year, still is less than a year old. And, on the surface, it could be said that recent events do not differ dramatically from the early phases of some earlier business cycles that also began with strong growth and improved price performance -- but later deteriorated into accelerating inflation and stagnating real activity. That past record should be warning enough to resist any temptation to sit back and let events take their course, hoping that the momentum of expansion and the progress already made against inflation will be sustained pretty much on their own.

Moreover, there are obvious potential obstacles in the path to sustained progress. Most importantly, the current prospect that federal budget deficits will remain exceptionally large into the indefinite future is a major factor propping up interest rates and continues to pose a serious risk to the stability of financial markets in the future, threatening the balance and ultimate sustainability of the recovery itself. The economic and financial problems of many developing countries -- aggravated by the high level of dollar interest rates -- remain a dark cloud over the international financial system, and unless contained could jeopardize our own economy. And, despite our substantial progress against inflation, doubts about the sustainability of that process, and temptations to revert to attitudes and behavior characteristic of the 1970's, could undermine prospects for continuing economic expansion. In these respects, we are in a period of testing.

It is well within our capacity to pass these tests. But it will take a positive approach, not a wait-and-see attitude. Data for the past fiscal year provide some sense of the budgetary problem; in fiscal 1983 the federal budget deficit, not counting Treasury financing of off-budget programs, apparently reached close to $200 billion, nearly twice as large as the previous year's deficit, which itself had been of record proportions. The 1983 federal deficit amounted to about 6-1/2 percent of nominal GNP: prior to 1983, there had been only one year in the past three decades in which federal deficits were as much as 4 percent of GNP.

Obviously, the magnitude of the federal deficit in future years will depend on both the actions of Congress and on the strength of the economic recovery. A large portion of the 1983 deficit -- perhaps half -- reflected the influence of the business cycle on federal receipts and expenditures. As the economy improves this "cyclical" element in the deficit will become smaller.

But given currently existing legislation, the non-cyclical, or "structural" part of the deficit is all too likely to rise further. Indeed, under even the most optimistic economic assumptions now being made, the federal deficit appears likely to remain at levels, relative to the size of the economy, that are without historical precedent during periods of economic expansion.

A year ago there appeared to be a growing commitment in the Congress to address the problems associated with federal deficits. Today, I fear the sense of urgency has dissipated. Instead, with the economy growing again, there may be a temptation to try to live with historically unprecedented peacetime deficits.

That course implies great hazards. Even in the period just completed -- during which private credit growth was reduced substantially by the recession -- the influence of heavy federal borrowing contributed to the persistence of high interest rates. Maintaining large deficits in coming years makes it far more likely that interest rates will remain historically high well into the recovery, and posing a risk to the sustainability of the expansion.

The progress we have made against inflation -- if sustained -- is one fundamental force that should tend to make interest rates lower over time. But the huge budget deficits have an impact in the opposite direction. One result is to dampen prospects for business investment, particularly for long-lived investment with relatively slower "pay-out." But that investment is what is needed to revitalize some of our basic industries, and to support productivity generally.

Some of those same industries also suffer from depressed exports or strong import competition. To the extent that large capital inflows are induced by pressures on our domestic capital and credit markets, those inflows have contributed to maintaining the dollar at "artificially" high levels, viewed from the perspective of the current competitive position of our industry. In the short-run, those capital inflows may help to moderate pressures on the financial markets. But, viewed in a longer perspective, we have the irony of the largest and richest country in the world in effect turning to foreign investors to help finance its government deficits, while, by the same process, draining vitality from the firms and industries that in the past have been important exporters. As I noted earlier, exports have been a weak element in the business picture, and our trade and current account deficits are growing toward levels that would be unsustainably large. The longer that process lasts, the greater the potential instability for the U.S. and for the world economy.

The persistence of large federal deficits and a high interest rate environment also complicates the effort to deal with the international debt situation. The developing countries -- excluding those that are members of OPEC -- have a total indebtedness of about $575 billion. Of that total, about $285 billion is owed to banks around the world, with more than $100 billion owed to U.S. banks. The level of indebtedness is high relative to the current income-generating potential of those economies, and the great bulk of the debt is in dollars, paying dollar interest rates. As you know, difficulties in servicing these debts have been widespread.

Thus far, problems have been contained through an extraordinary degree of cooperation among borrowers, private creditors, national authorities, and international organizations. The borrowing nations themselves have undertaken strong adjustment measures to restore financial stability, increase debt-servicing capacity, and improve their credit-worthiness. There also has been a major cooperative effort among the lending banks to agree upon financing programs involving the restructuring of existing debts and provision of some new loans.

At the center of this process have been the coordinating efforts of the International Monetary Fund. On several previous occasions when I have testified before the Congress, I have urged prompt action to bolster the resources of the IMF. However, as you know, the work on that important legislation has not been completed.

International understandings look toward action before the end of next month, so time is growing short. Apart from the actual funds involved, our failure, alone among nations, to participate in this effort would send a strong message around the world that we do not support the cooperative efforts to manage and contain the debt problems of the developing countries. Put positively, participating in the proposed increase in IMF resources is a necessary and prudent investment in our own future.

Another important element to dealing with the current external financing problems of developing countries is a concerted effort to maintain the flow of bank credit to these countries. The question is sometimes raised whether such lending will be at the expense of lending to domestic borrowers and the expansion of our own economy. In that connection, I would emphasize the new bank lending to these countries will, in the aggregate, be at a substantially reduced pace from that of recent years and, as I have noted, we are on balance currently large net borrowers from the rest of the world. In the absence of these cooperative lending efforts by banks and the IMF, I do not believe we could be successful in avoiding widespread defaults or worse. The clear threat would be that such an international financial disturbance would have major repercussions on our own credit markets, our interest rates, and our growth prospects -- far outweighing any effects on our markets of the limited foreign lending required to maintain stability internationally.

Finally, I must emphasize the crucial importance of maintaining the progress against inflation. As I noted earlier, looking back, the recent data on prices and wages is favorable. However, it is also true that some temporary factors for a while caused measured rates of inflation to exaggerate the slowdown in underlying rates of inflation. As temporary factors have subsided, there has been some increase in reported monthly rates of price increase from the essentially flat record of the first half. That is not, in itself, surprising, but it does warn against any sense of complacency.

The fact is there continue to be deep-seated concerns both in financial markets and among the general public that more strongly inflationary trends could soon resume. The experience of the 1970's with accelerating inflation, despite some cyclical "pauses," is still deeply ingrained in people's minds, and, looking ahead, there is concern about whether appropriate restraint will be maintained over money and credit growth in the face of sustained huge deficits.

