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MONETARY REFORM AND ECONOMIC STABILITY

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MONETARY REFORM AND ECONOMIC STABILITY

WEDNESDAY, MAY 16, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Symms, and Mattingly.

Also present: James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Robert R. Davis, Christopher J. Frenze, and Paul B. Manchester, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. It is a great pleasure to welcome you, Congressman Kemp, to initiate our hearings on monetary reform. We look forward to your views, which I always find provocative as well as informed.

Indeed, it is time for provocative ideas. The last 15 years have been characterized by less stability in prices and the level of business activity than should have been achieved. The conduct of monetary policy has been a key element in determining this pattern. We cannot maintain the improvement in living standards that the American people deserve unless we reduce the tendencies toward cyclical instability and inflationary bias.

The problems of monetary instability are not problems that are likely to be solved quickly by one well-intentioned directive, nor are they problems created by any individuals, past or present. And I want to emphasize that in my opinion, after many, many hearings on the Joint Economic Committee with regard to the Federal Reserve Board, interest rates, and the problems we are having in this country, that we are dealing with a problem that is primarily institutional in nature, and I don't believe we can point fingers or blame individuals. In fact, it is difficult to identify, with the rapid changes, deregulation, and other factors, what is considered M1 and M2. The fact is that the ideal money supply growth has been continually violated, when we have an 8-percent money infusion in the last year and in the last 2 months a zero growth.

Those wide variances have been generated by unpredictable discretionary decisions. Because of this volatility, measures have been introduced by yourself, and myself and Senator Mattingly in the Senate, and we are going to be looking at some of the procedures.

The problem is not one of inappropriate individual action but rather a problem of inappropriate institutional incentives, procedures, and accountabilities.

Our forefathers recognized long ago that we guaranteed good government by designing institutions that lead ordinary men to make wise decisions, not by relying on the benevolence of wise men. The same is true with monetary policy.

We have been blessed with civil servants of unusual wisdom and dedication in the Federal Reserve, but we have asked them to perform in flawed institutions. Monetary policy has been given a conflicting mandate to boost real economic growth, lower unemployment, lower interest rates, and maintain price stability. With these conflicting objectives, it is little wonder that there is little accountability for monetary policy. No one has decided what monetary policy can do and what it cannot do, so for what can the Federal Reserve be held accountable? I believe that our central bankers have done as good a job as is possible while under political pressure to reach an impossible goal.

So we must recognize that our task necessarily is one of institutional reform. Any changes must be undertaken with great care, but the benefits to be gained from increased economic stability are too important to be ignored.

Some of the recommendations made at these hearings are likely to be comprehensive and far reaching. A more modest first step would be to make the present conduct of policy more transparent by revealing changes in policy to the public immediately. The Senate version of the Federal Reserve Reform Act of 1984, which Senator Mattingly and I cosponsor, contains a version of this idea designed to reduce market uncertainty and induce more stability in monetary policy itself. It certainly would be in the traditions of democratic society to reveal the intention of policy to the public, and knowledge of monetary policy is a prerequisite to meaningful accountability, and that's the key.

Again, I welcome you, Congressman Kemp, and I now yield to my distinghished colleague, Senator Mattingly, who has been a leader in this whole area ever since he first set foot in the Senate.

Senator MATTINGLY.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman.

I think this hearing on Federal Reserve accountability is very timely. During the last 2 months, we have seen the prime interest rate rise by 1½ percentage points. I think the rise in percentage points, as we all know, has a costly effect on our economy. Many industries, especially housing and the automobile industry, are extremely sensitive to rising interest rates.

Consider the following example. If an individual owns an $80,000 home with a $64,000 mortgage for 30 years, his payments are $708 per month. For every point the interest rates go up, the monthly mortgage rates for that mortgage will increase $50. In just the past few weeks, we have seen $75 a month added to the cost of buying a home for the working taxpayers of our country.

It is no wonder, then, that for every 1 point rise in interest rates, there will be 250,000 fewer home sales a year. For every point increase in interest rates, there will be a decrease of 150,000 housing starts.

High interest rates will kill our current economic recovery really as dead as last year's Thanksgiving turkey.

Many schools of thought exist as to why the interest rates are rising. Certainly the large Federal budget deficits, caused by an uncontrolled appetite for spending by Congress, are a contributing factor. But the extremely tight monetary policy followed by the Fed is a major factor in interest rates rising. I'm not suggesting that we turn on the printing presses as we have done in the past, but during the month of April the growth in the money supply was negative. In fact, it was minus 1.2 percent.

Now, if somebody knows how we can maintain healthy growth in the economy while the money supply is squeezed, I'd like to hear it. I don't think it's possible. If it is, we ought to call it the Houdini Theory of Economics, because that's how neat a trick it would be.

With this monetary policy, we won't have to worry about inflation running rampant in the United States. We won't have to worry about that at all. The bad news will be that everything else about this economy will be going down the tube.

I don't want to try to politicize the Federal Reserve System. I think we have enough trouble now dealing with the political results of their actions. They cause enough problems with their erratic policies when they seek to fine tune the economy. If they were overtly involved in politics, it would only make things worse.

I am concerned about the lack of openness practiced by the Fed regarding its policy decisions. These decisions have tremendous effects on the economy and on the business decisions in our country. Therefore, institutional reforms are necessary to make them more forthright.

The Federal Reserve System has become like a college of cardinals. Everyone from financial experts, to Government leaders, to average investors, must sit around listening to rumors and watching the smoke coming from the chairman's cigar, hoping somehow they will guess right about Federal Reserve policies.

Decisions made by the Federal Open Market Committee are not announced for weeks after that. I see no purpose that is served by this secrecy and delay. I do see a lot of harm in this.

I have introduced, as Senator Jepsen said, Senate bill 2620, the Federal Reserve Reform Act of 1984, in the Senate, and I know Congressman Kemp, who is going to testify, has introduced the same legislation in the House. And I hope Senator Symms will also cosponsor our legislation. I won't go into the details of it because Congressman Kemp will give us that.

But I think the bottom line of that legislation is, as long as the President is going to be hung because of monetary policy crimes, I think we at least ought to give him the right to pick his own accomplices.

Thank you, Mr. Chairman.

[The written opening statement of Senator Mattingly follows:]

Written Opening Statement of Hon. Mack Mattingly

Mr. Chairman, this hearing on Federal Reserve accountability is very timely. During the last 2 months, we have seen the prime interest rate rise by one and a half percentage points. The rise in interest rates, as we all know, has a costly effect on our economy. Many industries, especially housing and the automobile industry, are extremely sensitive to rising interest rates. Consider the following example of how rising interest rates depress housing starts and sales. If an individual owns an $80,000 home with a $64,000 mortgage for 30 years, his payments are $708 per month. For every point the interest rates go up, the monthly mortgage rates for that mortgage will increase $50. In just the past few weeks, we have seen $75 a month added to the cost of buying a home for the working taxpayers of our country.

It is no wonder then that for every one point rise in interest rates, there will be 250,000 fewer home sales a year. For every point increase in interest rates, there will be a decrease of 150,000 housing starts.

High interest rates will kill our current economic recovery as dead as last year's Thanksgiving turkey.

Many schools of thought exist as to why interest rates are rising. Certainly, large Federal Budget deficits caused by an uncontrolled appetite for spending by Congress are a contributing factor. However, the extremely tight monetary policy followed by the Fed is a major factor in interest rates rising. I'm not suggesting that we turn on the printing presses as we've done in the past. But during the month of April, growth in the money supply was negative. In fact, it was minus 1.2 percent. If someone knows how we can maintain healthy growth in the economy while the money supply is squeezed, I'd like to hear it. I don't think it's possible. If it is, we should call it the "Houdini Theory of Economics" because that's how neat a trick it would be.

With this monetary policy, we won't have to worry about inflation running rampant but that's just the good news. The bad news will be that everything else about this economy will be going down the tube.

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I am concerned with the lack of openness practiced by the Fed regarding its policy decisions. These decisions have tremendous effects on the economy and on business decisions. Therefore, institutional reforms are necessary to make them more forthright.

The Federal Reserve has become like a college of Cardinals. Everyone from financial experts, to government leaders, to average investors, must sit around listening to rumors and watching the smoke coming from the chairman's cigar—hoping somehow they will guess right about Federal reserve policies.

Decisions made by the Federal Open Market Committee are not announced for weeks. I see no purpose that is served by this secrecy and delay. I do see a lot of harm.

I have introduced the Federal Reserve Reform Act of 1984 in the Senate and I know Congressman Kemp, whom we will hear from later today, has introduced similar legislation in the House. My chairman here today is a cosponsor of my bill.

It would require the Federal Open Market Committee to publish decisions on the day they are made. Let's end the guessing game. The public has a right to this information.

Second, my bill would make the Secretary of the Treasury and the Chairman of the Council of Economic Advisers ex-officio members of the Federal Open Market Committee. They would not be able to vote, but they would be able to take part in the discussions. In this way, the Fed would be certain to be informed on the administration's thinking. Likewise, the administration would know the direction the Fed was taking and why. They might not agree but at least everyone would be informed. It would make it more difficult for an administration to completely wash its hands of monetary policy.

My bill, would also cut in half the 14-year terms of the Board of Governors and it would bring the Chairman's 4-year term more in line with that of the President's term. There would still be a 13-month overlap for the chairman which would provide some continuity. But a president would be able to appoint a new chairman within 13 months if he had serious disagreements with the incumbent.

As long as a president is going to be hung because of monetary policy crimes, at least give him the right to pick his own accomplices.

Thank you.

Senator JEPSEN. Senator Symms.

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

I see that you have three very distinguished witnesses this morning, all with excellent credentials, and I appreciate you holding these hearings, and I look forward to hearing what they have to say.

I don't have a statement to make, but I'll have some questions that I will ask at a later time.

Senator JEPSEN. I thank you.

Welcome, Congressman Kemp.

Your prepared statement will be entered into the record, you may proceed in any manner you so desire.

STATEMENT OF HON. JACK KEMP, A U.S. REPRESENTATIVE IN CONGRESS FROM THE 31ST CONGRESSIONAL DISTRICT OF THE STATE OF NEW YORK

Representative KEMP. Thank you, Mr. Chairman.

Let me thank you for holding these hearings, and let me thank your colleagues to your right for their comments and for their interest. I can't think of a more important issue facing this country than establishing the type of a monetary policy, Mr. Chairman, to which you alluded, a monetary policy that will give the American people what they desperately need. They need sound, honest money. They need a Federal Reserve Board policy that has made those institutional changes that will give markets more information so that our markets are not driven by rumor and gossip and innuendo and leaks.

Markets can deal with information if they get the information. The problem is that today in our markets, which were once called the Eighth Wonder of the World, they are not getting information simultaneous to the changes that are made—in secret, in the dark, at night, behind closed doors, by a group of wise men, one woman, Mrs. Teeters, who are making decisions over the value of our currency, who are making decisions about interest rates, who are making abstract decisions with regard to how high nominal GNP should be in this country, which affects not only our own Nation, our own debt, our deficit, our own trade policy, but, as other people have mentioned, is affecting our Third World neighbors, our ability to trade with other countries, and of course causing a great deal of pain and austerity on our border in Mexico.

I think it is interesting that today, when Miguel de la Madrid speaks before a joint session of Congress, I'm sure he will bring up the interest rate policy of the Federal Reserve Board and the impact it is having adversely on his ability to finance the debt that was incurred in the late 1970's. Every 1-percent increase in the prime rate in the United States drives Mexico's debt burden up by $600 or $700 million.

So what we are talking about today is not just a policy that we should not be parochial about it. I don't want to see, nor do you, Mr. Chairman, a monetary policy designed to reelect Ronald Reagan or Republicans or Democrats. We need a monetary policy that will give the American people what they desperately need—stability, information, an intellectual guideline around which they can make decisions over their savings and investment accounts that will stretch out their horizons, that will help build an industrial base that can compete in world markets and, of course, put this Nation back to work and help reduce that debt burden in this country and in the world by establishing a bigger port, a bigger industrial base, a bigger and broader economic base.

So I am delighted, Mr. Chairman, that you are holding these hearings. I think it's the single most critical issue facing this country and the world today in terms of the impact for good or bad that monetary policy has.

One other thing. You mentioned that we are asking the Fed to do a lot of things. I don't disagree with that, but I think it is important that we realize for years we have been told we cannot achieve price stability and economic growth at the same time. There are some in this town, and particularly in academia—not the ones who are there today, but nonetheless there are those in academia who say that growth in and of itself is inflationary, that inflation is caused by too many men and women working.

I come from Buffalo, NY, Mr. Chairman, and I know you come from Iowa. I would say the farmer, the small business people of Iowa, those of western New York, have a big stake in what happens on these issues, and you are to be commended for holding the hearings, and I just again want to thank you.

Thank you again for allowing me, with unanimous consent, to put into the record my full testimony. I'd like to read just a couple of pages and then get to the bill, because I think the question of why are interest rates raising in the recovery is probably the key issue at stake. And I think the institutional reforms, to which you alluded and to which I am testifying today, are critical to providing not only the markets with more information, Mr. Chairman, but allowing us to provide the kind of monetary policy that will give this country and the world what it very much needs.

I think the need for such a reform was made recently and dramatized or illustrated recently by an incident involving Mr. Frank Morris, the president of the Federal Reserve Bank of Boston. According to the Washington Post of May 2, 1984, Mr. Morris disclosed to a group of business economists that the Federal Reserve Board tightened its monetary policy and allowed the Federal funds rate to rise at its March 26–27 meeting of the FOMC, the Federal Open Market Committee, because it was concerned, Mr. Morris said, that the economy is growing too fast.

This disclosure created an uproar, as you know, Mr. Chairman. The next day the Wall Street Journal reported one Fed official said, "I choked when I opened my paper this morning." Federal Reserve Board Governor Henry Wallich declined any comment, but he said, "I would only be compounding the indiscretion."

Randall Forsyth put the reaction more pungently in Barron's on May 7:

> Frank Morris got a lot of his colleagues at the Federal Reserve Board mad at him last week by doing what central bankers are never supposed to do: saying very loud and clear what the monetary policymakers are up to.
>
> The President of the Boston Fed—

He goes on to say—

told a meeting of economists in Beantown that the Federal Open Market Committee voted unanimously to tighten policy at its March 26-27 meeting in order to slow down the economy. That revelation wasn't supposed to be made until the minutes of the confab were released on May 25, just before Wall Street and everybody else breaks away for the Memorial Day weekend. And if FOMC decisions are to be leaked—

This is again Randall Forsyth in Barron's—

before their appointed time, that's the job of a certain tall, bald, cigar-smoking official who calls favorite reporters, not the Reserve Bank heads who blab.

This incident, I repeat, Mr. Chairman, is not insignificant. I've been here 14 years. All of us have been here for various times. I have never in my career in the Congress come across a situation such as this.

It is significant, I think, for two reasons. In the first place, it highlights the fact that the 12-member FOMC Committee, which meets in secret, does not disclose its decisions for a long time, between 5 and 6 weeks, after they are made, unless a member of the FOMC should happen to leak the results to some favored party, such as Mr. Morris' business economists in this case.

Let me say parenthetically that if you knew in private that the Fed had tightened at a previous meeting and no one else knew it, you could sell D marks and buy dollars, because certainly the dollar would rise in foreign exchange markets. You could sell bonds and buy something else. In other words, a few people can profit by that inside information.

Now, if the FTC found out that people were trading in inside information, as they have done recently, there would be hell to pay. But this is done routinely, Mr. Chairman, and I think it's outrageous, and not only is it outrageous that a favored few get this information, it is impoverishing other people, consumers, homebuyers, as you pointed out, farmers, small business people, our Third World allies, and of course is affecting our trade balances adversely.

There is not even a legal requirement to release the decision. It's just a review, a résumé of events that are released. What purpose does secrecy about decisions already made serve except to churn speculation about policy and increase the opportunity for insider trading, as I pointed out?

Again, I believe in the law of efficient markets. I think markets can deal with information, but it should be timely, it should be open, it should be as candid and truthful as we possibly can be. And every agency of the Federal Government today operates to the degree possible in the sunshine, except one, and that's the FOMC, meeting in secret and allowing leaks to drive our markets.

And that is an outrage. Not only is it outrageous; it certainly is impeding the ability of our bond market and our capital markets to get information, and of course to resume their function of providing the oxygen and the seed corn and the capital of this country to flow into the most efficient uses for the good of the American people, and of course our economy.

Second, Mr. Chairman—and I bring this up for obvious reasons—the incident brings into question the propriety of the policy itself. Why in the world is the Federal Reserve trying to slow down the economy? On what mandate does the Fed decide that the growth of the economy is prima facie evidence of inflation when there is no market anywhere in the world that leads to that conclusion, other than what they predict will be nominal GNP in the future, predicated upon a backward-looking market which is the nominal GNP in the first quarter of 1984.

Put another way, what on earth is wrong with strong economic growth if it is accompanied by low or no inflation, Mr. Chairman?

For the first time in almost 20 years we are seeing a strong economic recovery with a very low rate of inflation, almost no inflation as reported by the wholesale price index in the month of April, and yet they are allowing the Federal funds rate to rise which pushes the prime rate up and causes many of the problems, and I think is helping to cause disequilibrium in our financial markets.

If it is concerned with price stability, why isn't the Fed targeting price stability instead of economic growth?

I think there is something very much wrong, Mr. Chairman. I've been talking about it now for more than 1½ years; you have been talking about it, many Members of Congress on both sides of the political aisle are deeply concerned, and they are concerned not just with the process, Mr. Chairman, but with the present policy.

Together with many colleagues in the House, I have recently introduced two pieces of legislation, H.R. 5459 and H.R. 5460. I'm not going to go into any great detail, but I would just like to make a very brief explanation of what those two bills would do.

The 4-year term of the Chairman of the Federal Reserve would begin in February of the calendar year after the year in which the President's term begins. This would make the President's and the Chairman's terms concurrent except for a 1-year lag. This provision is supported by both Chairman Volcker and the administration.

We put the Secretary of the Treasury as an ex officio on the FOMC. He used to be, up until the 1930's. This provision would restore his earlier status and would increase input, I think, Mr. Chairman, between an administration and the Federal Reserve Board and help bring into if not synchronization at least into coordination our fiscal and monetary policy.

The terms of the seven members of the Board of Governors would be reduced from 14 to 7 years.

But the most important thing, Mr. Chairman, as you pointed out, the Fed would have to announce its change in policy on the day the decisions are adopted. This measure, advocated over the years by many prominent economists, including Milton Friedman, would end volatile speculation in the financial markets due to the rumors and uncertainty about Federal Reserve policy.

As you know, under current law there is no requirement that decisions be released. The new provision would end that dilemma.

Insofar as the policy of the Federal Reserve, I would suggest, Mr. Chairman, as in my second bill, that it be the policy of the Federal Reserve Board, through its Open Market Committee, to maintain as low an interest rate as possible and as stable an exchange rate as possible, and encourage as strong an economic growth as possible to the extent that such policy is consistent with long-term price stability.

Current law states a number of desirable objectives but it does not give any direction as to the relative importance, nor does it anywhere state that price stability or the integrity of the U.S. dollar as the overriding goal toward which Federal Reserve policy is directed.

Our bill would establish a price rule for conducting monetary policy.

We would have the Federal Reserve Board Chairman and the Secretary of the Treasury be directed to develop an index, a proxy, a leading indicator around which the FOMC could conduct its policy with an eye on those worthwhile objectives of economic growth and lower interest rates, but all subordinated ultimately to the integrity of the dollar and low rates of inflation.

I agree with Senator Mattingly. We do not want the Fed trying to lower interest rates by printing more money. It wouldn't work. If they just tried to zoom on the money supply, as the current usage of the term implies, it would raise interest rates. It would destabilize our markets.

What we need is an intellectual guideline, an institutional change, around which people can stretch out their horizons and once again predict the value of the U.S. dollar over a long period of time and reduce the risk premium that is now being charged in the lending for those who want to borrow over a long period of time.

I will just close with this thought. People say, "How would you know when to sell, when to sell bonds and drain reserves out of the system or buy bonds and inject reserves into the system?"

You would do it not around nominal GNP; you wouldn't do it around backward-leading indicators; you wouldn't do it around the lag effect of the so-called money supply. You would look at some index of raw commodities as a proxy for future rates of inflation or deflation. I submit to you, Mr. Chairman, that one of the most important institutional changes we can make is to depoliticize the Fed, and to protect its independence by giving it a rule around which it can make decisions that will bring to the American people the sound money that was really the hallmark of the American dollar for decades.

And I appreciate so much you giving me this opportunity to testify. I know you have other witnesses for whom I have high regard. I would like to close at this point and maybe just engage in a colloquy with those who are here today.

Thank you, Mr. Chairman.

[The prepared statement of Congressman Kemp follows:]

PREPARED STATEMENT OF HON. JACK KEMP

Mr. Chairman, I appreciate the invitation to testify before the Joint Economic Committee on legislation designed to improve both the policy and policy-making of the Federal Reserve System.

The need for such a reform was made clear recently, Mr. Chairman, by an incident involving Frank Morris, the President, of the Federal Reserve Bank of Boston. According to the Washington Post of May 2, 1984, Mr. Morris disclosed to a group of business economists that the Federal Reserve tightened monetary policy at the March 26–27 meeting of the Federal Open Market Committee, because it was concerned that the economy is growing too fast.

This disclosure created something of an uproar. The next day, the Wall Street Journal reported one "Fed official" as saying: "I almost choked when I opened my paper this morning." Federal Reserve Board Governor Henry Wallich declined comment, saying, "I would only be compounding the indiscretion."

Randall Forsyth put the reaction more pungently in Barron's (May 7):

"Frank Morris got a lot of his colleagues at the Federal Reserve mad at him last week by doing what central bankers are never supposed to do: saying loud and clear what the monetary policy makers are up to.

"The President of the Boston Fed told a meeting of economists in Beantown that the Federal Open Market Committee voted unanimously to tighten policy at its March 26-27 meeting in order to slow the economy. That revelation wasn't supposed to be made until minutes of the confab were released on May 25, just before Wall Street and everybody else breaks away for the Memorial Day weekend. And, if FOMC decisions are to be leaked before their appointed time, that's the job of certain tall, cigar-smoking officials who call favorite reporters, not Reserve Bank heads who blab."

The incident is significant for two reasons, Mr. Chairman. In the first place, it highlights the fact that the 12-member Federal Open Market Committee, which meets in secret, does not even disclose its decisions for a long time after they are made, unless a member of the FOMC should happen to leak the results to some favored party, like Mr. Morris' business economists. There is not even a legal requirement to release the decisions, ever. What purpose does secrecy about decisions already made serve, except to churn speculation about policy and increase the opportunity for insider trading? And why do we have to piece together a guess about what the Fed is doing by reading between the lines of the newspapers?

Second, the incident brings into question the propriety of the policy itself. Why in the world is the Federal Reserve trying to slow down the economy? Put another way, what on Earth is wrong with strong economic growth if it is accompanied by low or no inflation rate? If its concern is with price stability, why isn't the Federal Reserve targeting price stability, instead of economic growth?

I believe that there is something wrong, Mr. Chairman, both with the process of Federal Reserve policy-making, and with the recent policy itself. Together with many colleagues I recently introduced two pieces of legislation designed to address these two concerns, H.R. 5459 and H.R. 5460. In my testimony, I would like to explain these two bills and the reasoning behind them.

PROCESS

When the Federal Reserve System was established in 1913, the discretion of its executive was limited, both by its charter and by the system within which it operated We were under a gold standard, which meant that the Fed has no monetary powers, and the Fed was originally given a very limited control of credit and banking. Over the years, the first constraint was weakened and finally eliminated, while the Federal Reserve's regulatory powers and control of credit were steadily expanded. In the past decade, for the first time in its history, the Federal Reserve has enjoyed sweeping powers over both money and credit. Yet the Federal Reserve continues to formulate policy under conditions of relative secrecy and lack of accountability which have long since become obsolete.

There is a manifest need to allow the markets and the American people more—and more timely—information about policy decisions which affect them. Today there is not even any legislative requirement for the FOMC to release minutes or publicize its policy decisions, although it has become customary for the Committee to release a selected summary after an irregular interval of one or two months.

Recently, this delay had engendered extreme uncertainty in the world's stock, bond, commodity and currency markets, as they have reacted to each rumor and perception of monetary policy changes. It is axiomatic that the efficiency of markets depends on the general availability of accurate information. The recent uncertainty has undoubtedly damaged the stability which is necessary for economic and investment decisions. This benefits no one but those who trade upon rumor and real or imagined inside information. The continuation of Fed secrecy under these circumstances is an anachronism, as many respected economists, such as Milton Friedman, have pointed out.

All agencies of the government have undergone similar democratic reforms in the last 10 or 15 years. Disclosure naturally tends to be resisted at first by those within the institutions themselves. But "sunshine" and freedom of information measures have been applied to countless other agencies, with positive effect. Clearly, it is a positive benefit where no overriding national security interest is involved. The time has come for the United States' central bank to participate in the general openness.

Its decisions are too important to be held from the knowledge of the American people.

Our first bill, The Federal Reserve Reform Act of 1984 (H.R. 5459), contains several provisions which would open the decisionmaking process of the Federal Reserve. However, it is important to note that the traditional relationship between the Federal Reserve and the Congress would be unchanged. The bill's provisions are as follows:

1. The Federal Open Market Committee shall announce changes in its policy on the day the decisions are adopted.

This measure, advocated over the years by many economists, including Milton Friedman, would end volatile speculation in the financial markets due to rumors and uncertainty over Federal Reserve policy.

2. The 4-year term of the Chairman of the System shall begin in February of the calendar year after the year in which the President's term begins.

This makes the President's and Chairman's terms concurrent except for a one-year lag. The provision is supported by Chairman Paul Volcker, the Reagan Administration, and the House Banking Committee.

3. The Secretary of the Treasury shall be made an ex officio member of the Federal Open Market Committee.

The Treasury Secretary was a member of the Federal Reserve Board for many years, until the mid-1930s. This provision would restore his earlier status. This would increase the input and understanding of the Administration with regard in formulating monetary policy. It would also make it impossible for the Administration to disclaim responsibility for a monetary policy in which it had no part. When I questioned him before a House subcommittee recently, Treasury Secretary Donald Regan supported the idea.

4. The terms of the seven members of the Board of Governors would be reduced from 14 to 7 years each.

This would permit a somewhat faster turnover of membership. However, a 7-year term would still provide continuity in policymaking—which was apparently the original idea behind the 14-year term—since it is longer than terms of U.S. Presidents, Senators, or Congressmen.

Taken together, these measures would modernize the Federal Reserve, bringing its practice of decisionmaking to the threshold of the twenty-first century.

POLICY

Just as important as the way in which policy is made, is the effectiveness of the policy itself. Much of the current uncertainty over Federal Reserve policy reflects the unlimited discretion of the Federal Open Market Committee, and the absence of any established rule for guiding its policy.

This is partly a failure of the law. Surprisingly, the legislation authorizing the Federal Reserve contains no direction stating that the integrity of our currency should be the central bank's overriding goal. Our second bill, the Balanced Monetary Policy and Price Stability Act of 1984 (H.R. 5460), corrects this omission by instructing the Federal Reserve, for the first time, to make long-term price stability its overriding objective. Thus it would avoid inflationary as well as deflationary swings in prices.

Also, in the absence of a firm monetary standard like the precious metals, the Fed needs stricter guidelines for its discretion in setting intermediate policy. Accordingly, our second bill would direct the Fed to abandon its on-again, off-again policy of "targeting" measures of the money supply which are constantly being shifted, changed, and redefined. Nor would it be permitted to "peg" interest rates, as it did for many years, without reference to its overriding goal of price stability.

If the central bank's objective is price stability, we believe it should actually target some proxy for the general price level, and not something else. H.R. 5460 directs the Federal Reserve Board Chairman and the Treasury Secretary to devise a price index for this purpose; to set a target range for the index; and to conduct FOMC policy according to this target. Under the current monetary standard, no other guide can possibly determine whether monetary policy is too loose (inflationary) or too tight (deflationary).

Specifically, H.R. 5460 does the following:

1. The bill makes it clear for the first time that of all the desirable goals mentioned in the authorizing legislation, price stability is paramount. The bill states that "it shall be the policy of the [Federal Open Market] Committee to maintain low interest rates and stable exchange rates, and to encourage strong economic growth, to the extent that such policy is consistent with long-term price stability."

2. The bill establishes a "price rule" for conducting monetary policy.

(a) The Federal Reserve Board Chairman and the Secretary of the Treasury are directed to develop a price index to assist the FOMC in conducting its policy.

(b) The index shall contain one or more commodities, such as the precious metals, which are chosen for their sensitivity primarily to secular or long-term trends in inflation and deflation, rather than to the business cycle or supply disturbances.

(c) The Chairman and the Secretary shall establish a target range for the price index which, in their judgment, will not result in a decline in the general price level.

(d) If the index rises above the target range, the FOMC shall tighten the cost and/or availability of bank reserves; if the index falls below the target range, the FOMC shall ease the cost and/or availability of bank reserves.

(e) In case of a serious threat to domestic or international financial stability, the Chairman, and the Secretary together may, after a joint declaration of the extraordinary circumstances, set a new target range.

A word of explanation is in order about the price index, Mr. Chairman. While there are many existing price indexes which could conceivably be used, none of them was specifically designed for conducting monetary policy. Many of the indexes go back three or four decades, or even more. By permitting the adoption of a new index, our legislation permits the monetary authorities to take advantage of the latest research on the subject.

Having said that, though the bill does not require it, I am personally convinced that the best proxy for the price level is also the oldest—the precious metals, and specifically the price of gold. The purchasing power of gold over long periods has remained remarkably constant. It is the most "monetary" and forward-looking of all commodities. Indeed, I think we must eventually restore a modern gold standard. But that goes beyond my purpose here today.

If the "price rule" policy outlined in H.R. 5460 had been in place, it is likely that we would have avoided the wild swings in prices, interest rates, unemployment, exchange rates, and economic growth, of the past dozen years.

3. The Secretary of the Treasury is directed to seek the establishment of a new international advisory task force, and ultimately an international monetary conference, consisting of representatives of the major industrial nations. The purpose of the task force and the conference is to explore reforms of the international monetary system which would improve world-wide price stability, stability of exchange rates, and the prospects for liberal trade and strong, noninflationary economic growth.

This provision lays the groundwork for reform of the international monetary system. It would address many of the root causes of the international debt crisis, of pressures for protectionism, and of debilitating currency swings like the fall of the dollar in the 1970s and the rise of the dollar since 1980.

In summary, Mr. Chairman, the time is long overdue for a reform of the Federal Reserve—both concerning the process of policymaking, regardless of the content of policy; and concerning the nature of the policy itself. Our two bills, H.R. 5459 and 5460, are designed to address both problems. I am firmly convinced that these bills would result in much better Federal Reserve policy, while increasing the stability of the markets by providing more accurate and timely information about policy decisions.

Our ultimate goal is not merely better monetary policy, Mr. Chairman, but hope for those Americans whose lives are touched in any way by the value of money. Greater certainty of policy, and greater confidence in price stability, will mean lower interest rates, higher economic growth, and more jobs for working men and women like my Buffalo-area steelworkers. While monetary policy often seems to be obscure, it really translates into a bread-and-butter matter for most Americans. That is why we must go ahead and undertake the necessary reforms of monetary policy and continue the progress which has begun, toward full employment without inflation.

Thank you again, Mr. Chairman, for permitting me to bring this legislation to your Committee's attention.

Senator JEPSEN. Thank you, Congressman Kemp.

Senator Mattingly, you may proceed.

Senator MATTINGLY. I really don't have too much to add. We have so much unanimity in here we ought to just go ahead and pass the legislation.

Let me ask you this. You addressed part of it, the dramatic cycle swings in money in the economy that tend to obscure some of the other trends such as productivity and growth which I believe is a result of the effort to lower taxes and total public spending.

Would you comment on that problem caused by the volatile monetary policy for interpreting the impact of Reagan's fiscal initiatives.

Representative KEMP. Well, let's face it. That's the biggest debate in this town. There are those who say it's the fiscal policy that's driving the interest rates, and I don't deny the fact that you can overspend and put pressure on the capital markets and cause a higher real interest rate by just forcing more spending on the Government.

I have been accused in the past of saying deficits don't matter. I have never said that. I do not believe that. I think that deficits do matter, and I'm just as concerned about deficits as anybody else.

However, having said that as a premise, I don't think you can explain the current disequilibrium in our financial markets or the bond market simply by looking at the deficit alone, nor do I think it is the deficit in this case that is driving the interest rates, because at this point in the recovery the deficit is coming down marginally as State and local governments boost revenues with higher rates of employment and higher business profits and a better cash flow for U.S. industry, and more men and women working and paying sales tax with higher retail sales and the various indicators that we have seen in the recovery of 1983 and the first quarter of 1984.

I won't go into detail, but the recovery has brought about a much better financial picture at the State and local level. Some people have suggested it has led to a surplus at the State and local level of almost $46 to $50 billion.

Having said that, the national deficit has dropped from a predicted 1984 level of $190 billion to, at least in the first quarter on an annualized basis, something closer to $160 billion. Many financial analysts say we don't know what it's going to be because we don't know, as the chairman pointed out, and as you pointed out, Mr. Mattingly, what the policy of the Fed is going to be.

The point I wanted to make was here you have a recovery, very strong, nominal GNP in the first quarter of 1984 racing along at 12 percent, real growth at about 7.5 to 8 percent, helping put people back to work and establish the conditions for a broader base to our industrial expansion, and the deficit coming down, and then you hear from Frank Morris in Boston that the Fed decided to let the Federal funds rate, which had been trading at 10⅜ and 10⅝, go up to 11⅜ or 11⅝, which of course put pressure on the prime rate. And they did it because the economy was too strong.

So we are in a catch 22. They are saying the recovery will put pressure on higher interest rates, so they want to raise interest rates in order to slow down the economy to reduce the request for credit that will otherwise lower interest rates and get the economy growing again.

Talk about an argument that is fatuous and circular, that is one that I think is absurd on the face of it, and has to be answered by

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those of us who believe that you can have price stability and economic growth simultaneously.

So I think the most important thing we could do for that fiscal policy is to continue the recovery, make sure that interest rates are allowed to come down consistent with price stability and not reigniting inflation, as you pointed out before. And I submit that if interest rates were allowed to come down to where the Federal funds rate was, say, somewhere in the 8 to 9 range, and the recovery was continuing to expand on into, say, 1984–85, and then you saw signals that inflation was predicted in the markets, you would see it in the price of gold, you'd see it in the precious metals, you'd see it in commodity prices, futures and spot, you'd see it in velocity, you'd see it in some of the things that I'm sure will be discussed a little bit later. You'd see it in futures markets. You'd see those leading indicators pointing to it. Then, of course, the Fed could move to sell bonds and drain reserves, but to be selling bonds and draining reserves and limiting the credit supply of this country at this point in the recovery, without any market telling us we should, I think is rather at odds with our hope of getting the deficit down.

Senator MATTINGLY. Let me ask you this question because I think some people probably try to criticize our legislation by saying that it wouldn't make any difference if they announced it like they do now, later, rather than the day they make it. I think you need to sort of develop that just for a moment, really what impact will that have? Because I can see somebody writing right now and saying, "Well, it doesn't make any difference if they do it 30 days from today or do it today." Could you develop that?