There are strong grounds for believing that these attitudes and expectations may be lagging behind reality and that underlying inflation rates are lower -- and can continue to move lower -- than is generally perceived. Indeed, with the period of low inflation still lengthening, with spare capacity still extensive in many sectors, and with strong domestic and international competition, and with labor amply available, there is a rare opportunity to "build in" greater stability.

Whether that optimistic view will, in the end, prove correct depends in part on the attitudes and behavior of business and labor. We currently see strong efforts to contain costs and improve efficiency in industries subject to the most intense competitive pressure, whether because of depressed markets or other factors. In some other areas, new wage contracts or pricing policies appear out of touch, both with our recent experience with inflation and with current conditions in labor or product markets generally. Rather, we see symptoms of a kind of carryover -- or a "hangover" -- of attitudes instilled in a more inflationary environment. Should those attitudes be reinforced and generally prevail, our effort to move toward sustainable economic growth with greater stability would be greatly complicated.

Experience suggests expectations developed over a lengthy period of accelerating inflation are rarely suddenly changed. But they will change over time, so long as public policy remains steadfast in its commitment to an environment of greater price stability.

Monetary policy inevitably must play a central role in that process, essentially by containing growth of money and credit to amounts consistent with containing inflation over time. I doubt that such efforts can ever be reduced, in a complex changing economy like ours, to a simple mechanical formula to govern growth in one measure of the money supply or another. For instance, in the midst of both institutional and economic change last year and during the early part of 1983, the Federal Reserve accommodated faster growth in some of the various monetary aggregates than it had planned earlier, responding in part to the visible evidence of a pronounced slowdown in the turnover or "velocity" of money. With some indications that more normal patterns may be returning, and with the momentum of recovery strong, limited steps were taken to resist monetary and credit growth during the spring and early summer. In a real sense, in a climate sensitive to inflation and the possible future inflationary implications of current policy, timely steps to pre-empt excesses can avert the need for much stronger action later.

In recent weeks, all the monetary and credit aggregates have moved comfortably within the target ranges, easing concerns of a surge in liquidity growth. In addition, interest rates, for the most part, have edged slightly lower in recent weeks, following moderate increases in late spring and early summer. But the looming budget deficits remain as a focus for doubts about the future.

In conclusion, the economic situation, in its broadest terms, does not differ dramatically from the situation that was apparent at midyear. Current economic indicators have continued to show a strongly growing economy coupled with only moderate rates of inflation. At the same time, concerns about the longer run outlook that were apparent at midyear are still with us today. Now, as then, we broadly know what policies are needed to provide greater assurance of sustained economic growth and lasting price stability. What remains to be done is to implement those policies.

Senator JEPSEN. Thank you.

Mr. Chairman, the reigniting of inflation is a concern of a great number of people, yet the polls indicate the majority of the people in this country don't realize that inflation has had a dramatic drop back to where an $11,000 a year income person today with the drop in inflation combined with tax cuts have about $1,362 additional purchasing power.

How do we get that message out? Why, in your opinion, doesn't the majority of the American public realize or appreciate that inflation has dramatically been decreased?

Mr. VOLCKER. I think there are several reasons, as I read it, Mr. Chairman.

First of all, people have become so habituated and so concerned about inflation over the years; they have seen some other occasions where inflation came down cyclically—not as much as in this cycle—but episodes where it came down only to go up again and end up at a higher rate than that at which it started.

That breeds a certain amount of skepticism and cynicism, understandably. When you go through the longest and strongest inflationary period that we have ever had in this country, you don't expect the scars to disappear right away in terms of behavior and attitudes.

Second, of course, on balance, if you look over a period of a year, prices are still up a little bit. Anyone shopping or thinking of bills has not seen a dramatic decline that really brought the message home. They can still say that in many cases prices are higher than they were a year ago. They probably say that more frequently than is in fact the case, because prices are up very little from a year ago; nonetheless, progress has not, in that sense, been dramatic enough to really send the message home—except, of course, in the energy area where we had at least an actual decline in gasoline prices and home-fuel prices and all the rest for several months.

I think it is partly a matter of time. Partly people are concerned—and I think it is a legitimate concern—about whether policy will continue to be shaped in a manner that promises to continue the improvement we have seen.

An important point here, which is very often overlooked, is that for roughly the past 18 months we have had an increase in real incomes for the average worker, despite the lower wage trends. While that shouldn't seem unusual in the sweep of history, it is the first time in about 5 years we can say that. All during that extreme inflationary period, return to the average worker was declining or at best holding steady. Now it is improving and, of course, that's reinforced by the tax decrease; before taxes real income is getting better and after taxes it's gotten much better.

Senator JEPSEN. I advise the panel and the committee that we will have a 5-minute time limit and we can go around twice. It's obvious there's going to be a great deal of interest as people continue to come here.

Mr. Chairman, in your prepared statement you mention that only the export sector remains a major depressant on growth of real gross national product.

What portion of our high interest rates and unemployment can be directly and individually attributed to this country's foreign trade deficit?

I would point out that the agricultural exports in this country is the largest positive contributor to our trade balance, yet even here our agricultural trade balance through May of this fiscal year is off almost $6 billion—or last fiscal year I should say—or 30 percent, compared to the same time period last year.

Do you have any comments?

Mr. VOLCKER. I would not say that the trade picture has contributed to the higher interest rates. The argument runs the other way around, to a degree; the high level of interest rates and the relative pressure on our credit markets has helped—I don't think it's the only factor, but it has helped—produce the large capital inflow. As money comes in, people buy dollars and sell other currencies. That presumably tends to keep the dollar higher than it would otherwise be. The level of the dollar, in turn, affects the trade picture, so the trade picture is the by-product, in part, of the conditions in our domestic credit markets. That, in turn, comes back in part to the deficit picture.

We put a lot of pressure on our domestic credit markets if we want to finance more activity in the United States than our domestic savings can accommodate. We're going to draw in capital from abroad. The other side of that coin is that it will drive our trade picture into deficit. It's got good and bad features in the short run, but if it's not sustainable in the long run it's an element of instability. Clearly it is depressing for those many industries that have important potential export markets to find their competitive positions damaged worldwide.

Senator JEPSEN. You say instead of the trade having an effect on interest rates, the interest rates have an effect on the trade?

Mr. VOLCKER. Yes.