Representative KEMP. Well, someone asked Chairman Volcker what he thought about this legislation, and he said it would tie his hands. And I asked the question, "Why would it tie his hands?" He has so much power over policy, and of course the members of the FOMC do. Why is it going to tie their hands? What's wrong with giving markets more information in an immediate sense? And does it help the markets to allow for rumor and gossip and innuendo and leaks to drive our markets? And they see what happens in the bond market.

Senator SYMMS. If it isn't going to tie his hands, what good is it going to do, then? [Laughter.]

Representative KEMP. Well, I guess I look at this from a little bit different perspective than the gentleman from Idaho, at least in this regard. I know the framework from which the question is asked. Let me just take it, though, from a premise that I think is an important premise, which is that the independence of the Fed is something that I think, if we can talk long enough, we can come to a common agreement. You don't want a Fed that is politicized. We don't want a Fed operating on a Paul Volcker standard, which it is today. It shouldn't be Jack Kemp's standard; it shouldn't be Ronald Reagan's standard. We don't want a Republican or a Democratic or Tip O'Neill or anybody else.

My point is that if markets are to be efficient, they need information immediately. And you're right, the Chairman of the Federal Reserve Board, at least with regard to changing policy, should not be allowed the type of flexibility that he has where he can keep information away from those markets.

So, yes, to the extent that I would like to tie his hands in that regard, I agree with the gentleman.

Senator MATTINGLY. But that space between the time they make that decision and the time it is announced, the speculation is dangerous.

Representative KEMP. Absolutely.

Senator MATTINGLY. That's the bottom line.

Representative KEMP. Not only is it dangerous, Senator Mattingly, it is inefficient. It doesn't do what markets need.

Senator MATTINGLY. But you can't help but have it get out.

Representative KEMP. Yes, that's what happened with Mr. Morris. He went out to his clients and he said, "Aha, the growth in the economy was to high in the first quarter. We tightened. We allowed the Federal funds rate to trade at higher levels," and if you knew that you could make a lot of money. But that isn't what I'm worried about, as much as I am worried about the fact that it is causing such discontinuity in our financial markets that no one can predict what is going to happen over the next 48 hours, much less day to day. And it is causing everyone to shorten their horizons; it is causing a traffic jam in short-term instruments; it is reducing the maturity rates of U.S. bonds; it is causing the Treasury to be unable to sell its 3-year paper and 20-year paper and 30-year paper, and it's forcing homeowners and small business people and farmers to suffer the highest real interest rates in the history of this country.

Senator SYMMS. I have been told the Treasury won't even go into the market to make a Treasury bill auction unless the Chicago Board of Trade is open, because without the protection that people can have that are buying them and ability to hedge, they simply can't do it.

Representative KEMP. It certainly caused pandemonium. To a certain degree last week there was pandemonium in our bond market.

Senator SYMMS. Well, the bond market scratched two full market points here a couple of days, and that cost everybody in this country money—the small businessman, the homeowner, the little people. And I think to some degree part of it is stirred up by the hysteria of the news media in addition with the secrecy. I mean Dr. Doom from Solomon Bros. can go out and give a speech and it will change the market a couple of points, because it makes the news. And sometimes I wonder what position his bond house holds when he makes those speeches with respect to the futures markets. But that's not the question I want to ask.

As one here who voted against Chairman Volcker's reconfirmation as Chairman of the Fed, and when asked, when the administration called me and said, "We heard you were going to vote against Paul Volcker and we wonder who you recommended?"—and I'm really impressed with your testimony, I might say, Jack. I wasn't sure when people were talking about Jack Kemp for Federal Reserve Chairman if it was a good idea. [Laughter.]

But after hearing your testimony, I think it is a good idea.

Representative KEMP. No politics, please.

Senator SYMMS. But they asked me the question, "If you're not going to vote for him, who do you recommend?"

I said, "Well, you should do it one of two ways. Your goals should be to remove uncertainty from the market, so if you want to go on a price standard on a commodity base and get somebody who believes in gold, then you should pick out some credible business person that understands the question, like Louis Lehrman, and put him in as Chairman of the Federal Reserve so the market can predict which way it's going to go with the Fed."

"Or," I said, "if you want to talk about monetism and use the monetist philosophy, you should put somebody who is a credible monetist in who will put a monkey in there punching the machine every month and so the market can adjust to it, like Milton Friedman." Milton Friedman would have been a choice—he wouldn't have been what you're talking about with a price index but at least it would have been consistent and the market could adjust to it.

But what we have, I think is the worst of both worlds.

But the question I want to get to with the reform bill—and I haven't sponsored it yet but I'm very interested in it—is there anything about the particular operation of the Federal Reserve right now that limits them from doing what they are doing without this legislation? Why couldn't they do that right now?

Representative KEMP. That's a good question. Actually, they are under no obligation to release the information. Congress, who set up the Fed, has never required that the Fed deliver timely information to the American people. And really, the responsibility, the obligation is on the backs of the U.S. Congress for not doing it. It is outrageous that we would let them get away with this and, frankly, we should be held accountable. And that's why I'm making such a fight over this, and I appreciate the interest of our distinguished chairman and his colleagues.

Could I just make a footnote to this. I don't think we ought to get into a debate between Milton Friedman and Louis Lehrman or Preston Martin. I think the point has to be that money does matter. Milton Friedman is right. Money matters. What monetary policy is all about matters desperately to our markets and to our country and to a world that has cried out for the dollar to once again be the standard, the numerare, if you will, that it once was under the Bretton Woods International Monetary System.

But irrespective of that, I think it is really a shame that we now have members of the Federal Reserve Board and a Chairman who think that growth in and of itself is inflationary. That is what bothers me.

Senator SYMMS. Well, I think that's outrageous.

Representative KEMP. And they are not looking at anything other than what happened to the economy 3 months ago. And I am suggesting that if that is the way we are going to drive our markets in the future, that is going to shorten everyone's horizon. It's going to keep the risk premium in the interest rate very much higher than it otherwise should be. It's going to cause terrible problems to Third World countries that we desperately need as friends and allies and neighbors and markets for American exports. And it's just going to cause all sorts of continuing problems, notwithstanding what it does to the social equation in people's lives, young married men and women, small businessmen and women, farmers, steel workers.

I just think that the Congress has this responsibility and ought to act.

Now, many members of the Democratic Party are beginning to say something along these lines, and we haven't come to a synchronization of our efforts yet. But Lee Hamilton and members of this committee are talking about this.

Senator SYMMS. Congressman Kemp, I want to ask you one more question, a question that the conservative establishment in and out of Washington would ask, which is: For next year they'd say the Congress is projecting to spend $925 billion, approximately. They are projecting revenues of about $750 billion, which is about 19 percent of the projected GNP, and the spending is about 25 percent of the GNP. If the Congress would just bring the spending back down to below that 20-percent level of the GNP so there wouldn't be such a difference, you wouldn't even know who Paul Volcker's name was.

How do you answer that?

Representative KEMP. I disagree with that. Fiscal policy cannot be discussed in a vacuum which is the whole argument that I think we are trying to make today, and that the President and Don Regan have made. It suffers the brickbats of most of the editorialists in the Eastern newspapers for daring to suggest that promoting economic growth and getting more men and women back to work will not only be healthy to our country in terms of the social consequence but it would also be healthy to the budget.

Senator SYMMS. It is interesting that Ronald Reagan has a budget which on paper looks out of sync or out of balance to the extent that you mentioned—revenues are 19 percent of GNP and spending is 24.5 to 25 percent of GNP. Clearly something happened in 1980 and 1981 and 1982 to cause that huge amount of expenditure for social programs that are linked to the health of the economy.

And I think the President is wise, as is Don Regan, and a few people in this town, who have focused some of their intellectual and political capital on making the economy expand to bring about a healthier industrial base, to bring about a more competitive trade balance, to try to bring our spending down, and to recognize that you can't have a healthy balance or equilibrium in your fiscal policy until you have a healthy economy.

Representative KEMP. I think it's an important debate, I would say to my friend from Idaho, because, frankly, as a conservative—and I share the gentleman's premises to a certain degree—I don't think you could get spending down without a strong recovery. Because if the recovery should collapse, if we should go into a recession in auto, steel, housing and farming, or if we don't continue the recovery, you are never going to be able to get spending down without literally abolishing programs upon which this country depends for its security, and upon which this nation depends to protect people from economic disaster. I don't think you'd see any of us in this room ever in office again. I don't think the American people want us to follow that type of thing.

Senator SYMMS. My time is up, and I thank you very much. I just want to say, Mr. Chairman, as one Senator, I'm very glad I was here to hear this witness this morning, and I wish we had the whole Senate here, both sides of the aisle, but particularly I wish we could get at least one party in this town to focus on this issue. I think you have done an outstanding job.

Representative KEMP. Thank you.

Senator JEPSEN. Thank you very much.

If I might take a few moments here to exchange some thoughts with the Congressman.

If the Federal Reserve announced the nature of changes in monetary policy immediately, there would seem to be a tendency, then, to make firmer decisions rather than to have policy contingent on every shortrun event and the exercise of judgment. There would be less discretion, and this would tend to lead to a less variable policy and result in a more stable economy.

Is that fairly accurate?

Representative KEMP. Mr. Chairman, I generally agree with that. I would be a little bit concerned that you cannot just say that consistency is the sole target, because we could have a consistently bad policy, and I think that would be dangerous.

For instance, if we just merrily targeted one policy that led this country into a situation such as Britain has followed—you know, for 4 or 5 years they have been trying to get their economy back in shape, and they have very high interest rates. They have a lower deficit as a percentage of their economy than we do, and they have changed their policy.

So I would be concerned about the statement, but I know the context in which it is being stated. But I don't want a consistently bad policy. I think what we want is a consistently good policy. The best policy we can give the American people is price stability and an interest rate policy that is consistent with the noninflationary economic growth of this country.

Senator JEPSEN. Would you agree with this statement: If the Government takes too much of people's money to spend, the economy can't grow; we need to keep taxes down to stimulate spending.

Representative KEMP. Gee, that sounds familiar, Mr. Chairman.

Senator JEPSEN. But this has little to do with how much money the Fed prints, which controls inflation.

Representative KEMP. The trouble with measuring the supply of money, Mr. Chairman, is we live in a global economy in which money is fungible and you can't just trace a dollar to someone's pocketbook and say that that amount of cash in circulation in the United States or Washington, DC, with a 6-month lag or a year lag, is going to determine the nominal GNP at some future date. With all due respect to my friends, I think this is a debate that ought to be ongoing, and I hope we can find some marriage between my friends in the monetarist movement and my friends in the price stability movement, because on fiscal policy they do agree, or we do agree.

I am not sure yet that you can measure price stability with an M, particularly because we live in a global economy; we don't live in a partial equilibrium situation where you can measure just the money supply of the United States. With money being fungible across the borders and electronically, and not knowing what the effect is, I think we have to be very careful that we look at an indicator that would tell us what the future level of inflation or deflation is. And I just happen to think that rather than looking at an M, although it is important, we should be looking at a P, some price rule around which we can engage, whether people view the future with the hope that our prices can be stable.

That is my main concern at this point, Mr. Chairman.

Senator JEPSEN. I am hearing daily, as I work in the hustings, in my State of Iowa, that the deficit is the single most serious thing we have; it's the villain; it's causing the high interest rates. In discussions when you point out the fact that the deficits have risen rather dramatically in the last few years and interest rates have fallen by about half, then we get into the real interest, and the reason is made that the spread has increased. But that isn't actually true, either. The inflation rate was about 13.5 and the interest rate was 21.5, but on the firing line they were charged 23 and 24 in my State in those days. So the real rate is lower even though the deficit is higher. But as you indicated, Congressman Kemp, the deficit is somewhat less than it has been. The deficit today is 13.5 or 14 percent less than it was a year ago.

Representative KEMP. Yes sir, that's right.

Senator JEPSEN. The deficit has dropped dramatically in the last 5 months, and yet interest rates are blipping up. This situation tells us what?

Representative KEMP. It tells us we have an FOMC and a Chairman of the Fed, as I pointed out in my testimony, Mr. Chairman, who is allowing the interest rates to go up because he is afraid that that growth is ipso facto inflationary. I don't see any market that would give that indication, Mr. Chairman. And that's our whole case. Not only does the institutional change need to be made in terms of giving the markets more simultaneously information, but it also has to change that policy that is allowing this Federal Reserve Board to raise interest rates in recovery which are going to increase the debt, increase the debt service, increase the deficit, increase the national debt, hurt farmers and businessmen and women and consumers and home buyers and young men and young women and our Third World allies. I can't think of any more people left in this work, other than those who can trade and speculate in international exchange markets on whether or not the dollar is going to rise or fall because they got some information from a leak from the FOMC. It's outrageous.

Senator JEPSEN. Isn't the deficit a symptom rather than a disease itself?

Representative KEMP. Absolutely. It's a manifestation. It's an example of the discontinuity that has been allowed to exist in monetary policy since 1979, when they switched from targeting interest rates in October of 1979 to targeting animal spirits. Because if you had Chairman Volcker speaking today, he would put a chart on that wall. There would be so many charts and so many targets by the end of the year, he will tell you, "Yes, we hit that one, and we hit maybe that one, "and if he didn't hit the right one he'd redefine the target.

So all we really know about what this country is undergoing in terms of monetary policy is a guess, an innuendo, and leaks. And there are no intellectual guidelines around which people can make decisions over long-term monetary policy or their decisions on savings and investment. And I submit to you, Mr. Chairman, that is inhibiting the recovery that is necessary to get the deficit down.

Senator MATTINGLY. It's not just the monetary policy but the bottom line of deciding how much growth we are supposed to have in this country.

Representative KEMP. A 9-percent nominal GNP.

Senator MATTINGLY. It is trying to decide what's high growth, which I think is stupid. The Fed has never said, "We want 7-percent growth in the economy"; right? I mean, if it's 7 percent they said it's too high; if it's 3 percent they say its too low. If it's 12 percent, nobody knows. You have a small group of people trying to decide how much economic growth, and they say growth if it's 12 percent is bad, which I can't understand. Will you explain to me why growth is bad?

Representative KEMP. Preston Martin had a good line the other day. Preston Martin said that there is no overheated economy; there are just overheated economists. And I agree with Pres Martin.

Senator MATTINGLY. But there are just a few people, though, making that decision, that is putting out the word that we shouldn't have growth in this country.

Representative KEMP. Well, I think they want growth, but the problem is they think we are in a situation in which we are rising up against the utilization of the capacity that is necessary—well, I didn't put it right. We are bumping up against existing capacity. When you get around 81-percent utilization capacity, somehow any more growth over a level of, say, 3 or 4 percent, might put pressure on prices, and, apparently, then bid up prices.

I mean, that basically is simplistic but it is their theory.

But what they don't take into consideration, I would say to my friend from Georgia, is that productivity is up. Productivity is a lot higher than was estimated by OMB and CBO and some of these economists, (a); (b), the velocity of money is less because inflation is down and people are willing to hold their currency longer because it's worth more.

Then, third, I would say to my friend, we changed the tax laws in 1981. We boosted the capital stock of the country. We made a significant impact in raising the total capital stock of this country in 1981 through our new changes in depreciation schedules, by lowering the tax rates, boosting the equity and venture capital markets. I think it's obvious that cash flow of businesses today is better than it's been in a long while which is important for generating the internal cash that is necessary to finance long-term investment. You don't finance all the long-term investment on debt. You finance long-term investment with the proper depreciation schedules and proper cash flow, which is beginning to have an impact on this economy.

So to look at the economy in one narrow factor, that is, utilization of plant capacity, and say that that's inflationary, or that inflation is caused by too many men and women working, is equivalent of Michael Blumenthal's statment in 1979 when he said inflation is caused by a factor that acts and interacts in strange and mysterious ways. And he left it at that.

And I submit that we now have a Secretary of the Treasury and a President and some people in this town, on both sides of the aisle, I might say—a lot who are not—who understand that the answer to inflation is more production, more productivity, more capital formation, more men and women working, more output in economic growth as long as prices are not rising.

That is the signal that we ought to be using, and I think we can design, through the Secretary of the Treasury and the Fed, a rule that will give us a monetary policy that will help stabilize exchange rates, lower interest rates, and continue this recovery which is critical to this Nation's health.

Senator JEPSEN. If interest rates today were actually a reflection of what historically they had been in comparison with inflation, they'd be considerably lower.

Representative KEMP. Yes, sir.

Senator JEPSEN. And now they're too high.

Representative KEMP. They're too high.

Senator JEPSEN. What do we need to do specifically in the two or three——

Representative KEMP. I think this bill, Mr. Chairman, is a start. I hope that people will give some thought to the second aspect of the package, which is a price rule, because——

Senator SYMMS. Is a price rule not in the bill?

Representative KEMP. Well, there are two bills, one of which is an institutional change in the Open Market Committee's operations, and the second one, alluded to in my testimony, addresses this question of why the Federal funds rate is trading this morning at 10.5 with inflation at a very low level? Why is the Federal funds rate, the cost of overnight money in member banks of the Federal Reserve, being allowed to trade at such a high level? It's because the Fed has been tightening credit conditions and draining reserves out of the system on an abstract belief that the economy is growing nominally too high. And I just find that to be inconsistent with this country's needs and inconsistent with our budget problems. And I wonder, Mr. Chairman, if the Chairman of the Federal Reserve Board is not trying to panic—I shouldn't say "panic" because that's too pejorative—is not trying to——

Senator JEPSEN. Stampede?

Representative KEMP [continuing]. Politicize the Congress into some type of a gross deficit down payment reduction package, that is, raising taxes, that would, I think, be another impediment to keeping this recovery going.

Senator SYMMS. I might just say to Congressman Kemp that when he testified before the Budget Committee, I asked him about five times if he wasn't just holding the Congress hostage to a big tax increase in order to lower interest rates, and he denied that. But he did finally come around and say, after all was said and done, that he thought a tax increase was necessary, which bothers me somewhat because I would have to agree with you, although I think I am probably more concerned about the deficit maybe than some of my colleagues are. The budget is balanced every year. It's just a question of the accounting system.

And it is ridiculous for people—the idiot mentality of the country is we never taught people about true economics and freedom in this country in our Government school systems. They don't understand that point of view.

Representative KEMP. Who doesn't?

Senator SYMMS. The general public.

Representative KEMP. I disagree with that.

Senator SYMMS. The news media talks about nothing but the deficit. First they talk about inflation, and then they talk about unemployment, and then they talk about interest rates, and now they are talking about the deficit. And the budget is balanced. We are balancing it by borrowing money now out of the public sector. And the Government is taking a portion of this money.

Representative KEMP. I have to go vote, which is probably lucky for you and the next witnesses.

If you put this to a referendum, if you ask the American people, "Would you want a government to once again guarantee the purchasing power of the U.S. dollar by making it convertible"——

Senator SYMMS. Oh, absolutely.

Representative KEMP [continuing]. "For a fixed amount of a precious commodity and make it as, say, good as gold again," if you just made that simple statement, I think they would vote overwhelmingly—now, the people would; not Wall Street, maybe.

Senator SYMMS. The people would vote overwhelmingly to limit the percentage of the GNP the Government could have, too.

Representative KEMP. Well, that's another debate.

Senator SYMMS. They have done it in proposition 1 in California.

Representative KEMP. I can't help but enter into the record the fact that my staff just informed me that Japan's capacity of utilization rate is 97 percent, and the inflation rate in Japan is 2 percent, and their interest rates are a lot lower than ours. There is no correlation that you can find between plant utilization on an abstract basis and the rate of inflation.

And the last thing that has to be introduced into the record is the idea that they are now flirting with the idea at the Fed that they should put an interest rate ceiling on loans to Third World countries, which implies that they are going to continue to tighten credit conditions on the consumers in the United States of America. That is credit allocation, and it didn't work under President Carter. And I just hope that this Congress speaks out loud and clear that we don't want the Fed bringing interest rates down for just a few. We think interest rates should go down not only on ourselves but the whole world to help boost the world economy and get this recovery extended to our Third World neighbors and friends in Europe and the rest of the world.

Senator JEPSEN. Thank you, Congressman. Have a good vote.

Representative KEMP. Thank you, sir.

Senator JEPSEN. The Chair would ask at this time that Senator Symms assume the chair.

Senator SYMMS. I will be happy to, Mr. Chairman.

Senator JEPSEN. I have had a contingency come up.

Senator SYMMS [presiding]. Though the Chair is not able to stay here, I would like to call up Mr. Paul Craig Roberts and Mr. Leijonhufvud.

I'm looking at the witness list here. Mr. Roberts holds the William E. Simon Chair in Political Economy at the Center for Strategic and International Studies, Georgetown University. And Mr. Leijonhufvud is from the Department of Economics at UCLA. So if we can have them both up here, we will hear from each of you, and then we'll have the questions.

So, Mr. Roberts, would you please proceed.

STATEMENT OF PAUL CRAIG ROBERTS, PROFESSOR, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY

Mr. ROBERTS. Thank you. My remarks will be very brief.

In the conduct of monetary policy, discretionary judgments have replaced principle. The view prevailed that the monetary authorities could do a better job if they were unencumbered with restraints and had the advantage of flexibility. However, in practice, discretionary behavior is not predictable and so uncertainty rose in the financial markets. Discretion also allows the monetary authority to behave in self-protective ways.

The removal of constraints on the Federal Reserve was gradual, and in today's system of flat money and floating exchange rates, it seems to be complete. In the public mind, the stability of financial markets rests on nothing more than the credibility of the Federal Reserve Chairman. Monetary uncertainty is a form of bad taxation, and disillusionment with discretionary management has produced demands to make the Federal Reserve accountable by placing restraints on its behavior.

The most often mentioned constraints are: First, to require the Federal Reserve to publicly announce all policy decisions at the time they are made, second, to make the Secretary of the Treasury a member of the Federal Open Market Committee, and third, to make the term of office of the Federal Reserve Chairman concurrent with that of the President of the United States.

All of these changes would, I believe, increase the effectiveness of the Federal Reserve System. Today, the ever-present uncertainty about the course and direction of monetary policy adds premiums to interest rates and reduces the stability of financial markets. The independence of the Federal Reserve and the secrecy with which it conducts monetary policy means that every President risks having his policies crowded out by those of unelected officials. The recent rise in interest rates is due almost entirely to the Federal Reserve's attempt to wrest control over economic policy away from the President.

When there are no clear rules, the central bank can substitute its own judgment. When this judgment is influenced by hysteria and ill-informed theories, as it was in 1981, and as it may be at the current time, the whole Nation suffers, and the economic policies of elected officials are preempted by Federal Reserve decisions.

Few who wield power are beyond settling scores, but I believe most adverse judgments by the Federal Reserve are due to the absence of clear rules and constraints on its behavior. Legislative steps that would reduce Federal Reserve secrecy and increase the predictability of monetary policy would enhance the prospects for successful economic performance.

Mr. Chairman, the Federal Reserve is an agency of Congress, and I am pleased to see that the Congress is beginning to understand the necessity of integrating the Fed into the rest of the Government and making it accountable on the basis of principle and well-defined law.

That concludes my statement, Mr. Chairman.

Senator SYMMS. Mr. Roberts, before you go on, before your colleague makes his statement, I do want to ask you to comment on one thing, and then I will have some questions for both of you pertaining to the bill. But I can't help but note that a writer in the Washington Post today—I don't know if you've seen the editorial page—J.W. Anderson, wrote a very vicious article about our Secretary of the Treasury, and I wonder if you'd care to comment on that. Did you see this article?

Mr. ROBERTS. Yes, I did see it. The Washington Post, in my view, has done nothing to contribute to informed discussion of macroeconomic policy in the United States, certainly not in the last 3 or 4 years. I think they have carried on an editorial page campaign against the administration's policy and against the representatives of the administration's policy. Generally they refer to us—not to our arguments or facts or logic, but they refer to us in personal terms, with pejorative terms. We have been called all sorts of names, and I think that's what you see this morning.

I think also the editorials, which I think the same Mr. Anderson is largely responsible for, have taken great liberty with the facts and basically in many cases are nothing but lies. I think this morning is another example of a lie. The Treasury's position is not that the Federal Reserve should print money.

What is going on is, we all should know, at least if we can believe the Federal Reserve, the Fed made a decision to tighten. The Treasury is protesting the decision to tighten. Somehow the Washington Post turns into an allegation that the Treasury is pushing the Fed for an inflationary policy.

Now, there is a great difference between protesting a tightening of the policy and advocating an inflationary policy, and that difference is too great to be overlooked by someone who is consciously trying to get to the truth. So I have nothing but contempt for this piece in the Washington Post this morning, and for many of their other editorials as well.

Senator SYMMS. I thank you very much, and I appreciate that very insightful view, I think, of a very accurate economic and realistic view of many, many of the editorials from that newspaper, and the attitudes they have had toward a limited Government, free-market philosophy in general, over a many, many year period. They have promoted Government solutions as a way of life. Just as a matter-of-fact thing, they automatically promote Government solutions to all problems and have not had confidence in the capitalist system and all the virtues that it has to offer. And I think that's been unfortunate, because a major newspaper of that significance, which does have a great deal of very informative information in it and covers a broad spectrum of information that we all look at for some of that information, can have a very positive influence. But when we have a bias against capitalism in the Nation's capital of the strongest capitalist economy left in the world, it is a negative impact on the economic growth of the country.

Now, Mr. Roberts, we have heard from Georgetown, and now we'll hear from UCLA. Welcome here from the west coast.

STATEMENT OF AXEL LEIJONHUFVUD, DEPARTMENT OF ECONOMICS, UCLA

Mr. LEIJONHUFVUD. Thank you.

Senator, in the last 3 years we have brought down the rate of inflation in this country from double digits to what now seems a tolerable level. But so far we have done nothing at all to ensure for ourselves a future of monetary stability. The monetary regime that we have allowed to develop in the United States in the last 20 years is a thoroughly bad one that has cost us dearly. So far, nothing has been done to reform this regime.

In some other writings I have called it the Random Walk Monetary Standard. Under that standard, the authorities decide one period at a time whether to accelerate, keep constant, or decelerate the rate of money growth. Only current economic conditions and immediate political pressures enter into this decision. Future money growth rates are left to the future. Nobody thinks about them today. Whoever will be in charge when the time comes will accelerate or decelerate as he or they see fit. The only rule that governs this process is that at each point in time, those who are in charge choose what seems the most convenient and expedient thing to do at that point.

There is no scientific or rational way for the private sector to forecast future price levels in this system that we have allowed to develop. The uncertainty attaching to any forecast of future prices grows exponentially with distance from the present. Different people will make different guesses so that the state of expectations in the market is apt to be incoherent.

The value of the dollar in 1994, for example, is a fit subject not so much for rational discussion as for sour or desperate jokes. Yet, in an economy, in a capitalist economy such as ours, people are forced to bet on the price level 10 years hence all the time, whether or not there is a rational way to forecast it.

The consequences of this monetary regime may be grouped into three categories.

First, long-term bond markets thin out and markets for some types of instruments tend to disappear. The raggedness of price adjustments in an inflation puts noise into the relative price mechanism and makes it more difficult to coordinate current resources efficiently. Frequent turnarounds in monetary policy will mean more frequent mistakes in output decisions. Such mistakes affect current profits adversely and the expectation of the continuance of their adverse effects on earnings reduces the incentive to invest in long-term capital. The increased risk of long-term nominal financing reinforces this depressing tendency on investment. So in this kind of monetary regime, you must expect that both productivity and capital accumulation will be adversely affected. This monetary regime is a recipe for stagflation.

Second, in this monetary regime, the ability to forecast inflation and to hedge against it when it cannot be forecast with any accuracy becomes more important to the success and survival of firms than efficiency and competitiveness in the production and distribution of goods and services. The rules of our system's natural selection of individuals for fame and fortune change: finance people will be favored over marketing people in corporations, lawyers over product designers, accountants over production managers. People, especially ambitious people, will reallocate their efforts and use their ingenuity accordingly.

Since the late sixties, playing the inflation right has been the way for ambitious Americans to make it big. But an entire people cannot improve their living standards by playing this game. Who takes care of making productivity growth happen while the rest of us takes care of our real estate deals and inflationary tax shelters? Again, we have allowed a regime to develop that is a recipe for stagflation.

Third, in this monetary environment, the real outcome of private contractual agreements becomes more uncertain. That means that contracting becomes a less effective, a less reliable method for reducing the risks, particularly of long-term ventures, to manageable proportions. When private agreements—contracting—increasingly fails, political lobbying becomes a substitute strategy for many groups. Thus Random Walk monetary mismanagement will bring in its wake efforts by all sorts of groups to obtain by public compulsion what private cooperation failed to achieve. Legislaturers will be swamped by demands to control this price or that rent, to regulate his or her way of doing business, to tax somebody and subsidize somebody else, and so forth. In trying to cope with it all, they will themselves become less efficient, just as the economy has become less efficient, in carrying out their proper business. The political system is perceived as losing legitimacy and politicians will come to face the ultimate indignity of public demands for new constitutional constraints on Government, such as a balanced budget amendment.

Now, dissatisfaction and even exasperation with the monetary instability of the last 20 years tempt many of us to propose radical reforms. But the knowledge that we are tampering with a system that we do not fully understand and the behavior of which we cannot accurately predict should caution us to proceed conservatively in these circumstances.

I wish to propose a modest and practical measure that could be undertaken more or less immediately. This measure does not require us to choose sides all at once, on all the issues that divide monetarists, Keynesians, and supply-siders, or for that matter Democrats and Republicans. The measure does not commit us to a radical restructuring of existing institutional arrangement or present policy procedures. It is not a jump into the dark with a large potential for unintended and adverse consequences. It is just one step that you can take, knowing that it is in the right direction, that is, toward a restoration of monetary stability.

Congress should, I think, legislate a maximum for the monetary base that the Federal Reserve could have in existence at any given time. This ceiling on the base should be stated at a Friedman growth rate rule. On the date that the legislation goes into effect, the legal maximum base should be set at some value, a few percentage points above the actual base at that date. From then on it would grow by x percent a year, x being computed as the difference between some long-run average for the growth rate of real output and the trend in the velocity of base money.

If you put this proposal into effect today, you might want to set the maximum legal monetary base 10 or 12 percent above what it is today and make it grow at 3 percent.

Please note that this proposal does not come down on either side of the age-old rules-versus-discretion debate. It sets a limit on discretion, but this limit could be rather wide initially and, in any case, discretion is not totally eliminated. At the same time, my proposal leaves room for other measures to limit discretion or to improve accountability. It could be supported, therefore, by most people on both sides of the rules-versus-discretion issue.

The proposal for a legislated base ceiling leaves open the choice of short-term policies and short-term operating procedures. As long as the Federal Reserve finds itself well below the ceiling, it can expand or it can contract, and it can execute either policy by using either quantity targets or interest rate targets, and so on.

Now, if the base ceiling proposal essentially takes no position on most of the monetary issues that have been debated annually in front of this committee for as long as I can remember, what earthly good could it possibly be? Mainly, a believable precommitment by the U.S. Government of this kind would greatly reduce the prevailing uncertainty about the dollar price level over the medium and the longer run. As long as the Fed is below the ceiling, it retains short-term discretion. But the possibility that U.S. monetary policy will come to follow a long sequence of predominantly inflationary moves will have been eliminated.

Reducing the uncertainty about the value of the dollar over the longer term will make long-term bond markets revive and, at the same time, will reduce nominal interest rates by reducing or, in the best case, even eliminating the inflation premium. More predictable future dollar prices will improve the allocation of real investment resources in the country. Over the somewhat longer run, personal saving, which has declined so much in our monetary mismanagement period, should revive, as the American public relearns that we cannot all get rich from real estate speculation.

For all these reasons, we should expect U.S. capital accumulation—and with it U.S. productivity performance—to pick up. This modest proposal would go a long way toward restoring the right financial conditions to make an end to this era of stagflation.

Although reducing long-term nominal uncertainty is the main purpose of my proposal, it is plausible that it will have the incidental benefit of also reducing the amount of short-term speculation on the course of monetary policy. The market's intense fascination with month-by-month, week-by-week variations in the growth rate of the money supply is a rather recent phenomenon, as is the demand that money supply decisions be revealed immediately.

Once it is clear that the Friday money supply announcements do not signal changes in the stance of the authorities over the longer term, short-term inflation expectations should also become less volatile. To the extent that this is achieved, we would regain the ability to predict the consequences of macroeconomic policies. This ability, of course, has deteriorated in this period of random walk money.

A brief historical note helps clarify the logic of the base ceiling proposal. In Britain, over 100 years ago, Peel's Bank Act of 1844 divided the Bank of England into two departments, an issue department and a banking department. The issue department operated on a rule which bound it to issuing Bank of England notes to a total value equaling the sum of the so-called fiduciary issue and the bank's gold holdings. This amounts to a base ceiling rule for a gold standard system.

The Bank of England Banking Department engaged in profit-making commercial banking, but in its role as a central bank and lender of last resort, it could also engage in discretionary stabilization policy with the note issue as the money base for the rest of the banking system.

What makes this system interesting to us today is the way in which it combined rule and discretion. The total amount of issue department note liabilities would set the ceiling on the banking department's possible expansion at any time. In instituting my base ceiling proposal, one might copy this feature of 19th century Bank of England organization and split the Federal Reserve Board into a rule-bound issue department and a stabilization department whose latitude for discretionary policymaking would without a doubt be the subject of continuing controversy before this committee.

A central bank operating under a base ceiling law would have to treat the difference between the maximum legal base and its actual base—its own excess reserves, so to speak—as if they were foreign exchange reserves and the bank was on a fixed exchange rate system. The stabilization department could pursue an expansionary policy, or step in as a lender of last resort, only as long as it had excess reserves on hand. If, trying to help the economy out of one recession, it went so far as to hit the ceiling, it would have to plan on a prolonged period of expanding at less than the permissible Friedman rate in order to accumulate the ammunition needed to be of help in the next recession.

Most constitutions have escape clauses. The monetary constitution that I propose needs one as well. We are not able to choose a growth rate for the base from today to the end of the century and be confident that it is or will continue to be the right one. Financial innovation is proceeding at a great pace at present and with unpredictable consequences for the future demand for base money. A 3-percent growth rate may be about right today, but proves to leave too much room for inflationary policies tomorrow.

I believe the Federal Reserve Act should be amended so as to make price level stabilization over the longer term the basic and overriding responsibility of the Federal Reserve System. The German Bundesbank operates under a law of this sort.

Now, other goals of social policy should either be eliminated altogether from the act or be clearly and explicitly subordinated to the price stability objective. This should be done, not of course, because price stability is the most important of our social goals—it isn't—but because it is an important social goal that can be achieved by monetary policy, whereas full employment, for instance, cannot. The central bank should be made to concentrate on the one important thing it can possibly achieve and not be made to chase after wild geese it cannot ever catch.

Such a provision in the Federal Reserve Act would express the basic intent of the monetary constitution and could serve, therefore, as the escape clause under which changes in the prevailing Friedman rule could be made. The Federal Reserve would have to come to Congress and argue that a 3-percent growth rate of the base, for instance, was too high to be consistent with longer term price stability. The Fed could then ask for a revision of the base ceiling on these grounds—but on these grounds only.