Senator JEPSEN. Congressman Hamilton.

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

First, I just want to have you confirm or reject an impression I have from your prepared statement, Mr. Chairman. I take it that where you talk about maintaining large deficits in coming years, you are saying it is more likely that interest rates will remain high; that with that sentence, you side with Martin Feldstein rather than with Secretary Regan in their celebrated dispute about the relationship of deficits and interest rates.

Mr. VOLCKER. I would believe that the plausible alternative is for a higher deficit to lead to higher interest rates, yes.

Representative HAMILTON. Thank you, sir.

Now your statements on inflation have interested me this morning and I find them combining a concern and an optimism, moving in several different directions in a sense. I know it's a difficult situation.

Mr. VOLCKER. That's about the way I feel.

Representative HAMILTON. Let me ask you, what is your personal judgment about the inflation forecast for the remainder of this year and 1984? And I ask that keeping in mind that the Federal Open Market Committee has set a 5-percent inflation rate in 1984. the administration has set a 5-percent inflation rate in 1984 with inflation falling subsequently, which would be most unusual given the patterns of past recoveries.

Mr. VOLCKER. Let me say, first, I don't think we've set a 5-percent inflation rate for 1984. The last time we polled the FOMC at the time of the midyear report, what we call the "central tendency" of the members was 4.25 to 5 percent. Five percent was within the range, but I think it was at the high end of that range that was projected. There were some people who had a higher figure than that, but I'm looking at the center of gravity, so to speak. There were also some who had a lower figure, I might say.

In looking at this outlook, both in the short and longer run, I think we do have to recognize, as I mentioned in my prepared statement, that certainly in the early part of this year and in the latter part of last year there were some strong, temporary influences operating on the price level. We actually had some declines in the consumer price index for a while. We had declines of more magnitude in the producer price index right at the time that energy prices were declining. We can't assume that that's going to happen every year. We had the pressures of the recession itself. We had the pressures associated with the strength of the dollar. You can't count on all these things continuing.

You get a normal tendency for commodity prices to come up from recession lows as the recovery proceeds. In other respects, as the recovery proceeds, markets would tend to eliminate and reverse some of those temporary influences.

At the same time, you have what I hope are more fundamental and lasting improvements at work, which are tied up in the wage-price-productivity sector.

Representative HAMILTON. Mr. Chairman, I appreciate these factors. My time is very limited and I'm anxious to get your projections.

Mr. VOLCKER. Without making a precise projection, my sense is that we can expect those temporary factors to continue. I would hope and expect the inflation rate next year to be confined well within the range—and toward the lower side and below that range—that I gave you as a central tendency of the Federal Open Market Committee members. The published figure might be higher next year than this year, but I would hope the longer term trend is being reduced as a result of this more fundamental change in the wage-price-productivity nexus.

Representative HAMILTON. Would you then feel that the fight against inflation has to play a decisive role in the conduct of monetary policy in the next few months?

Mr. VOLCKER. I would say it is not the only influence under all circumstances, but it plays what I would call a decisive role continuously. It should play it continuously.

Representative HAMILTON. In the year beyond 1984, would you expect then that inflation would be coming down?

Mr. VOLCKER. I would hope and expect, if we can get over a little hump here, which is probable, that we could see things in effect that would bring the trend of inflation down, yes. We're aiming at that.

Representative HAMILTON. Now let me ask one other set of questions if I may. They relate to Treasury borrowing plans for 1984.

I understand that the Treasury is planning to borrow up to about one-third of its total net new borrowing needs for all of fiscal year 1984 in the first quarter of the fiscal year. In other words, it looks as if it is proceeding on a path of front-loading.

Now that has very profound impacts with regard to interest rates in 1984, and I guess what I want to ask is: Is there, in your view, an economic justification for a pattern of borrowing by the Treasury that puts so much Treasury debt before the public at a time when interest rates remain extraordinarily high?

Now I understand, and I'm sure you understand, why that might be done, the front-loading, because as you move into 1984 with the elections coming up, things could be favorable from the standpoint of the administration with heavy front-loading. I'd like you to comment on that.

Mr. VOLCKER. I have no evidence of that hypothesis. I have had no discussions on the subject at all.

Representative HAMILTON. You are not aware of any pattern by the Treasury or borrowing?

Mr. VOLCKER. There are normally large seasonal changes in pattern, but I am not aware of any intentions or actuality changing the seasonal swings for purposes of the kind that you may be alluding to.

Representative HAMILTON. Are you aware that the Treasury plans to finance $50 to $65 billion in the current quarter?

Mr. VOLCKER. I don't recall the figure for the current quarter. I believe they have announced a figure for the current quarter, but I don't have it in memory, Congressman Hamilton. They began this quarter with a very high cash balance, so that technical reason ought to be a factor reducing it from what might have been earlier expectations.

Representative HAMILTON. Do the Federal Reserve and the Treasury consult with one another about the pattern of borrowing?

Mr. VOLCKER. We sometimes discuss it, but I don't recall any discussions that I was involved in the character that you're suggesting, regarding a pattern of borrowing several quarters ahead. Normally, the cash balance remains within historic limits. Sometimes, with the amount of money that they are handling these days and the flow of tax receipts and expenditures, those fluctuations can be large, but that's been true historically.

Representative HAMILTON. Thank you very much, Mr. Chairman. My time has expired.

Mr. VOLCKER. In fact, there tend to be technical limits constraining our ability to hold very large cash balances conveniently.

Senator JEPSEN. Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman.

Mr. Volcker, concerning the deficit in relationship to the nominal GNP, you say in your prepared statement that the 1983 deficit amounted to about 6.5 percent; prior to 1983 there had only been 1 year when it had been as much as 4 percent. But other nations have had larger deficits in relationship to gross national product and they have not had the higher rates of inflation.

I've always been one for 11 years that has pleaded to bring that deficit down to live within our means, but now I'm really concerned about it. I think maybe we oversold it. Maybe that's why we have this lack of confidence.

If you look during the Carter years, the deficit as a share of GNP fell even as interest rates went up, and right now that has been happening recently.

Now how do you explain that? And let me ask one other question so I won't run out of time. I'll let you have the time.

I'm concerned about our international trade. Now how are we going to expect everybody to be exporters? You know, we have some real problems with that. I have just recently discussed this with a panel in Europe and they are completely dependent on their exports. They are staying alive off our trade deficit. Well, if we lose that, then we're going to have to have more International Monetary Fund involvement or some way to keep them all alive.