In the gold standard era, the Bank of England had to ask the government's approval for a suspension of the convertibility of its notes into gold on several occasions. Provision for temporary suspensions of the base ceiling should probably be made. Suspension of convertibility to allow inflationary finance in times of war is a time-honored case that we hope not to have to relive again. But the possibility of country defaults on large debts to U.S. banks raises the specter of a lender of last resort caught with inadequate resources on hand. Temporary suspension in a case of this sort should be granted by Congress, but only with a required commitment by the Federal Reserve to return to life under the old base ceiling.

The unilateral decision by the United States to stabilize the purchasing power of the dollar—which is what my proposal amounts to—would create an incentive for some other countries to fix their exchange rates to the dollar as they did in the 1950's and 1960's. A possible transitional problem would be a dollar shortage for them and a deflationary excess demand for base dollars for us. The Fed could respond to this situation by asking for a revision upward of the ceiling growth rate under the basic price stability provision of that act, as I have here envisaged. Alternatively, the United States might agree to limited issues by the IMF of special drawing rights convertible into dollars.

The base ceiling proposal offers the potentiality of reconstructing the international monetary system, now pretty much in a shambles, around a sound dollar. I distinguish here a sound dollar, which would enjoy low interest rates, from our present strong dollar which borrows its strength at sky-high interest rates.

How the second, third, and umpteenth steps toward that objective should be taken, however, I will not attempt to anticipate here.

Now, the annual increase in the monetary base ceiling might appropriately be included in the budget as ordinary revenue. The Federal Reserve would simply credit the Treasury's account with the amount while receiving a corresponding amount of long-term U.S. bonds, but perhaps those bonds should not be interest paying.

The ceiling growth rate should also set the limit on how much of its deficit the Government could plan on monetizing at any one time. If it were made binding on Congress and administration, therefore, the proposal would induce a certain amount of fiscal discipline. Conversely, this monetary reform demands a measure of fiscal discipline in order to be credible—which is to say, in order to work.

Fiscal reform may prove more elusive than monetary reform. A balanced budget amendment would be a straitjacket, although perhaps one with the redeeming feature of being unenforceable. A looser constraint would be preferable, if one could be found that is nonetheless effective.

I have one suggestion to offer. Let each Member of Congress publicize his or her own version of the Federal budget. The administration's budget should be the benchmark. If the individual Senator or Congressman advocates, for instance, higher income taxes, lower defense spending, and higher spending on certain welfare programs, or some other such pattern, the Federal budget could be recomputed on the assumption that all the changes that he or she advocates would be passed. These individual budgets could be compiled, checked, and published by the Congressional Budget Office. The media and the voting public could then easily ascertain the overall level of expenditures and taxation and hence also the size of deficit or surplus that the Member is in effect advocating.

A reform of this sort would not always put us closer to a balanced budget, of course. What it could be expected to do is to produce budgets that come closer than they now do to the preferences of the voting public in these matters. It would also make the life of Members of Congress a bit more difficult than it is now. One does not expect, therefore, that Congress will require of all its Members that they commit themselves publicly to a budget in this way. But any individual Senator or Congressman could start the ball rolling by making up his or her Federal budget. If a big enough group had their budgets registered with the Congressional Budget Office, the practice should spread by itself without having to be made mandatory.

If the voting public were able to judge the overall fiscal stance of candidates for office in this way, it is reasonable to expect, I think, that we would end up with fiscal policies sufficiently responsible so that our future monetary stability would not be threatened from this all-important quarter.

In conclusion, the stakes are tremendous. We are, right now, facing great dangers and great opportunities on the economic front. The dangers are continuing monetary instability, perhaps with renewed inflation, a worsening of the international debt crisis, and growing protectionism here and abroad. If these dangers are not avoided, the opportunities cannot be grasped. The opportunities lie in the new technologies in electronics and biological engineering. If we have the wisdom to provide and maintain the neccessary environment of financial and monetary stability and of free trade and competition, we could have, I believe, a great investment boom of long duration that would carry the United Stastes and most other industrial and industrializing countries to entirely new levels of prosperity.

Thank you.

Senator SYMMS. Thank you very much for a very thoughtful statement.

Now, Mr. Leijonhufvud, there is no legislation—or is there legislation to advocate what you are advocating? Is any legislation necessary to do this?

Mr. LEIJONHUFVUD. Yes, I believe that to have the necessary effect on the market expectations, this would have to be legislation that was binding on the Federal Reserve.

Senator SYMMS. Well, the chart right up here to the right is an indication of our volatile money growth, the pattern of spending. And you're talking about trying to establish more of a consistent rate of money growth, if I understood correctly what your thesis was.

Now, this chart implies that a monetary contraction produced a recession in 1981 and 1982, and the monetary expansion contributed to the strength and recovery in 1983.

I'd just like to ask the question of each of you. Would you agree with that?

Mr. LEIJONHUFVUD. Senator, even if the recession were caused by other factors, and also the revival, money would be correlated with the movement in nominal income. It does not, therefore, directly imply or prove monetary causation. Nonetheless, it is my belief that this monetary policy had an important role in bringing it about.

Senator SYMMS. Well, it does require, then, that the Fed should be encouraging stability in money growth.

Mr. LEIJONHUFVUD. Yes.

Senator SYMMS. Mr. Roberts, do you want to comment on it?

Mr. ROBERTS. I agree with the statement of Mr. Leijonhufvud. The Fed will say, or some members of it will be tempted to say, that the economy moves along by itself and it pulls the money with it; therefore, they have no real responsibility.

I am convinced that the economy responds to the sharp accelerations and decelerations in money growth, and that the period during 1981 when monetary growth collapsed was the principal cause of the recession.

I believe, also, the explosion of money that began in the summer of 1982 and continued through the spring of 1983 played an important role in lowering the interest rates and producing the rebound at that time.

I think that what you see is a roller coaster, and if the economy is behaving that way on its own and money is simply moving along with it, then we as economists have really very little to recommend to the Congress about anything, because no one can explain why the economy would behave in this roller coaster fashion by itself.

So I think it is important to have a stable, predictable growth in money supply, and it is important to have a rule that is somehow enforceable and practicable that the Fed is required to follow.

This does not necessarily have to be a money rule. Mr. Leijonhufvud has his own version of the quantity rule which I think the Congress earlier made some effort to impose on the Fed by having them keep to the M-1 target.

Senator SYMMS. It is interesting to me if you go out and ask the average businessman or market broker or what have you what kind of policy they think the Federal Reserve is operating, they will say: "Well, they are operating the monetist policy." In my opinion, from what I have read about monetism, that is not true. Do you agree with that?

Mr. ROBERTS. Yes; I agree they are not following the monetary——

Senator SYMMS. They are not following anything. That's why I made the statement earlier that it would at least be consistent if someone went in and, as Milton Friedman said, put a monkey on a computer and crank out the same amount of money every month, at least the market could adjust to it.

And the points that both of you have made—and all three witnesses—about having the Open Market Committee's information go public so the market all gets it at the same time would at least be a predictable situation. People could adjust to the predictability of what was going to happen, hedging, and so forth.

I wanted to ask one more question. The three of you all have very impressive credentials, and what all three of you are saying—and I'm including Congressman Kemp—is that if we had some reforms to make the Federal Reserve more accountable, it would result in better monetary policy.

But could you give me some examples of where reforms in accountability have led to better improved operation of this public enterprise? Are there some examples of where this has worked?

Mr. ROBERTS. You mean in terms of the Federal Reserve? I think what you have had in the Federal Reserve is the opposite. You've had a series of——

Senator SYMMS. Maybe I can frame my question a little better. The politicians and bureaucrats who control public enterprise have a difficult time being accountable, like somebody in private enterprise is. And what I'm saying is if we continue to go on with a Government policy that confiscates the earnings from the people who work and then transfer it over and encourages people not to work, can we make a few reforms with the Federal Reserve and expect to really have any lasting, good changes?

I think I like this proposal you have made, and it looks like you have made some excellent proposals, too, and I think Congress should work on this. However, I would like to be one Member of the Senate that avoided using some form of a gimmick—and I don't mean a gimmick; it's an honest—you're talking about trying to get more honest money and more predictable money, money that is of value, that people can rely on to expand their economic horizons, which is an honest idea, but to phase it in here with this basically dishonest system that confiscates the wealth and the work from those who are in the producing sector of our society and enhances the lives of some people who aren't producing.

That's my question. Can we make those reforms and not have one system to drag the other one down?

Mr. ROBERTS. Mr. Chairman, I think I would agree with your feeling that you can't expect honest money, assuming you could get it, to solve the problem if at the same time you are confiscating the earnings of people who are earning and transferring it to those who aren't. Because what we are doing there is violating all the property rights of the system. Therefore, it does no good to establish monetary certainty but then create amazing uncertainty in the form of other property rights.

So I think your feeling is true, and I think what we need is a system that establishes the stability and predictability of our property rights in general. And that cannot be achieved merely by establishing predictability in monetary policy.

Senator SYMMS. I will ask one last question.

Mr. LEIJONHUFVUD. If I may, I certainly agree that it is desirable to have property rights as predictable as possible. I also agree with what is implicit in Mr. Robert's statement, that unpredictable monetary policy amounts to the same thing as making property rights unpredictable since the real outcomes of contracts become unpredictable.

At the same time, I would say that with the proposal that I made, which is not for a fixed Friedman growth rate rule on what the Federal Reserve is doing from month to month or year to year, but a maximum on the monetary base that they could have outstanding at any one point in time, so it leaves it open for these other short-term operational issues—to make that proposal workable and to get stable money out of it, you don't need to reform the entire fiscal system. You just need to make sure that fiscal policy overall is sufficiently responsible that it would not create a situation in the medium-term or long-term future, where monetization of the deficits become unavoidable, where nobody can avoid monetizing the debt issue. That sort of minimum of fiscal responsibility is the only thing required for this monetary proposal. You can make it desirable but not a grounds for——

Senator SYMMS. So you don't counterfeit the currency, is what you're saying; you don't monetize the debt to an excessive amount, at least.

Mr. LEIJONHUFVUD. That's correct.

Senator SYMMS. With respect to this fixation on M1 that the Fed talks about all the time, isn't it true that they really don't control the percentage of the money supply or the amount of the aggregate money supply that they used to do before we had banking regulation and money market funds and all kinds of different financial instruments?

Mr. Roberts, or either of you.

Mr. ROBERTS. I think the Federal Reserve can control its balance sheet, control the monetary base, and it certainly has an important degree of control over M1. And I do not agree with the rationales which basically say that the Fed has targeted a form of money over which it has no control. There is no reason for the Federal Reserve Chairman to be supportive of an M1 target if he has no control over M1.

Senator SYMMS. Except the M1 is not the whole money supply.

Mr. ROBERTS. No; it's not the whole money supply.

Senator SYMMS. The Fed's activity today can have an impact on short-term interest rates; is that correct?

Mr. ROBERTS. Yes, and in the long term.

Senator SYMMS. With your reform package, you are saying we could have more stability, which would have a longer term impact on long-term interest rates. It would have a bigger effect on long-term interest rates. Right now short-term and long-term interest rates are historically high. The reason for that, it looks like to me, is because of uncertainty of both the fiscal policy of the U.S. Government and the monetary policy.

Mr. ROBERTS. Yes; the generalized uncertainty about property rights and who has what and what the outcome will be.

This chart—I don't know who prepared it; it is obviously based on official data—shows that it is M1 that tracks GNP.

Senator SYMMS. Mr. Leijonhufvud, maybe you'd like to give us a counterexample of how this worked in reverse or positive with respect to Sweden. They sure went through a bit of socialism in Sweden, I know that. They are trying to get out of it now.

Mr. LEIJONHUFVUD. I think that is an open question.

Senator, I would like to respond to the question about do we have any examples of where legislation has improved performance.

I think that we don't in this country. At the same time, I think there is something that is going systematically wrong with our discussion of this monetary instability problem, and that is true in the economics profession and in the newspapers, and it is also true at these hearings every time they come up.

I think we have, ourselves, gotten caught up in this steady shortening of the time perspective that we are thinking about when we talk about the effects of inflation on economic performance. What we ought to be thinking about is how to reform the system so it gives more stability over the longer run. But when you call people in here to talk about that, they invariably talk about money growth rates over the last 2 months and about the prospects for the next 6 months and what they would like to do to Volcker today or whoever the person is who is in charge.

Nobody here is talking about what to do to construct a system that gives us stability over the next 10 or 15 years on the average, which is what you must talk about if you are concerned with long-run interest rates.

Improving the Federal Reserve accountability in making them release information from the Open Market Committee meetings soon does not help you over a 10- or 20-year time horizon. As a matter of fact, what that proposal does is to make sure that the Federal Reserve Board members sit, so to speak, in hotter seats, so that Members of Congress on either side of the aisle can turn up the temperature of those seats with greater facility when the monetary policy is not to their liking. It is very speculative that that would improve long-run stability. It may make for increased instability.

Now, the proposal that I have made for a maximum, a ceiling, to the monetary base, would leave open all these short-term issues. You can continue to debate them. If you get convincing evidence of what week-to-week operating rule is the best, by all means add that to it. But the controversy before this committee on these issues is going to go on indefinitely. But, you need to think about the longer term issues now. There is one thing you can do right now, which does not opt for either side on all these technical monetary management issues, and that will definitely help.

Senator SYMMS. Thank you very much.

Mr. Roberts, a closing comment.

Mr. ROBERTS. For the first time today I want to disagree with Mr. Leijonhufvud. I think everyone who is testifying today——

Senator SYMMS. I was going to be disappointed if we had two distinguished economists like you here and you agreed on everything. I'd say something was wrong.

Mr. ROBERTS. I think the motivation of the hearing is to try to establish a rule that will last through time and give us long-term stability. I think that is the thought behind holding the hearing.

I think Mr. Leijonhufvud would find, if all he did was to get his base rule and he does not require any of these other items such as for the Federal Reserve to announce what it is doing when it does it and for there to be some political accountability of the Fed—there is none now—that he would find the Federal Reserve could evade his rule just as easily as they have evaded it in the M1 targets.

Senator SYMMS. I guess the one question that probably should be asked that I didn't ask is: From a traditional economic viewpoint, traditionally in the United States normally what has been good for the economy has been bad politics—this is before Ronald Reagan—just because of the general misconceptions and myths that people believe that are promoted by the establishment news media, that somehow funny money and big spending—people can somehow spend themselves into prosperity. With the exception of the President calling for a reduction of across-the-board tax rates on working capital, we have the conservatives on the side who are trying to advocate sound economic policy that it wasn't good politics, and then losing elections for years and years and years.

Now, if you are going to make the Fed more political—and we have always criticized the fact, for example, that when President Carter was running for reelection, the interest rates were pretty high but then they started trending down, and they got down fairly low in September of 1980. As soon as the election was over, boom, up go the interest rates.

And some people have said that's politicizing it. Now, under the proposal that Congresssman Kemp and Senator Mattingly are making—and I think you were instrumental in the formation of that, or some of the ideas behind it anyway—is this just going to make this thing more political so that the swings in the money supply will be even greater? Because you will have the President thinking that the Fed should be more politicized, the Secretary of the Treasury be on the Open Market Committee, who will be a presidential appointee, and the President will appoint a new Chairman of the Fed a year after he is elected so it would be his man.

Mr. ROBERTS. I don't think so, because I think what is lacking is any political accountability.

Senator SYMMS. You make a good point there.

Mr. ROBERTS. If the Federal Reserve, for example, had to report to the Treasury, as many central banks have to do—if the Federal Reserve had to report to the Treasury, which is going much further than simply making the Treasury Secretary a member of the FOMC, at least everyone would know, if the policy was bad, who was responsible. It would clearly be political authorities. They would clearly be.

But the situation we now have is that the Fed can act in such ways that produce recessions which then can be blamed on the administration for cutting taxes, or the Fed can produce high interest rates by tightening money and it can be blamed on the administration for cutting taxes.

So you have a situation today where the Congress has given the Federal Reserve an enormous amount of power and has not constrained it in a constitutional way. If you had constitutional scholars here today, at least half of them would be urging that the Congress has made a grant of power to the Federal Reserve that is in conflict with our constitutional principles.

Senator SYMMS. I happen to agree with that, but that has never been proved in court, has it?

Mr. ROBERTS. I don't know.

Mr. LEIJONHUFVUD. May I add something to this. The politicization of central banks is itself a result of how we have allowed the monetary system to change. If you think back 25 years ago, or 50 years ago, you will find a nonpolitical central bank in this country—and 75 years ago we don't find a central bank.

Senator SYMMS. Right.

Mr. LEIJONHUFVUD. But the whole idea was to have a central bank, staffed by people knowledgable in banking and money markets, that are professional people. Now, you can put professional people in charge of running a gold standard or a gold exchange standard, or a monetary constitution like that. You could put them in charge of executing a Friedman rule.

Senator SYMMS. Frankly, Mr. Leijonhufvud, as far as I am concerned, we don't need a Federal Reserve. We could just turn it all over to the market. But I realize that's not a political practicality now. I wouldn't feel bad if we just abolished the Federal Reserve. Every bank would have to have good money, and then this would mean that good money would then come back into vogue. The way it is now, with the Government monopoly on money, they run the good money into the coverage and use the Federal Reserve as their exchange to buy things with.

Mr. ROBERTS. Mr. Chairman, I think what Mr. Leijonhufvud was leading up to is the statement that it was the Keynesian demand management or the intervention of Government in macroeconomic policy which led to this process.

Senator SYMMS. I'll say one thing. I am a great admirer of President Reagan, but I think he made a confusing—and this is no aspersions on Chairman Volcker personally, but I think he confused the issue more of what Reaganomics was all about by reappointing him as Chairman, whether they had a meeting of the minds or not. From what I have seen the Federal Reserve doing in the last 2 or 3 months, President Reagan evidently didn't get a very good commitment out of Chairman Volcker when he made the appointment.

Mr. LEIJONHUFVUD. Senator, the point, if I could make it, was that under the present system, it is open to the monetary authorities to, in a sense, decide what the price level is going to be. And I am saying "monetary authorities" here because that is only the Federal Reserve. The decisions they make have tremendous redistributive implications. If you were to choose a number for the price level next year, if you can bring it about, whichever number you choose implies a pattern of taking wealth away from some people and giving it to others, because you affect the real outcome of the contracts that these people have already made.

Now, in a system like that, it is inconceivable that in the long run you will go on having it so that monetary policy is made by nonelected people meeting as a Federal Open Market Committee and saying, "We don't want to be subject to political pressures," because their day-to-day decisions have tremendous political repercussions.

So it is a system in which a depoliticized central bank is just not a feasible alternative.

Senator SYMMS. It's impossible.

Mr. LEIJONHUFVUD. It's absolutely impossible.

Senator SYMMS. That's a good point.

Mr. LEIJONHUFVUD. At this point you can go in one of two directions. You can sort of go with the flow of the deterioration of our monetary system and say, "We are already so far down that road that we must totally politicize monetary policy decisions"—even on the month-to-month decisions, never mind longer term decisions, but week to week.

Or you can start thinking about turning back into a system where the design of the monetary system is done by Congress, and the day-to-day execution of monetary policy under that system is left to professionals who come up here once a year and are judged on professional criteria, so to speak, whether they are doing a good job or not.

At the present there is no such thing as judging the Federal Reserve on professional criteria. You have to judge them on political criteria. And those are going to be different on the two sides of the aisle so there is never going to be unanimity.

Senator SYMMS. Well, I want to thank both of you very much for your time and patience to be here this morning. And I might say it is my intention to put into the Congressional Record later today Senator Jepsen's opening statement, Congressman Kemp's statement, and each of you two gentlemen's statements, and make a little summary about what this discussion was about so that more of our colleagues will know that the Joint Economic Committee is exploring what is certainly a very important part of economic recovery in this country. I thank you both for your contribution to this.

Do you have one last thing you were trying to say, Mr. Roberts? We'll give you the last word if you want it, and then I'm going to hit the gavel here.

Mr. ROBERTS. Mr. Chairman, it might be useful to have this on the record to illustrate the points Mr. Leijonhufvud was making.

When I was Assistant Secretary of the Treasury in the Reagan administration, when we came to office we requested a monetary policy which would consist of a stable, moderate, and predictable growth of the money supply. We requested the Federal Reserve to gradually reduce the rate of growth, which at the time we took office was very high, by 50 percent over a period of 4 to 6 years. We thought this would avoid the roller coaster cycle, which I think helps destabilize the markets, and send a message that inflation was on the long-term, winding-down path, slowly reducing the growth rate of money. This could be done without provoking the usual liquidity crisis that sets off the roller coaster. And all forecasts of the Reagan administration were made on the basis of that assumption about monetary policy.

Well, the Federal Reserve paid no attention whatsoever. And far from delivering the policy we expected, they produced 75 percent of that reduction, which we wanted spread over 4 to 6 years, the first year. And they did this because they were under the influence of theories, which I believe were largely erroneous. One was about core inflation. The core inflation was allegedly so high nothing could be done in monetary or fiscal policy that would succeed in lowering it very much.

And the second idea they had was that the fiscal policy of the Reagan administration was so expansionary that no matter how much they tightened the money supply, inflation was going to rise.

So there you have an institution, with enormous power, operating entirely on the basis of false theories that we can see from experience are false. The Federal Reserve did not intend to cure inflation overnight. They were absolutely astonished when they learned they had brought the entire international monetary system to the brink of collapse, because they were operating under the theory that the fiscal policy of the Government was going to cause inflation to rise, no matter how tight they made monetary policy, and they wanted to be sure there was no money growth so no one could blame them for what they thought would be a rise in inflation.

This illustrates, I think, that you cannot give enormous power to an institution that has no clear rules, that is not politically accountable, and which can operate on the basis of erroneous theories, because the political consequences have been rather drastic.

So I think, Mr. Chairman, I'd like to have that on the record, and that would conclude my statement.

Senator SYMMS. Thank you very much.

The committee stands in recess.

[Whereupon, at 11:45 a.m., the committee recessed, to reconvene at 9:30 a.m., on Tuesday, June 5, 1984.]

MONETARY REFORM AND ECONOMIC STABILITY

TUESDAY, JUNE 5, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 9:40 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen and Symms; and Representative Lungren.

Also present: Dan C. Roberts, executive director; and William R. Buechner and Robert R. Davis, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The Joint Economic Committee hearing will come to order.

Congressman Patman, we welcome you today at our second round of hearings on the institutional setting that influences monetary policy. Your presence confirms that there is widespread dissatisfaction with the rules and accountabilities that govern monetary policy. There is a bipartisan interest in a serious examination of monetary performance, particularly regarding the appropriateness of performance criteria established by Congress.

In addition to the issue of accountability for realistic goals, there is also a problem of adequate information regarding monetary policy. The simple obligation of informing the public about Government policies is an essential part of a democratic society, and is a tenet in virtually every level of government. A major exception exists in the Federal Reserve System. The monetary policy arm of the Federal Reserve, the Federal Open Market Committee, meets 10 times a year to set policy, but conceals that policy for about 6 weeks. The decisions reached at an FOMC meeting are not released until after the next meeting, so the public is in a perpetual guessing game about the course of monetary policy. In fact, no one in Government knows the true course of policy except a select few in the Federal Reserve System.

It is high time that the Federal Reserve stop operating in the dark. Its policies can have a dramatic impact on economic growth and interest rates in the short run, and determine the course of inflation in the long run. How can America's business and labor leaders carry out their tasks effectively while guessing about the direction of monetary policy? How can investors and savers enter the market with any degree of confidence? How can the public plan appropriately for the education of their children or to provide for their retirement years?

The advantage of more timely information about monetary policy seems overwhelming. This immediately raises the question, why is such information not provided now? I think the answer lies in the first problem to which I alluded, the lack of a clear mandate for monetary policy from Congress. As long as Congress persists in the tendency to set goals for the Federal Reserve that are outside the capabilities of monetary policy, the Federal Reserve has an incentive to remain secretive about the formation of policy. Ultimately, the roots of monetary instability must lie in the institutions, incentives, and accountabilities created by Congress.

I welcome you, Congressman Patman, and I would advise you that your statement will be entered into the record and you may proceed in any manner you so desire. Thank you for coming.

STATEMENT OF HON. BILL PATMAN, A U.S. REPRESENTATIVE IN CONGRESS FROM THE 14TH CONGRESSIONAL DISTRICT OF THE STATE OF TEXAS

Representative PATMAN. Thank you, Senator Jepsen.

Mr. Chairman and members of the committee, I would like to thank you for holding these hearings to investigate the appropriate function and mandate of monetary policy. There is no more timely subject before this Congress today. Banks are failing at the fastest rate since the Great Depression. Already this year, 34 banks have been forced to close, if that number has not risen since I prepared my testimony. Just recently, Continental Illinois of Chicago was saved from collapse only by an unprecedented Government rescue. Third World debtors are threatening to default on their loans. A siege of rumors caused Manufacturers Hanover Trust Co.'s stock to plummet on May 24, 1984, and it dragged down with it the shares of other money-center banks and various others who were not even involved with the problem.

The Wall Street Journal aptly described it as a bad case of nerves within the financial system and I believe that it is in large part due to the action of the Federal Reserve Board and those actions of the Federal Reserve System. There have been many questions raised about the capability of the Federal Reserve to exercise proper and prudent monetary control. But one thing is certain, the secrecy surrounding the actions and monetary decisions of the Federal Reserve only compounds the problem of market uncertainty.

Since decisions made by the Open Market Committee are not available until 45 days after the meeting, Government economists and other economists are forced to rely on guesses and rumors as the basis for their actions. Forty-five days is entirely too long to wait for information that should be a mater of public record.

For this reason, I have introduced H.R. 1432, a bill to amend the Federal Reserve Act. It would require that the Board of Governors of the Federal Reserve System send to Congress as soon as possible—but not later than 7 calendar days after the Federal Open Market Committee takes action—the changes that are likely to result in the existing trend rate of growth of any of the monetary aggregates, credit aggregates, or any of its economic targets as set by the Federal Reserve.

If H.R. 1432 were enacted into law, Congress would know within 7 days any decision likely to change the existing trend in these important indicators. This would alert us to a problem, and we would be able to consider the necessary response in a timely manner. Instead, we must wait until the ox is already in the ditch and then do our best to pull him back on the road again.

Each report would be required to state for each of several economic indices the initial level and the estimated change in the level that is likely to result from action taken by the Federal Open Market Committee and the Federal Reserve. The Federal Reserve would be asked to forecast the likely result in 3-, 6-, and 9-month intervals on certain key economic indicators. Interest rates would be included as well as the Federal funds rate, the rate of 3- and 6-month Treasury bills, and the rate for securities with a maturity of 20 years that are offered by the Treasury.

We know from recent experience during the recession in 1982 that high interest rates had a devastating effect on small businesses and farmers in addition to the rest of the ecomony. Since 1978, the prime rate charged by banks to low-risk business borrowers has shown considerable volatility. It's the volatility that causes a great deal of problems in business today as well as with the consumer. The prime rates went from 6.38 percent in 1977 to 18.87 percent in 1981 to 14.86 in 1982 to 11 percent in 1983. Most recently, on June 4, 1984, it was 12.5 percent. This has caused deep concern in my areas, not just because of the rates the businesses have to pay, but because of the influences on variable-rate mortgages which add an element of instability and insecurity to the budgets of many families throughout this Nation because of their obligations with home mortgages based on variable-rate loans.

The high interest rates that resulted from policies of the Fed have undoubtedly contributed to bankruptcy and the surge in business failures. Compare the figures: 30,528 businesses filed for bankruptcy in 1978, while 77,503 filed for bankruptcy in 1982. During the last week of December 1983, 540 filed for bankruptcy, compared to 228 the previous year. Business failures for the 1983 year totaled 30,334, compared with 25,346 the previous year.

These high interest rates have also contributed to the worst trade deficit in history. The United States had a giant trade deficit of $60 billion in 1983, compared to $42 billion in 1982, and we expect the 1984 deficit to go over $100 billion. I think it's a matter of deep concern also that the Federal Reserve has apparently embarked upon a course of spreading the weaknesses of these larger banks due to their Third World indebtedness. Throughout the banking system the reauthorization has been of many of these larger money-center banks to take on other banks throughout this Nation. These small banks are now in good shape, but they will be rendered weaker and less effective by being taken over by a bank with the weaknesses of these large money-center banks.

In addition to forecasting interest rates that would result from actions taken by the Federal Reserve, the report would also be required to state the expected interest rate for bonds issued by certain corporations, the rate of business and household bankruptcies, and other such measures of economic performance.

The bill would require updates on actions by the Federal Reserve until a new monetary early warning report is issued. This would assure that we would always have the latest information in an early warning report based on sound economic indicators. It's a healthy thing for the Fed to take this action, assembling the monetary early warning report prior to putting into effect any changes that it makes in the monetary aggregates or other economic indices. It would make us more confident, I'm sure, that the Fed actually knows what it's doing and it foresees the long-range implications of its actions—actions which have been devastating in the past.

Long-range economic policy planning is a necessity. Congress must have all the facts from the Federal Reserve Board in order to act with maximum responsibility.

The financial markets and businesses all over the world are in need of stability. Business depends on long-range planning. Nothing is more important than knowing as precisely as possible what the monetary policies are going to be. Withholding that information for 45 days accomplishes nothing. It does encourage rumors, and makes financial forecasting a guessing game better played by charlatans than those with a sound economic background.

The sunshine laws have proved that the public wants and needs to know what its Government officials are doing. When first these laws were passed, many predicted dire results. The opposite has occurred. We are discovering that the more informed the public is, the more likely it is to make the right decisions. Further, there is less opportunity for "backroom deals" and other shenanigans that benefit a few at the expense of many.

Why should we tolerate secrecy in the operation of the Federal Reserve Board and the Federal Open Market Committee? These are not even elected public officials, yet they are making decisions profoundly influencing the economic conditions of this country and the whole world.

It is time that we acknowledge what has been the case for years: The business decisions on which our economic future depends are based, more and more, on sophisticated computer models, and that these models are useless unless they can be based on accurate and timely information.

The same is true for the important policy decisions that Congress must make. We must have timely information. We need an accurate monetary early warning report.

Thank you, Mr. Chairman.

Senator JEPSEN. I thank you, Congressman Patman.

In your opinion, what accountability is there for the conduct of monetary policy and is that accountability effective?

Representative PATMAN. With the secrecy we now have, I think there's little accountability, and that's one of the important things that we seek in the monetary early warning report, a disclosure of what the Fed itself sees to be the result of its actions. That would give us the accountability I think in time.

Senator JEPSEN. Well, in your opinion, would the inclusion of the Secretary of the Treasury and the Chairman of the Council of Economic Advisers as ex officio members of the Federal Open Market Committee improve the administration's understanding and input on the monetary policy and, by the same token, would such an inclusion be likely to improve the Federal Reserve's understanding of the economic policy of the administration? We would have a liaison built in there. Would that be a good idea?

Representative PATMAN. I think it would help the administration, but I think the Congress needs more communication with the Federal Reserve and I think the Federal Reserve needs to make more effort to communicate its decisions and its thinking to the people throughout America. I think we saw in 1981 the Fed's putting on the brakes while the Congress was stimulating the economy. It seems as if they could have walked down a few steps down the street and told either the Congress or the President what they planned to do, and that they were actually going to undertake the program that would negate what the Congress was trying to promote throughout the country.

Senator JEPSEN. Well, right now, Congressman, the Congress presently requires the Federal Reserve to answer to both business cycle and price stability and what problems are created by this dual responsibility for the Federal Reserve, if any.

Representative PATMAN. They are not incompatible. I think that those are just part of the many responsibilities of the Fed—price stability and low inflation and economic viability for this Nation. We have American manufacturers selling on the open market at a penalty and at a handicap by paying the high interest rates that we have in this Nation and competing against the Japanese enterprises that pay much lower interest rates. We are handicapped in our sales by these policies and, in addition, artificially increasing the value of the dollar which almost takes away our farm markets in international trade and many other markets for American products.

Senator JEPSEN. In your opinion, what is the chief cause of the interest rates moving upward here recently?

Representative PATMAN. I think that the Fed itself has encouraged that movement upward, with or without justification. It depends on the person who examines the facts, but there are many of us who feel like they are prematurely trying to stifle what business uptake we have in the present economy and will likely cause another recession for this Nation.

We need to know what they are planning on these things as early as possible and that's one reason why I am very much interested in this monetary early warning report.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

Congressman Patman, I wasn't here for most of your testimony. I have reviewed it, however, and have looked at your legislation and I congratulate you on being one of the champions of having the Congress take a look at the Federal Reserve and monetary policy. I guess the first step is recognizing that there's something there that we should have some influence over. I think for a long period of time, Congress hasn't recognized the authority we have over the Federal Reserve. I do believe that we ought to have some sunshine thrust upon the Fed, but I am a little concerned about some of the terms of your legislation.

Let me just phrase it this way. One of the causes of monetary instability is that Congress gives the Fed so many conflicting goals. If in fact we consider price stability the No. 1 goal of monetary policy, does not the legislation you have sponsored raise the danger that price stability particularly, and ultimately the interest rates and economic growth, might be sacrificed for short-run considerations?

In other words, I like the idea of shining the Sun on the Fed, but your requirement causes them to hit or suggest they're going to hit certain targets within a very short period of time over a number of different indices.

Representative PATMAN. Congressman Lungren, actually what my legislation would require is that the Fed just simply give us the results that it anticipates from its actions, not that it targets these indices in any way, not that they set a rate that it wants to target for long-term Government bonds, 90-day Treasury bills; but that it simply tell us and tell the American public what it anticipates will be those rates when it takes the action it has taken. This is what they should know at the time they take the action, of course, and this won't require their achieving any particular target.

Representative LUNGREN. After a few short reports it might require that they start hitting those targets or there's going to be a little concern out in the body politic, isn't there?

Representative PATMAN. I think people show a wide tolerance for what the Fed has done and what targets it must have had and its policies and this simply would require that they be more clear.

Representative LUNGREN. Let me ask you this. I know the chairman has asked you something about this, but I'd like to find out, do you think price stability is the No. 1 goal that we would ask for the Fed to achieve?

Representative PATMAN. Long-term price stability is critical to this Nation. That is, controlling inflation. Of course, we've got other problems, too—the deficit.

Representative LUNGREN. I understand that, but sometimes I wonder if we set targets where we let people know what it is we intend to happen in terms of interest rates over short terms of time that that might interfere with the overall goal of price stability. That's the problem I have.

Representative PATMAN. As I say, they could target very high interest rates and report it to us as what they expect will result from their policies and simply justify that by saying that's necessary in order to control inflation, if that's what they actually believe, and apparently they did believe that several times in the not too distant past. These policies put upon this Nation a recession that cost this Nation, according to the testimony we received in our House Banking Committee, $1 trillion. Another economist, this one was from Harvard, Benjamin Friedman, who made that calculation about the cost of this most recent recession, and another witness before our committee, testified that the cost was $800 billion. I haven't even required that they estimate the cost of what their policies will be to this Nation. But there are so many, many things that result from the actions they take in the Federal Open Market

Committee that I think we need to get a handle on them. Of course, I do put in here not only are these standard and classic economic indices reported on, but such other measures of economic performance as are necessary to indicate the full effect of such action upon the economy. That would include perhaps price stability and a price index of some kind, either on commodities or other components of the prices we pay.

Representative LUNGREN. Thank you, Mr. Chairman.

Senator JEPSEN. I thank you, Congressman Patman. Do you have any closing statement?