How do we reconcile that? Who's going to be the consumer?

Mr. VOLCKER. I suppose I have to answer both of your questions by saying that a lot of things are involved in both cases. A lot of things go on in the economy other than the budget deficit. You have to appraise what's going on in those areas of the economy to get an appropriate analysis of the budget deficit. As far as the size is concerned, relative to other countries, we are doing pretty well in the international league. But the significance of the deficit has to be looked at in terms of the savings potential of particular economies as well. And, unfortunately, among the major countries, we have, I believe, the lowest savings rate and have had for a long period of time. You see the other extreme—and it is an extreme case—in Japan. That's a country that in recent years has had pretty sizable deficits. They've had much lower interest rates than we have had. They've been having some trouble with growth by Japanese standards, but they have grown. They haven't had much inflation; they have a very good inflation record. They also generate private savings equal to something around 20 percent of their GNP, whereas we generate 7 or 8 percent.

Representative HOLT. Is it improving—our savings?

Mr. VOLCKER. You always have difficulties statistically with international comparisons, but that gross difference between 8 percent and 20 percent is not a statistical mirage. There's no doubt that their savings rate is some multiple of ours; whether it's 20 percent or equivalent to 16 to 24 percent or whatever, it is much, much larger than ours.

In Germany the contrast is not so stark, but it's very apparent. It looks stark until you make the comparison with Japan. I don't remember the figure offhand, but the German savings rate is around 12 percent, as I recall it, roughly 50 percent higher than ours.

If you have a different structure of that sort and you have different habits, different savings propensity, you have to judge the deficit in that connection.

What we know is that our deficit is much larger, as a percent of GNP, currently and prospectively than it was in the past, but our savings rate doesn't appear to have changed much. It has not changed much historically, and I don't think you can count on that kind of dramatic change in the future. It's a very sluggish kind of figure.

As far as the cyclical influences are concerned, there is no doubt that in many cycles it is typical for the Government deficit to decrease—not from such a big base as we're starting with—while other credit demands are rising very rapidly in response to the growing level of business activity. Interest rates sooner or later rise even though the deficit is declining.

What we have to fear now is a combination of rising private credit demands and not having the deficit fall away as much as it did in the earlier cycle, thus compounding the interest rate effect.

As to your trade question, just to comment very briefly, it is true that not everybody in the world can be a net exporter. Except for statistical problems, of which there are plenty, theoretically the trade picture has to balance out for the whole world. If everybody tried to get a net export surplus, we would have a deflationary influence in the world and we'd be in trouble. It is a question of proportion.

In some sense, certainly the growth of our economy is helpful in the whole world situation, helpful to other countries. The fact that for a time we can provide a good market for other countries, particularly developing countries, is very important. But we cannot do that as a sustainable position over time; it can't last. It's a question of proportions. Our trade deficit has run around $75 billion a year—higher in some recent months—and that begins to get to levels—not begins to get, it is at and moving beyond levels—that can be sustained over a long period of time, because that has to be financed. It also has consequences for the vitality of some important industries in the United States.

Representative HOLT. Thank you.

Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Scheuer.

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

In talking about the conditions of developing countries as you have, the big problem facing the developing countries is the tremendous projectable increase in their labor markets. In Central America and Mexico, the increase in the labor markets over the next decade or two is absolutely horrendous and you get a clear impression of push factors, sending their young people up north, that is frightening, especially in terms of our southern borders being totally out of control.

What do you think the international financial institutions can do to do something about the projected job shortage in the developing world which both the International Labor Organization and the World Bank estimate will be about 750 or 800 million by the end of the century just to keep up with where they are now, which is, of course, more than the entire employed population of the developed countries of the Western World?

I know that's a tough question.

Mr. VOLCKER. You obviously are raising a very fundamental and longer term question that can only be answered satisfactorily in terms of the internal growth in those countries. Clearly they have to maintain a high rate of growth over that kind of perspective.

What kind of contribution can the international institutions make? Let me divide it down into two categories. First, there are the so-called developed institutions, developed banks that are in the business of providing longer term credit for productive projects and that can support, over a period of time, the efficiency and growth of those economies—

adding both to the employment opportunities and to the productivity of those economies and making them viable in terms of their competitive position worldwide as well as internally.

Representative SCHEUER. May I interject there a moment? If you take a good hard look at the record of the World Bank, the IMF, and the regional financing institutions, the Asian Development Bank, the African Development Bank, and the Inter-American Development Bank, you see they have an extraordinary predilection for capital intensive projects that typically employ very little labor, that typically use no domestic raw materials in the countries in which they are developed, that typically do not produce a product for use in that country, that ignores the one asset that that country has which is a tremendous surplus of labor.

These economic enterprises are generally owned by the elites of those countries and produce a product for international trade, the profits generally being banked in a numbered account in Switzerland, and very frequently, with all the financial aid from the international lending institutions and all of that high tech development, they find that all the manure is piled up in a very small corner of the field and the rest of the field is parched and dry and unproductive. If you look at the plight of the average person, they've been helped very little and sometimes not at all by these vast development loans from the Western World.

Would you consider that perhaps the Western World ought to have some criteria as to the approriateness of the use of these loans and the kind of economic enterprise that they would stimulate; whether they should be labor intensive and job producing; whether they should be located in rural areas to stimulate some activity there; whether they should use local materials; and whether they should train local people? Do you think it makes sense to continue the pattern that we have seen so far with an awful lot of capital going into those countries into capital intensive projects which is not primarily what they need, ignoring their vast pools of labor, and adding very little to the productivity of those countries?

Now you mentioned the word "productivity" and you mentioned the words "capital intensive," and I just couldn't help interjecting a clear-shot question.

Mr. VOLCKER. You raised a question that has been debated in the council of the World Bank and other institutions for many years. It's quite a while since I've looked intensively at the patterns of their lending, but it's my impression that the thrust of your comment may not be really correct for several reasons.

First of all, while these institutions can play an important catalytic role, the basic growth dynamics of a country are going to be inspired within that country, from their own domestic savings. That's where it's going to come from, however helpful these other institutions can be. There are certain capital-intensive projects that can provide a convenient focus for the external financing that's needed and turn into a logical development plan for those countries.

Second, I think there has been a considerable effort by all of these institutions to try to respond to the kind of concerns that you suggest.