Representative PATMAN. No, sir. I appreciate very much your attention and the opportunity to speak before this distinguished committee. It's an honor to be present here today and I thank you.

Senator JEPSEN. At this time I would ask Edward J. Kane, professor, Ohio State University, and George G. Kaufman, professor, Loyola University of Chicago to come to the table. I welcome both of you to this hearing. Professor Kane and Professor Kaufman, and we are happy to have two such distinguished academic economists at our hearing today. Your willingness to share your expert opinions on the underlying causes of monetary instability is greatly appreciated and we look forward to your testimony.

Do you have any opening comment, Congressman Lungren?

Representative LUNGREN. No, Mr. Chairman.

Senator JEPSEN. I would advise you that your statement will be entered into the record and you may proceed in any manner you so desire.

STATEMENT OF EDWARD J. KANE, EVERETT D. REESE PROFESSOR OF BANKING AND MONETARY ECONOMICS, OHIO STATE UNIVERSITY, COLUMBUS,

Mr. KANE. Thank you, Mr. Chairman.

I appreciate your committee's willingness to hear my views on whether and how to make monetary policy decisions more accountable. It is a subject about which I am not very hopeful.

In politically or economically difficult times, incumbent politicians engage in a bipartisan practice that has come to be called Fedbashing. They pointedly blame the economic ills of the country on the "misguided" policies of an "independent" Federal Reserve System. Far from acknowledging a prior role in encouraging Fed officials to select the very policies they currently wish to disavow, Fedbashers seek to distance themselves from policies that are currently unpopular with potential swing voters. Other things equal, more dissatisfied polls show swing voters to be with any aspect of the national economy and the closer the date of the next election, the more abuse Fedbashers tend to heap upon the Fed.

What makes the game work is that Fed officials take their bashings manfully. Typically, their own defense is to point out that fiscal policy and such unforseeable events as financial innovations or oil shocks cause monetary policymakers insuperable difficulties. This gracious acceptance of blame supports the perception that monetary policy is a delicate art and increases the credibility of Fedbashers' basic efforts to heap political guilt for questionable policies onto the Fed.

In turn, Fed officials profess an unswerving resistance to political pressure and accept the role of scapegoat for two reasons. First, because the structure of decisionmaking at their agency depersonalizes blame and second, because serving as scapegoats lets them preserve a series of valuable bureaucratic privileges. These privileges include budgetary funding for this agency, longer terms of office for agency leaders, and greater prestige and policy control than the agency leaders of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission.

An essential place in the Fedbashing process is held by congressional hearings convened, as today's hearings are, to evaluate mechanical rules for dictating policy decisions to Fed officials and to consider structural reforms that would reduce the Fed's special bureaucratic privileges. By reminding Fed officials of their agency's vulnerability to an organized congressional attack and of the value of being able to call forth a Presidential veto in the clutch, these hearings fan Fed interest in maintaining good relations with congressional leaders on both sides of the aisle and, especially, in staying on the good side of the President and his staff. In charting a policy course whose perceived effects on interest rates inevitably harm the interests of some politically powerful economic sectors, Fed officials can ill afford to antagonize these important players.

Past cycles of committee hearings confirm the value of the game to bashers and bashed alike. Congress has enacted a series of marginal adjustments in Fed powers and responsibilities just large enough to keep activist congressional reformers working at the game. This year's marginal adjustment is likely to focus on the timing and content of reports on policy decisions taken by the Federal Open Market Committee. It is no accident that, through the Fed's 70 years of existence, Congress and the President have remained content not to force the Fed to submit openly to their wills. By leaving the Fed's high command a substantial amount of ex ante discretion, elected politicians leave themselves room to blame the Fed ex post for whatever aspects of its policies happen to go wrong. This conception amounts to a scapegoat theory of the bureaucratic structure of the Fed.

In offering ritualistic defense against congressional and executive branch criticisms, Fed leaders cannot fail to appreciate that political benefits accrue to them from allowing incumbents to use their institutions as a scapegoat. Their patient acceptance of such criticism contributes to the stereotype of Fed decisions as a continuing series of policy errors. Although Fed officials would rather not be seen as a collection of inveterate bumblers, the valuable bureaucratic privileges that politicians grant them for bearing this opprobrium make the game worthwhile.

What puzzles me about those who labor at reforming the Federal Reserve is their presumption that the controlling problem is only to show that a particular change in the structure of Federal Reserve decisionmaking would lead to better monetary policy performance. The catch is there are a great many different structural reforms that can be shown to lead to better policy. The truly controlling question is why wasn't one of these fundamentally better arrangements adopted years ago. The answer is twofold. First, important segments of the electorate see themselves as having a distributional interest in preserving current arrangements. Second, supporters of different reforms let efforts to support their particular idea of best become the enemy of the good. By not addressing the structural and political incentives, economic reformers permit their various schemes to cancel each other out.

If proposals for asserting congressional authority over monetary policy are to have a substantial chance for success, their sponsors must find a way to address the political and bureaucratic incentives that make current arrangements so cozy both for incumbent politicians and for the Fed. The Fed's acceptance of contradictory goals and its discretionary use of a self-selected bevy of intermediate policy targets let it reverse its economic priorities quickly in response to political pressure with minimal embarrassment. Structural ambiguity permits Fed officials to fuzz over the important political compromises they effect between goals desired by different sectors and lets these compromises be made with minimal short-term political stress for elected politicians.

Fed leaders make uncomfortable compromises between their need to respond to immediate political pressure and their desire to improve the long-run performance of the national economy. Political goals and constraints complicate the dilemmas inherent in the Fed's economic policy mission. Over short accounting periods, macroeconomic goals such as high employment and low inflation require contradictory action. Nondiscretionary policy rules, such as gold standard or monetary growth rules, are naive brute-force ways of reducing the myopic bias that day-to-day political pressure and macroeconomic lags to impart to monetary policy. Policy rules serve as a mechanism for ensuring consistent decisions over time, decisions which could establish an enduring macroeconomic balance. But such rules create political frustration. They generate palpable political costs that professional politicians cannot afford to wish away. A policy rule establishes consistency in policy priorities over time only by walling in the interim reaction of sectoral interests to foreseeable, and especially to unforeseeable, policy burdens that such rules thrust upon them. Such rules are not politically attractive to Congress. They seek to prevent losers from using the political system to protect themselves against both anticipated and unanticipated losses caused by monetary policy. Such a rule promises to build up political pressure not only against itself, but even against the larger political system of which it is a part.

A central bank is a political institution whose macroeconomic mission has important political overtones. With the major exceptions of West Germany and Switzerland—countries whose postwar constituencies against inflation proved unusally strong—politicians in advanced countries have chosen to bind their central banks into the formal political process far more tightly than U.S. politicians have secured the Fed.

Although limited autonomy was given to the Fed ostensibly as a way to assure less inflationary monetary policies, the fragility of the Fed's special bureaucratic priviliges has turned its quasiindependent status into a political leash. If U.S. politicians' only goal was to give our country better macroeconomic performance over the long run, they would long ago have made themselves more directly accountable for central bank behavior.

Most incumbent politicians revel in the political benefits of Fed-bashing. Presidents and congressional leaders will keep the game running as long as the political benefits of Fed-bashing exceed its political costs. Before the balance of benefits and costs can reverse, voters must place in office individuals whose concern about economic performance is strong enough to overcome the symbiotic relation that now exists between elected politicians and the Fed. For this to occur, either the public must learn to see through biennial and quadrennial efforts to scapegoat the Fed or critics of the Fed must agree on a unified plan for reform. As it is now, internecine squabbling among sponsors of sensible alternative central banking arrangements serves to shorten the political leash under which the Fed operates and to strengthen its institutional capacity to serve as an after-the-fact scapegoat for unpopular macroeconoimc events. As long as would-be monetary reformers speak with many voices, their efforts serve to mystify the task of monetary policymaking and to keep Fed officials battling to preserve their special bureaucratic status, while the sheer level of the noise they make drowns out their most telling criticisms about the absence of a clear line of political accountability for Fed actions.

Thank you.

Senator JEPSEN. Thank you, Mr. Kane.

Professor Kaufman.

STATEMENT OF GEORGE G. KAUFMAN, PROFESSOR, LOYOLA UNIVERSITY OF CHICAGO

Mr. KAUFMAN. Thank you, Mr. Chairman. I am very glad to be here today.

The disappointing behavior of the economy over much of the past 15 years has encouraged policymakers and analysts alike to reexamine how our economy works, what went wrong, and the role of economic policy. Some have concluded that the failure of economic policy to perform better lies at least as much in the existing institutional arrangements as it does in our lack of knowledge of economic relationships and that this is particularly true for monetary policy and the Federal Reserve System. Thus, it is fitting and important that the Joint Economic Committee conduct these hearings at this time. I have considered this problem in some detail in recent months and will summarize my thinking in this statement.

The Federal Reserve is unique in our system in that it is probably more independent of Congress and the administration de jure than any Government other than the U.S. Supreme Court and the Federal judicial system. This independence was introduced in 1913 when Congress established the Fed and reinforced in 1933 and 1935 when Congress overhauled the structure of the system. The independence was intended to insulate the system from day-to-day political pressure from both the Government and the financial community. Thus, the terms of the Governors were progressively lenghthened to 14 years, the Secretary of the Treasury and Comptroller of the Currency were removed as ex officio members of the

Board in 1935, and the Fed did not have to go to Congress for its annual funding.

History suggests that this structure may have made the Federal Reserve more independent from political and business pressures than other Government agencies—although there is strong evidence that the System has not been as free from Presidential influence as is often believed. But it clearly did not isolate the System from day-to-day economic and financial concerns. The Fed has operated on a fine-tuning basis throughout most of its entire history. It responds to a large number of concurrent forces in the economy in an attempt to be immediately responsive to a large number of intermediate and final targets. In addition, despite widespread knowledge that its actions affect macrotargets only with a considerable time lag—in some cases, months or years—the Fed generally waits until the undesirable condition, particularly inflation, is upon us before taking action—a "do not fire until you see the whites of their eyes" philosophy. These strategies, although well intentioned, are to blame for much of the country's relatively poor overall macroperformance in terms of price stability and unemployment. In attempting to serve many masters, the Fed has served none very well. To improve these results, it would be desirable for the Federal Reserve to limit its goals to one or, at most, two that it can structurally achieve and to wait out time lags. This also implies that Congress should not ask the Fed to achieve goals that are beyond the Fed's powers to achieve; for example, short-term full employment or real sector growth. Monetary policy affects primarily nominal variables.

Such a change would be more far-reaching than it may at first appear. For the Fed, it would mean that it may expect to be held strictly accountable for the achievement of the specified target. This will surely clip its wings. For Congress and the administration, it means that they cannot continue to use the Fed as a scapegoat for poor economic performance. Congress and the administration themselves would have to accept direct responsibility for the country's economic performance. Because we live in a highly complex and uncertain world, the resulting increase in responsibility and accountability for conditions that may at times be beyond their control would not be welcomed by the Fed, Congress, or the administration.

No Government agency—or, for that matter, any of us—wants its wings clipped, particularly one that treasures its independence as much as the Fed. Thus, it has fought back hard to preserve its independence and power whenever they were threatened. Like Congress, the Fed has generally laid the blame for the poor performance of the economy on others, particularly on fiscal policy and the Federal deficit. Indeed, such behavior was predicted in 1933 by Senator Huey Long when he argued against removing the Secretary of the Treasury from the Board: "When the Secretary of the Treasury is dissociated from the Federal Reserve Board, then the Federal Reserve Board will constantly 'pass the buck' and say, 'it is the Treasury Department that is responsible' and the Treasury Department will 'pass the buck' back and say that it is the Federal Reserve Board that is responsible."

How right he was. The Fed tends to spend as much time in its speeches discussing fiscal policy—over which it has no control—as monetary policy, which is its responsibility.

Whenever Congress has attempted to increase its control over Federal Reserve monetary policy in the post-Korean war period, the Fed has responded by emphasizing the economic undesirability or technical impossibility of being evaluated by one or two performance measures. In the mid-1970's, in response to dissatisfaction with both the performance of the economy and Fed policy, Congress required the Fed to specify target rates of growth in monetary aggregates over the next 12 months. The Fed responded by increasing the number of money supply definitions and by continually shifting the base period, making it difficult, if not impossible, to evaluate its success in achieving these target ranges. This defensive strategy was used even in the 1979-82 period when the Fed was supposedly placing increased emphasis on monetary aggregates. It is now clear that the Fed adopted its 1979-82 operating procedures both to signal an increase in the intensity of its anti-inflation program and to escape from being tagged with the responsibility for the higher interest rates that could be expected to occur as a result.

But, as has been well documented, not only did interest rates increase and become more volatile, as was widely predicted, but money supply also became more volatile, which was neither predicted nor should have occurred had the Fed actually operated to control the money supply. The reasons for the Fed's behavior in this period have been analyzed elsewhere—and I will not go over them here. Moreover, when the Fed's concern shifted again from inflation to unemployment in 1982 and lower rather than higher interest rates were a goal, it deemphasized monetary aggregate targeting. As is shown in the accompanying charts, since 1975 the Federal Reserve has almost consistently missed its own monetary growth targets, generally overshooting them.

The struggle against increased congressional intervention in its policies has been waged with almost equal intensity regardless of who was the Chairman of the Board—whether short or tall, economist or noneconomist. Indeed, not only has the Fed been reluctant to be judged by any one measure of performance, it has been reluctant to accept any one theory of how the economy operates. As was recently reiterated by Gerald Corrigan, president of the Federal Reserve Bank of Minneapolis, in his 1983 annual report, eclecticism and judgment are the key words for Fed operations:

> The economy and expectations about the performance of the economy are simply too complex to assume that simple and inflexible rules hold the key to economic success. * * * There are no simple formulas for economic prosperity * * *. The policy process must be sprinkled with a generous dose of judgment and flexibility and a willingness to adjust policy and policy targets as changing economic and financial developments warrant.

Why has Congress permitted the Fed to operate in such a freewheeling manner, particularly as it has held other agencies to stricter standards of accountability? I believe that there are two primary reasons. One, because economic performance is not always on target, Congress and the administration wish to avoid responsibility and being voted out of office. They prefer to shift the blame to the independent Fed over which they are perceived to have little control. Two, the Fed uses its leverage as the lender of last resort to argue that, unless its freedom to determine its own mode of operation is maintained, it cannot be held responsible for any major economic crises that may arise when its hands are tied. Because of the complexity of the economic process and the electorate's relative unfamiliarity with it, it is easier to shift the blame for poor economic policy than for most other Government policies.

It follows from the above that to change the Fed's operational style seriously requires a modification of its institutional structure. As we eventually learned about other regulatory agencies, it is not the person in charge that generally matters, but the nature of the agency. Just as, with rare exception, most ICC, FCC, or CAB chairpersons could not be distinguished, in retrospect, by the actions of their agency, the recent Fed chairmen cannot be easily distinguished by the resulting monetary policy or strategy. The organization tends to capture its managers, and central banks operate similarly in almost all countries under almost all shades of governments—they tend to be "economic meddlers."

Recommendations for institutional modifications of the Federal Reserve to correct this problem vary greatly. Former Chairman of the President's Council of Economic Advisers, Herbert Stein, for example, has recently proposed that the Fed's economic staff be reduced in size to cut back on the amount and diversity of information that the Fed can analyze. This should force it to focus more on a limited number of macrogoals. Under this proposal, the Fed would maintain its independent status, although it would lose much of its regulatory powers, which encourage it to mix micro and macro objectives. Others have questioned the appropriateness of an independent agency in a democratic political structure. Despite the fact that military policy is probably at least as important and technologically complex as monetary policy, we do not have a de jure independent Joint Chiefs of Staff or Department of Defense. The operation of the country, including the economy, is evaluated every 2 or 4 years by the electorate who can and do throw the "rascals" out if they do not like what they see. Thus, whether they wish to avoid it or not, Congress and the administration bear the ultimate responsibility for the Fed's monetary policy, just as they do for fiscal policy and military policy, and are accountable to the electorate. If the Fed is unwilling to accept greater accountability to Congress or Congress is unwilling to surrender its favorite economic scapegoat to permit Fed independence from day-to-day temptations, which is my preferred arrangement, the Fed should be brought into the Treasury Department with much the same structure as the Comptroller of the Currency. Thus, monetary and fiscal policies—the two major tools of macroeconomic policy—will be combined under one authority for the electorate to evaluate.

Whether this structure would work better than the current structure depends on what is meant by "work." If the extant system has worked by most generally accepted measures, this committee would not be holding today's hearings. The United States has remained a world military power even though the Joint Chiefs, Department of Defense, and even the CIA are organized within the administration and are accountable in a meaningful sense to Congress. It is difficult to imagine that we would have been better off if this had not been so or that we would be much worse off if the Federal Reserve was structured in a similar way.

Mr. Chairman, a number of my fellow economists have given thought to this topic and I list some of their publications in the reference attached to this testimony.

[The prepared statement of Mr. Kaufman follows:]

Prepared Statement of George G. Kaufman

The disappointing behavior of the economy over much of the past 15 years has encouraged policymakers and analysts alike to reexamine how our economy works, what went wrong, and the role of economic policy. Some have concluded that the failure of economic policy to perform better lies at least as much in the existing institutional arrangements as it does in our lack of knowledge of economic relationships and that this is particularly true for monetary policy and the Federal Reserve System. Thus, it is fitting and important that the Joint Economic Committee conduct these hearings at this time. I have considered this problem in some detail in recent months and will summarize my thinking in this statement.[1]

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History suggests that this structure may have made the Federal Reserve more independent from political and business pressures than other government agencies -- although there is strong evidence that the System has not been as free from presidential influence as is often believed.[3] But it clearly did not isolate the System from day-to-day economic and financial concerns. The Fed has operated on a "fine tuning" basis throughout most of its entire history. It responds to a large number of concurrent forces in the economy in an attempt to be immediately responsive to a large number of intermediate and final targets. In addition, despite widespread knowledge that its actions affect macro-targets only with a considerable time lag -- in some cases, months or years -- the Fed generally waits until the undesirable condition, particularly inflation, is upon us before taking action -- "do not fire until you see the whites of their eyes" philosophy. These strategies, although well intentioned, are to blame for much of the country's relatively poor overall macro performance in terms of price stability and unemployment. In attempting to serve many masters, the Fed has served none very well. To improve these results, it would be desirable for the Federal Reserve to limit its goals to one or, at most, two that it can structurally achieve and to wait out time lags. This also implies that Congress should not ask the Fed to achieve goals that are beyond the Fed's powers to achieve; e.g., short-term full employment or real sector growth. Monetary policy affects primarily nominal variables.