Mr. McNamara introduced a very aggressive lending program in the agricultural sector in the World Bank during his tenure. I can't give you a breakdown, offhand, of the proportions of their lending activity and how it has changed, but there certainly has been a consciousness that real gains in productivity and efficiency and in terms of the economic needs of those countries could be gained in areas beyond the building of a dam or other tangible capital-intensive project. Where that precise balance lies, I think, has to be looked at in terms of the whole development effort of the country in which these institutions can only play a very useful catalytic role. But in the mass of investment, even the poorest countries have to generate the bulk of it at home.

These institutions don't have that kind of money.

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

Mr. VOLCKER. If I could just get in one plug for the IMF. You asked about institutions in general supporting this process; it's often said the IMF is working in the other direction at the moment, with restrictive austerity programs. This is, in a sense, a shorter-term battle against your longer-term perspective. The battle is to maintain a kind of financial equilibrium, a creditworthiness of those countries that's essential if they're going to have the foundation for the long-term growth that you so clearly see is required.

Representative SCHEUER. Well, I favor that IMF policy and I'm concerned about the international debt structure and the vulnerability of our banks and, with the chairman's indulgence, I'll ask you to elaborate on that just a little bit.

Mexico seems to be doing a little bit better. Brazil is in serious shape. Argentina, with its political situation, is an absolute mare's nest of problems, and other countries are doing about as badly.

What do you see—let's say one or two of those be made against our budget deficit—it's constructive in our domestic terms. It's one measure that I think unambiguously would move our interest rates down, taking account of all the other considerations, would therefore at the same time help this external problem. And that external dimension is a significant part of the whole problem.

Mr. VOLCKER. So far as the early part of your comment is concerned, I think the question is the one of contagion or spreading default. You can always handle isolated instances, even large isolated instances more easily. The picture now is a mixed one and I have been of the opinion, and I've made no secret of the fact, that this is a battle that's going to have to be fought over a period of time. It's going to take continuing effort. It's not that you can put a program or the Mexicans can put a program into effect and the banks lend for a year and the problems are gone. There are a lot of countries involved and these adjustment programs and financing programs are going to have to be extended over a period of years. So it's going to be a constant battle on many fronts and I think we just have to wage that and you don't necessarily have to win every one, but you have to prevent it from becoming a kind of mass contagion.

Representative SCHEUER. I appreciate the chairman's indulgence.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Chairman Volcker, in July you testified before the Banking Committee providing your midyear monetary policy report to the Congress. At that time you said the threat of Government borrowing crowding out private borrowers was widely recognized and that there was a comfortable assumption that this crowding out wouldn't take place until 1985 or beyond. You said you felt that the day of reckoning would come much sooner than that because of the speed of recovery.

Do you still feel that way and when do you anticipate this crowding out to occur?

Mr. VOLCKER. You know, I read a lot of commentary about how there's no crowding out today, but there's going to be crowding out tomorrow, as if—pick your day, March 31—we will suddenly announce there's a lot of crowding out and something dramatic will happen.

This is a continuing process. I think interest rates are higher today than they would be with a smaller deficit currently and prospectively. To the extent those higher interest rates are inhibiting homebuilding or home buying or some business investment, there's some crowding out already. It obviously has not been of a nature that prevents the economy from rising rapidly. I suppose that's the question: Will this problem become so acute in nature that repercussions in financial markets will have strongly adverse repercussions on the economy itself? I think that depends partly on how fast the economy grows. We've got kind of a "Catch-22" situation. If it grows very rapidly and continues to grow very rapidly—which is a good thing in and of itself—and that generates more rapid private credit demands, it brings the day of potential additional pressures on the market sooner. That doesn't depend upon any artificial election date. It depends upon what's going on in the economy—among other things, the rate of growth. You could spin out a plausible hypothesis that says the economy would continue to expand at a satisfactory but slower rate of speed; it will not generate all that many additional credit demands during this period, and we are not going to see any striking effects for a year or two. It depends upon the assumptions you put into your predictions.

What I would say, unambiguously, is that there are risks involved that we ought to avoid taking. They are very important risks, and to the extent progress is made on the budgetary side, we limit those risks.

Representative SNOWE. Well, do you then think it's possible for the economy to grow at the present level of deficits?

Mr. VOLCKER. It has grown at the present level of deficits.

Representative SNOWE. Can it continue?

Mr. VOLCKER. It can continue for a while. If you look at this abstractly and don't take account of a lot of realities and a lot of uncertainties that I think are present in the real world, you can live with this kind of deficit at the extreme almost indefinitely. It will give you a very skewed economy, an unbalanced economy, a less productive economy, a less investment-oriented economy with less housing, but you'll survive. It is a more fragile economy, but it can continue to grow.

But I think there is a substantial risk that repercussions would be more severe than that, that anticipations enter into the market's concerns when they see interest rates moving in an adverse direction. If they move too rapidly, the inflationary expectations begin affecting behavior in a way that is inconsistent with both stable financal markets and continuing economic advance. All the risks lie on that side, and we ought to get rid of them.

Representative SNOWE. How would you describe the present mix of fiscal and monetary policy and is there a balance or is it unbalanced?

Mr. VOLCKER. I think it's unbalanced as long as those deficits are as large as they are prospectively.

Representative SNOWE. So the pressure is great on the Federal Reserve Board to move this economy or the recovery on a noninflationary track rather than Congress?

Mr. VOLCKER. It puts weight on financial markets and putting weight on financial markets adds to our problems. I think that's fair to say.

Representative SNOWE. Finally, what is the maximum level that the 1984 deficit can be without placing upward pressure on interest rates?

Mr. VOLCKER. I would hope that under certain hypotheses interest rates could move lower. We have a powerful factor holding the interest rate trend down and that is the inflation progress we've made. If that could be sustained, if real interest rates look high to the typical American, if bonds look like a good buy—and all those factors should be at work—it tends to put interest rates down. Now, as I see it, that happy kind of forecast is jeopardized by the budget deficit. The outcome will be less happy than otherwise. How much less happy depends upon all these other factors I mentioned, and I don't think there is any magic, budgetary number I can give you.

The size of the underlying deficit, which is a crude measure of the size of the problem in my judgment, is probably in the neighborhood of $100 billion and growing. It doesn't have to be dealt with all in 1 year, but it gives you a sense of where, to be comfortable, you should be going over the next 3 or 4 years. If a sizable chunk of that reduction were put in place now, with the implication that more would be dealt with later, then I think we would be in a much better situation than now, where the deficit is large and there's also great skepticism about whether anybody is ever going to face up to it.

Representative SNOWE. Thank you

Senator JEPSEN. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I'm interested in pursuing the lines of questioning put to you by Congressman Hamilton.

If you were counseling the business and labor people on what you expect the inflation rate would be in terms of making their decisions, what would you tell them?

Mr. VOLCKER. I'd tell them that in fact I think it's going to be lower than most of them probably think.

Senator SARBANES. And what figure would you tell them?

Mr. VOLCKER. I haven't given a precise figure, but in answering Congressman Hamilton I indicated that while we're absorbing this move from temporary depressing factors you would expect the inflation rate to be higher than it was in the first half of this year, but I would hope that it's at the low edge of those figures around the central tendency, and I hope that——

Senator SARBANES. What were the figures in the first half of this year and what were the figures around the central tendency?

Mr. VOLCKER. The first half of this year the Producer Price Index was actually negative. The Consumer Price Index was pretty close to flat, maybe with a small plus. That was a temporary situation.

Senator SARBANES. Did you indicate at Hot Springs on October 7 that they sought to use a figure of 2.6 percent?

Mr. VOLCKER. No. I cited that as what the figure had been over the past 12 months.

Senator SARBANES. Now that 12-month period——

Mr. VOLCKER. I put that exactly in that context. It had been 2.6 percent over the past 12 months. You couldn't necessarily expect the result to be that good in the next 12 months.

Senator SARBANES. Now that 2.6-percent figure was during a period in which the Fed for most of the period was easing up on the money supply; is that correct?

Mr. VOLCKER. The money supply was growing rather rapidly during most of that period, yes.

Senator SARBANES. Now why did the Fed contract the money supply?

Mr. VOLCKER. Why did the Fed contract the money supply?

Senator SARBANES. Tighten up beginning in——

Mr. VOLCKER. We haven't contracted the money supply.

Senator SARBANES. I strike the word "contract." Tighten up, beginning in May 1983?

Mr. VOLCKER. We were in a situation at that point where we had had a considerable period of rising money supply, not simply in the M–1 figure that attracts a lot of attention, but also there was some tendency at that point for the credit figures and the broader monetary aggregates to speed up a bit. This was against the background of a rapid increase in economic activity and a lot of momentum in the economy at that time. There were indications that some of the distortions in the monetary figures, and more particularly in the monetary velocity, might be coming to an end. That's a difficult judgment to make, but I think that's true, that some of the gross abnormalities—if I may cite it that way—had receded so it appeared appropriate to take a modest step toward somewhat more restraint on bank reserve conditions under those circumstances, looking, among other things, toward a more sustainable rate of——

Senator SARBANES. Well, are you expecting inflation to take off again?

Mr. VOLCKER. Take off in an imminent sense? No. But I worry about what will happen to inflation down the road.

Senator SARBANES. Well, you cited a 2.6-percent figure for an August-to-August period, which is a pretty low level of inflation.

Mr. VOLCKER. Correct.

Senator SARBANES. And at the same time, you're moving to tighten monetary policy.

Mr. VOLCKER. Exactly, because what we do today is going to have an influence on the inflation rate down the road, next year, the year following, the year following that. It's part of a continuing pattern, and I'm well aware that that inflation figure for the past year had some temporary ingredients. It also had some ingredients that I believe can last, and our policy ought to be directed in a way to encourage those fundamental, continuing factors to prevail over the years ahead.

Senator SARBANES. Do you expect the interest rates to go up or down in the near future?

Mr. VOLCKER. I'm not going to predict interest rates.

Senator SARBANES. Do you think the Treasury should be borrowing heavily in the first quarter of the next fiscal year?

Mr. VOLCKER. My problem is that the Treasury has to borrow heavily continuously, given a deficit of the size we have.

Senator SARBANES. Well, Congressman Hamilton's question ran to the front-loading problem. Should they do that?

Mr. VOLCKER. I don't know of any plans along those lines.

Senator SARBANES. Are you familiar with that article by Lindley Clark in the Wall Street Journal in mid-August, the title of which is "The Odd Couple: Treasury and Fed Try To Reelect Reagan?"

Mr. VOLCKER. I sometimes read articles by Lindley Clark. I have no particular recollection of that one.

Senator SARBANES. Now that was a question that Congressman Hamilton put and that I'm putting. We didn't conjure this up ourselves. I think we're prompted to ask it by this article. And am I to understand that—it seems to me that is a charge or allegation to which the Fed would be very sensitive. Are you not familiar with that article?

Mr. VOLCKER. I recall reading some place the kind of charge that you are making that the Treasury plans to do all this borrowing in the first half of the year or some such thing.

Senator SARBANES. You mean elsewhere than this article?

Mr. VOLCKER. I remember having seen that some place.

Senator SARBANES. Well, what's your response to his allegations?

Mr. VOLCKER. First of all, I have absolutely no knowledge of such an intention. I have not had time to run down every accusation of that sort that I read from Lindley Clark or elsewhere in the press. I get a stream of material—I see it because I can't avoid it—about how all our actions are politically motivated, and I think it's nonsense. A lot of people seem to have a deep conviction along that score. It seems to me contrary to the facts.

Senator SARBANES Well, I'm offering you the opportunity right now to answer it and place it on the record.

Mr. VOLCKER. That's what I'm trying to do.

Senator SARBANES. He makes certain comments about exactly how you're pursuing your policy.

Mr. VOLCKER. That we're involved?

Senator SARBANES. Yes.

Mr. VOLCKER. I don't know what accusation he makes of us, but I deny that our policy is motivated by any electioneering strategy.

Senator SARBANES. Well, Mr. Chairman, my time is up. I may come back to this I think. I think it would be helpful, Mr. Chairman, if you took that article and rebutted the specifics of it and placed that in the record.

Mr. VOLCKER. There may be something specific to rebut, but that accusation is made frequently, and the irony is that it's made in both directions in connection with the last election.

[The article referred to by Senator Sarbanes follows:]

[From the Wall Street Journal, Aug. 16, 1983]

THE ODD COUPLE: TREASURY AND FED TRY TO REELECT REAGAN

Speaking of Business

by Lindley H. Clark Jr.

You remember the Federal Reserve. That's the agency on Constitution Avenue that's always yammering about its independence. The administration and the Fed do talk sometimes, but as often as not they seem to be talking at one another, instead of with each other.

The Treasury Secretary keeps the Fed on its toes by arguing one week that the central bank is making money too easy and then, a week or two later, deciding that everything is fine. The Fed replies that the administration is causing the trouble by cutting taxes and busting budgets.

The administration would have loved to replace Fed Chairman Paul Volcker with someone but it couldn't agree on anyone. The Treasury has occasionally thought about proposing that the Fed be made a part of—you guessed it!—the Treasury.

The upshot of this, astonishingly enough, is that the Federal Reserve and Treasury appear to be embarked on a joint project: Reelect Ronald Reagan.

All of the elements of this are a little tricky, and I will not guarantee that there have been any joint negotiations. But the aims seem obvious enough.

Let's start with the Fed. The central bank mangled monetary policy in 1982. At the start of the year it permitted a sharp explosion of the money supply. And then, as usual, it lurched in the opposite direction, slamming on the brakes.

One result was that the economy, which had seemed to be pulling out of the recession, continued to stagger. The Fed, finally aware of what it had done, then lurched in the opposite direction, expanding the money supply briskly from mid-1982 until mid-1983.

Once again, the Federal Reserve realized that it had overdone things, or at least several of its officials did. With a roaring boom under way, a majority of the Federal Open Market Committee, the system's chief policy-making body, decided to try some delicate fine-tuning.

As far as I know that phrase, fine-tuning, was first used in connection with economic policy by Walter Heller, then President Kennedy's chief economic adviser. It was a felicitous phrase, never really intended to apply literally to policy. The Fed, however, seems to be deadly serious.

Since May it has been tightening money slightly by limiting the reserves it supplies to the banking system. The result so far has been an increase of a point and more in interest rates.

The aim is to tone down the boom a little without stopping the recovery. Part of this artistic conception is the international element. Interest rates will be allowed to rise, but not enough that they enlarge unduly the debt-financing costs of underdeveloped countries or strengthen the dollar enough to bring real disaster for America's exporters. It's a difficult assignment, but the Fed apparently believes it's equal to the task.

With the economy growing comfortably but not exuberantly, private borrowing demand will be restrained. And that is where the Treasury begins to play its part. With budget deficits close to $200 billion, the Treasury has to borrow a great deal of money every fiscal year. Its next fiscal year starts on Oct. 1. So the idea may be to try a little front-loading.

Paul Markowski, chief economist of the consulting firm of Buckingham Research, suggests the Treasury has front-loading in mind:

"Indeed, unless they don't believe their own projections, the $60 billion to $65 billion new Treasury borrowing scheduled for the Oct. 1 quarter suggests that front-loading may be in their plans. For if they do another $50 billion to $55 billion in the following quarter—an excellent prospect—only one-third of the deficit, or $60 billion to $70 billion, would have to be financed during the six months prior to the elections."

So the Fed will keep the economy relatively subdued, leaving room for the Treasury to get most of its borrowing out of the way. That brings us up to the spring of 1984. Presidential campaigners will be in full cry.

The economy won't look tremendous. Growth will be fairly good, though, and unemployment will be edging down. Inflation will be modest by current standards, 5% or less. And wait. Better things are on the way.

Having shepherded the economy through many months of restrained recovery, the Federal Reserve then can step on the gas. Just how carefully this will be done is anybody's guess, but there's no political reason to worry about inflationary effects: They can't materialize until after the elections.

The boom will resume, and private borrowing demand will grow. But the Treasury, having already loaded up with cash, won't be crowding people out of the markets. Interest rates will rise, but not enough to choke off the strong recovery that will help reelect Mr. Reagan.

Is this cynical? Of course it is. And there's more.

The Federal Reserve's independence has always been more apparent than real. Robert Weintraub, senior economist of the Joint Congressional Economic Committee, carefully studied Federal Reserve history and discovered that the Fed always has delivered pretty much the monetary policy that the administration wanted.

Paul Volcker has been no exception. In 1980 the Fed didn't much like the idea of credit controls. Yet when President Carter authorized the Fed to impose them, it did so. The president got what he wanted.

Mr. Volcker has been given a great deal of credit for his persistence in monetary restraint through most of the 1981-82 recession and the consequent sharp drop in inflation. But anyone who thinks the Fed could have stuck with such a policy without the support of the administration is naive, not cynical.

Whatever degree of independence the Federal Reserve now enjoys lies mainly in matters of technique and detail. The central bank rebuffs congressional requests that it set targets for the gross national product, for instance. Such targets, Mr. Volcker maintains, would convey the impression that the Fed thought it was omnipotent. When the targets were not achieved there would be a wide feeling of disappointment.

There's probably something to what the chairman says. But the Federal Reserve in recent years has had some difficulty hitting targets for money-supply growth, something it does control. A missed GNP target or two probably wouldn't add greatly to the disappointment.

The Fed retains a modicum of independence by trying to make its job seem as complicated as possible. Monetary targeting was uncomfortably specific, but the central bank eased that problem by adding new targets, changing target ranges, adopting new base periods and making other alterations.

There is, of course, no assurance at all that the Treasury-Fed campaign to reelect President Reagan will work. The Federal Reserve has never been able to operate with delicacy before. But even non-fans of Mr. Reagan must hope that the Fed somehow pulls this one off.

There is a nagging question, though. If the Fed had operated more smoothly in the past couple of years, would this fine-tuning really be necessary?

Senator JEPSEN. Congressman Wylie.

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

Chairman Volcker, we're glad to see you here this morning.

In answer to a question by Congresswoman Snowe, you ended up by saying, "I doubt if anybody will face up to it," meaning that you doubt if anybody will face up to the budget deficit and demonstrate some concern about the size of it, and that means that you don't think Congress will face up to the budget deficit.

Mr. VOLCKER. I didn't mean to say that, and I don't know whether I did. What I meant to say, in any event, is that the American public has great doubts as to whether the Congress is going to face up to it. I retain that hope and conviction.

Representative WYLIE. Well, I agree with you that there's some doubt that we can face up to it right away because of the provincial interests that all of us have in certain aspects of the budget. So in a special order I suggested some national budget deficit committee, somewhat similar to the Social Security Commission, and we've introduced a resolution to suggest that we have a national budget commission modeled after the Social Security Commission to study this whole thing and make recommendations as to where we can decrease the deficit. We have suggested they report back by 1985. How long can we wait?

Mr. VOLCKER. That is too long, it seems to me; that would be my comment.

I think a commission of that sort—and I have heard that kind of proposal—may serve a purpose when you face a difficult problem of structural changes in the tax system. It seemed to be a useful catalytic kind of influence in the social security area, where there was a similar kind of problem. But I don't think we have the luxury of sitting back and worrying about what the ideal tax structure is and developing a long deliberative process before beginning to make some progress on this deficit.

The two things can go on concurrently. It doesn't mean that a commission of that sort would not have some merit on its own. If it were considered a substitute for action in the shorter run, for beginning to make progress, then I think it would be counterproductive.

Representative WYLIE. Well, I think there are three ways that have been suggested that the deficit might be reduced. One is for economic growth to increase, and apparently it is increasing. The gross national product was predicted to increase by about 4 percent and I noticed in a Wall Street Journal article now that it's going to be about 5 percent and you're suggesting it's going to be about 5 percent. Secretary Regan, in his testimony before our committee not long ago, said that he thought that economic growth could have a substantial impact on the budget deficit and indeed it could as the Congressional Budget Office has said that if the gross national product could grow by 1 percentage point it's apt to reduce the deficit by $83 billion, and 2 percent would be $166 billion, and those are their estimates.

Mr. VOLCKER. What percentage point?

Representative WYLIE. The Congressional Budget Office said that a 1-percent increase in the gross national product could reduce the deficit by approximately $83 billion.

Mr. VOLCKER. The decimal point must be in the wrong place——

Representative WYLIE. OK—accumulative over a 4-year period. But I think that's over-optimistic to suggest that the economy will grow by 2 percentage points on the gross national product. Would you agree with that?

Mr. VOLCKER. In general, obviously higher economic growth will bring additional revenues, will cut down on unemployment compensation, and that reduces the budgetary deficit. That's why I would focus on the continuing, underlying "structural" deficit, or whatever nomenclature you want to use. I think we are in a position where after you take account of growth—and of growth however fast you want to project it to a national full employment level—you're left with a great big deficit. That's what's exceptional about our situation now. You're not going to get rid of the deficit by growth. The faster the growth, the more the cyclical portion of the deficit will go down, but also the faster the private credit demands are generated. You don't get relief from market pressures that way, you get that by dealing with the structural deficit.

Representative WYLIE. Well, there is some disagreement as to whether that's achievable or not, an increase of 2 percentage points over the next 4 or 5 years. So then, the next possibility is a tax increase and more income over the past few years has not resulted in lower deficits, so I would sort of reject that out of hand as not being the way to reduce the deficit. And then that gets me back to reducing Federal spending, and I think that your observation there that Congress is not likely to face up to that is accurate, and that's why we thought this idea of a so-called budget deficit commission to look at all the programs—entitlement programs which make up about 48 percent of the budget now, and defense which takes up about 27 percent of the deficit. But you have commented on that and I just wanted to make that observation.

I noted in the Wall Street Journal also a statement that September's impressive economic performance has positioned the economy for a further solid growth without a major resurgence of inflation.

Are you concerned about the big increase in new car prices and the prospective rise in meat prices next year because of the drought or food prices?

Mr. VOLCKER. I think on a lot of points we clearly had a bad break in the weather situation. The experts all tell me that that will lead to at least moderately greater food prices next year, and that's one of the reasons why you project a higher inflation rate next year. How serious that is, I think, depends a lot upon how things look weatherwise and otherwise next year. Are we going to get a lot of soybeans harvested next fall? If we come in with a good crop next year, I think the situation may not be too damaging.

There are a lot of uncertainties in the world, weatherwise and otherwise. But certainly the crop situation is an adverse factor and while, in itself, could very well be temporary, the question in my mind is whether this brings the skepticism about the longer term rate of inflation.

If what happens gets Fed back into the wage-price policies generally, then it persists. If we can avoid that, inflation progress will be a lasting phenomenon. But there's enough uncertainty there so that, yes, I worry about it.

Car prices went up relatively moderately at the beginning of this year, as I understand it I'd rather see no increase, but that in itself is not going to put us off course. Here you have an industry that is showing production increases, productivity increases, and a rapid return to profitability, and I think there is a great opportunity for that industry to repair its competitive position, make profits, but they have got to be concerned about their cost trends.

Senator JEPSEN. I am having to go vote.

Representative WYLIE. May I ask one more question?

Senator JEPSEN. I think that we'll have your one last question and then we'll adjourn. I thank the Chairman for coming and, if I may, I would point out the same factors that go into these formulas that are put into these computers and spit out these projections also project deficits and all these things just goes back to when you do have a sustained recovery they work in the reverse way, and the same formulas now are showing that a 1.5-percent decrease in unemployment, a 1-percent drop cuts some $27 billion, and then you talk about the deficit and a 1-percent gross national product increase drops the deficits. In fact, the last 6 months or so things looked pretty well. When I was back in Iowa during the recess, the way things were reported, there may be a slight drop in the deficit, and some people say, "Gee, things got better when Congress was out of session." [Laughter.]

Mr. VOLCKER. Without commenting on the last point, I think I must say it's an illusion to think that this budgetary problem will be handled through growth alone. That will reduce the stated deficit, without any question, and I will take that any way I can get it. But it's that residue of deficit that's left that troubles me. The deficit becomes more important, more troublesome, the higher the level of economic activity, and so while you reduce the cyclical proportion, you're left with that undigestible lump in the midst of an economy that's generating a lot of private credit demands; and that's where the trouble is.

Senator JEPSEN. I thank you, Mr. Chairman.

Congressman Wylie, will you adjourn the committee?

Representative WYLIE. Yes. I happen to think you're right on that last point. The thing I want to pursue is the possibility that some countries might link their economies to our dollar. Israel talked about that for a little while.

What type of impact would that have on the value of our dollar and on our own economy?

Mr. VOLCKER. As far as a small country like Israel, with a population of two or three million, I think any impact would not be noticeable. It's just too small.

Representative WYLIE. Nothing to worry about if the other countries want to do that?

Mr. VOLCKER. Not from the standpoint of direct economic influence. There may be things to worry about from the Israeli standpoint, to the extent that it may or may not involve other kinds of commitments. But in terms of economic impact on our financial markets, on our economy in a gross way, it would not be noticeable. It raises questions, in concept, about the consistency of banking regulation, among other things, among countries that are all in a dollar zone. It raises a lot of questions, particularly from the Israeli standpoint, with pluses and minuses which would have to be balanced.

In terms of the gross economic impact on the United States, it's simply too small a country.

Representative WYLIE. Senator Jepsen gave me the opportunity to adjourn the committee this morning, and I do so now, and I thank you very much for your appearance here.

[Whereupon, at 11:50 a.m., the committee adjourned, subject to the call of the Chair.]

O