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No government agency -- or, for that matter, any of us -- wants its wings clipped, particularly one that treasures its independence as much as the Fed. Thus, it has fought back hard to preserve its independence and power whenever they were threatened. Like Congress, the Fed has generally laid the blame for the poor performance of the economy on others, particularly on fiscal policy and the federal deficit. Indeed, such behavior was predicted in 1933 by Senator Huey Long when he argued against removing the Secretary of the Treasury from the Board:

> When the Secretary of the Treasury is dissociated from the Federal Reserve Board, then the Federal Reserve Board will constantly 'pass the buck' and say, 'it is the Treasury Department that is responsible,' and the Treasury Department will 'pass the buck' back and say that it is the Federal Reserve Board that is responsible.[4]

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Whether this structure would work better than the current structure depends on what is meant by "work." If the extant system has worked by most generally accepted measures, this Committee would not be holding today's hearings. The U.S. has remained a world military power even though the Joint Chiefs, Department of Defense, and even the C.I.A. are organized within the Administration and are accountable in a meaningful sense to Congress. It is difficult to imagine that we would have been better off if this had not been so or that we would be much worse off if the Federal Reserve was structured in a similar way. (A number of economists have devoted attention to problems of monetary policy formulation and to the appropriate institutional structure of the Federal Reserve. I cite some of their studies in the attached list of references.)

Footnotes

1. George G. Kaufman, "Monetarism at the Fed," Journal of Contemporary Studies, Winter 1983, and "Who and What Is the Federal Reserve" (Public Lecture at Northern Illinois University), March 26, 1984.

2. Robert E. Cushman, The Independent Regulatory Commissions (New York; Oxford University Press), 1941, and Michael D. Reagan, "The Internal Structure of the Federal Reserve: A Political Analysis" in Commission on Money and Credit, Monetary Management (Englewood Cliffs, New Jersey; Prentice-Hall), 1963.

3. Robert Weintraub, "Congressional Supervision of Monetary Policy," Journal of Monetary Economics, April 1978. Ex-Chairman Arthur Burns has noted that:

> Viewed in the abstract, the Federal Reserve System had the power to abort the inflation in its incipient stage fifteen years ago or at any later point, and it has the power to end it today. At any time within that period, it could have restricted the money supply and created sufficient strains in financial and industrial markets to terminate inflation with little delay. . . . (But) if the Federal Reserve . . . sought to create a monetary environment that fell seriously short of accommodating the upward pressure on prices that were being released or reinforced by government action, severe difficulties could be quickly produced in the economy. Not only that, the Federal Reserve would be frustrating the will of Congress to which it was responsible -- a Congress that was intent on providing additional services to the electorate and on assuring that jobs and incomes were maintained, particularly in the short run.

Arthur F. Burns, The Anguish of Central Banking (Per Jacobsson Foundation, September 30, 1979), pp. 21-22.

4. Cushman, pp. 165-166.

5. James L. Pierce, "The Myth of Congressional Supervision of Monetary Policy," Journal of Monetary Economics, April 1978.

6. For example, George G. Kaufman, "The Fed's Post-October 1979 Technical Operating Procedures Under Lagged Reserve Requirements: Reduced Ability to Control Money," Financial Review, November 1982; Milton Friedman, "Monetary Policy: Theory and Practice," Journal of Money, Credit, and Banking, February 1982; Robert Hetzel, "The October 1979 Regime of Monetary Control and the Behavior of the Money Supply in 1980," Journal of Money, Credit, and Banking, May 1982; Robert D. Laurent, "Lagged Reserve Accounting and the Fed's New Operating Procedures," Economic Perspectives (Federal Reserve Bank of Chicago), Midyear 1982.

7. E. Gerald Corrigan, "Economic Prosperity: An Eclectic View," Annual Report, 1983 (Federal Reserve Bank of Minneapolis).

8. Herbert Stein, Presidential Economics (New York; Simon and Schuster), 1984, pp. 344-45.

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2. Erb, Richard D., ed. Federal Reserve Policies and Public Disclosure. Washington, D.C.: American Enterprise Institute for Public Policy Research, 1978.

3. Friedman, Milton. "Monetary Policy for the 1980s," in John H. Moore, ed., To Promote Prosperity: U.S. Domestic Policy in the Mid-1980s. Stanford, California: Stanford University, 1984, pp. 23-60.

4. ______________. "Monetary Policy: Theory and Practice," Journal of Money, Credit, and Banking, Vol. 14 (February 1982), pp. 98-118.

5. Hetzel, Robert L. "The Formulation of Monetary Policy" (Working Paper). Richmond, Virginia: Federal Reserve Bank of Richmond (April 1984).

6. ______________. "The Formulation of Monetary Policy in a Democracy" (Working Paper). Richmond, Virginia: Federal Reserve Bank of Richmond (January 1984).

7. Kane, Edward J. "External Pressure and the Operations of the Fed," in Raymond E. Lombra and Willard E. Witte, eds., Political Economy of International and Domestic Monetary Relations. Ames, Iowa: The Iowa State University Press, 1982, pp. 211-232.

8. ______________. "Politics and Fed Policymaking: The More Things Change, The More They Remain the Same," Journal of Monetary Economics, Vol. 6 (April 1980), pp. 199-211.

9. ______________. "Selecting Monetary Targets in a Changing Financial Environment," in Monetary Policy Issues in the 1980s: Proceedings of a Symposium Sponsored by the Federal Reserve Bank of Kansas City at Jackson Hole, Wyoming, August 9 and 10, 1982, pp. 181-206.

10. Kaufman, George G. "Monetarism at the Fed," Journal of Contemporary Studies, Vol. 6, No. 1 (Winter 1983), pp. 27-36.

11. ______________. "Who and What Is the Federal Reserve?" Public lecture delivered at Northern Illinois University, March 26, 1984.

12. Lombra, Raymond and Moran, Michael. "Policy Advice and Policymaking at the Federal Reserve," Carnegie-Rochester Conference Series 13 (Autumn 1980), pp. 9-68.

13. Newton, Maxwell. The Fed: Inside the Federal Reserve, the Secret Power Center that Controls the American Economy. New York: Times Books, 1983.

14. Pierce, James L. "The Myth of Congressional Supervision of Monetary Policy," Journal of Monetary Economics, Vol. 4, No. 2 (April 1978), pp. 363-370.

15. Reagan, Michael D. "The Internal Structure of the Federal Reserve: A Political Analysis," in Commission on Money and Credit, Monetary Management. Englewood Cliffs, New Jersey: Prentice-Hall, 1963, pp. 361-402.

16. Stein, Herbert. Presidential Economics. New York: Simon and Schuster, 1984.

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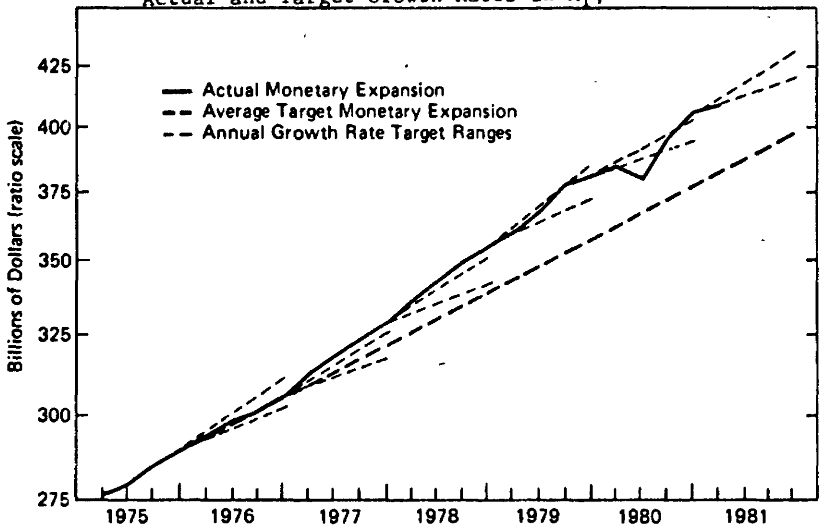
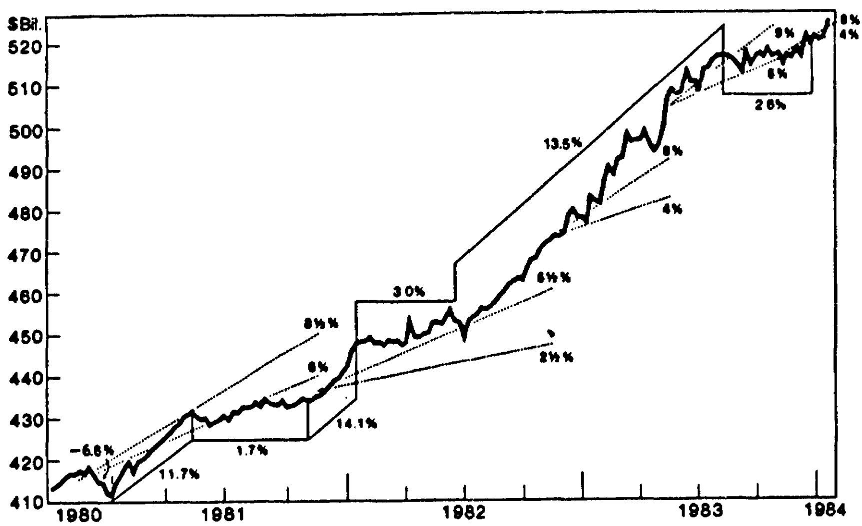
M1 VERSUS TARGET RANGE*

Actual and Target Growth Rates in M_1, 1975-1980



Source W Lee Hoskins, "Credibility Gap The Fed's Burden," *Business News and Trends* (Pittsburgh National Bank), May 29, 1981, p 2

Actual and Target Growth Rates in M_1, 1980-1984



* M' data weekly averages, seasonally adjusted.
Fed target ranges seasonally adjusted simple annual rates based on quarterly averages
Period-to-period growth seasonally adjusted compound annual rates based on monthly averages
Tentative 1984 M' target range (4% - 8%), as announced by the Federal Reserve in July 1983

Source: U.S. Treasury Department, January 24, 1984

Senator JEPSEN. I thank you, Mr. Kaufman.

I note that the monetary base, which the Fed controls, has slowed from an 8-percent growth rate last year to less than 5 percent the last 2 months. I believe in the month of April it was growing at the rate of zero.

Do you think that the growth rate was slowed primarily to achieve a long-run target of price stability or it affects other economic variables? One result has been that the Fed has raised interest rates. Isn't that correct?

Mr. KAUFMAN. I would like to think that the slow growth is for the purpose of slowing the rate of inflation. I happen to not be a fan of the base because two-thirds of the base is currency and currency is supplied pretty well to satisfy the needs of the public. I prefer to look at M1 and M1 is right back, as a result of what happened in the last few weeks or so, at its targets.

Did it affect interest rates? No, I do not believe so. I believe that all empirical evidence, as I interpret it, indicates that the main determinant of the rates of interest are the state of the economy and expectations about the rate of inflation.

Given the nature of the expansion, which at a minimum has been average and in some parts even faster than average, I was surprised that interest rates have not risen sooner because of the strengthened economy. The short-term rise in interest rates is very typical at this stage of the cycle. The rise in long-term interest rates is more troublesome and more difficult for economists to explain. Possibly it just represents the fear of the public that given the large deficits and possibly that the Fed has to monetize it or having to monetize it in the future that we might be headed for an acceleration in the rate of inflation.

Senator JEPSEN. I'd like to examine those two areas and then talk about the increased demand for credit. We hear talk about holding inflation down and concern about raising the rate of inflation. In fact, under the old formula, the one that up until 18 months ago was used to figure inflation and to compute all the labor contracts, it could have been formulated that our rate of inflation recently has been somewhere between 1 and 2 percent, closer to 1.3. That picture doesn't sound to me like inflation is running out of control. It's been hovering down in that area for a long time and a lot of people are saying that, given this monetary policy that holds inflation down and inflation in fact has been lower than it's been for many, many years and has been there for a long, long time, who is it that keeps telling us that inflation is running out of control? Has it?

Mr. KAUFMAN. At the moment, it has not. I think what it's telling us is that it is the market that determines the high interest rates. Given the rapid growth in the money supply in the last 1½ years, some of which are shown on this chart. I do not think, that the rise in interest rates is the result of a slow growth in the money supply or a too slow growth in the money supply.

As I mentioned in my testimony, one of the dangers of monetary policy is that the Fed—and I think to some extent all of us—are reluctant to take on factors that have not occurred yet. You point out the rate of inflation is reasonably slow, but there is a fear that it will pick up later. Monetary policy has its impact in the future.

What the Fed does now will determine what the economy does later on. So consequently, if there is a fear by predictors and people who make their living out of projecting, that there is danger of inflation in the future the Fed has got to take action now. We cannot wait until inflation is on top of us.

Senator JEPSEN. I don't mean to debate this, but the inflation rate has hovered in a very low range, not in fact lower than it would have been before the formula change, but that's the figure that generally now is reported and talked about. Under the old basis of inflation, which is what we used back in the early 1980's and what was used through most of our history up until about 18 months ago, it's been not only low but it's been there for a long time.

At what point are interest rates too high. When interest rates are combined with the agricultural economy, for example in my State—the agricultural economy and the housing economy have been brought practically to their knees—and any increase in interest rates is devastating. And when they look to the reason for that and we hear explanations being given that we want to make sure that we don't reignite inflation—when in fact inflation has been, as I say, basically low for a long time—who makes that judgment? How does that decision come about? How do they justify it?

Mr. KAUFMAN. I think that if the public believed that inflation was dead, we would have lower interest rates. I believe the rate of inflation has been slow, but not by historical standards. If we remember back in 1971, I believe President Nixon at the time imposed wage and price controls when the rate of inflation was only 2 or 3 percent. I think we sort of got adjusted to double digit inflation and maybe now 5 or 6 is not bad. The public may feel differently about this, but as I view the rapid growth in money supply, which to me has been quite rapid, given my readings of past relationships, I am fearful that we will have acceleration in the rate of inflation even though at the moment, as you know, it is quite slow.

Senator JEPSEN. We had a buildup of inventory of about $27 billion in the last quarter compared to $9 in the quarter previously and $4 previous to that. That $27 billion buildup in inventory created a demand for increased credit. That, coupled with the fact that the Fed has tightened the money supply going into the first months of this year—and I believe it was the month of April that it was zero growth rate—that combination of increased demand for money and credit due to what some people now call not an economic recovery but an overly expanding economy—the economic recovery has been passed and it's now an overly expanding economy—that combination, most students of economics tell me is the reason we've had an increase in interest rates. Is that wrong?

Mr. KAUFMAN. Well, if you take a look at May, the money supply rose very, very sharply again. I've observed the Fed for many, many years and I've learned that you can't go on a month-by-month, week-by-week basis. This is more or less a random movement and every time you feel the Fed is slowing down one month, the next month they speed up and conversely. I think one has to take a look at the performance of the money supply over a longer period of time within the target ranges. I believe now, last time I looked, we are very close to the M1 target at the top part of that range again.

Senator JEPSEN. Well, the fact is, we don't have monetary institutions that lead to public confidence and price stability, so we come back to the institutional reform, don't we?

Mr. KAUFMAN. Yes, sir.

Senator JEPSEN. Professor Kane, on the one hand, you warn about the political game of criticizing the Fed, and I agree this generally has been unproductive, but it seems that some progress must be made and this progress is more likely if we recognize that the problem is one of institutional incentives, not a problem of individuals. Would you agree with that?

Mr. KANE. The need to focus on altering institutional incentives is the major thrust of our panel's testimony: Congress must recognize the effects of existing institutional incentives and help the electorate to trace them back to the politicians that control them. As Professor Kaufman emphasized, Congress and the President have the job of deciding who should be held accountable for monetary policy. Under current arrangements, neither the executive nor the legislative branch is accountable for monetary policy decisions.

Senator JEPSEN. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

We can have as many economists appear before this panel and other panels as possible and they can all tell us about the different approaches we can use for monetary policy and they all sound equally persuasive, which leads me to this question. Professor Kaufman, you have indicated that the market is indicating its fear of inflation. Well, the market responds to a lot of things. They respond to certain people on Wall Street that have a reputation for being right. And until they have been proven wrong 10 times out of 10, people still listen to them. They find out 1 or 2 months after the Fed has decided what it's going to do with respect to their monetary targets and then respond to that, judging whether in fact they had properly anticipated what the Fed did when no one knew what they did. We've had Mr. Volcker before this committee and I've asked him what are the important indices that are used by him and his colleagues, and I said, "Are you concerned about unemployment?" And he says, "Oh, yes, we look at unemployment." I said, "Are you concerned about price stability?" He says, "Oh, yes; we look at price stability." I said, "Are you concerned about market basket price of commodities?" He said, "Oh, yes; we look at that." "Are you worried about aggregates?" "Oh, yes; we look at that." "Are you worried about GNP growth?" "Oh, yes; we look at that."

His statement to this committee at the beginning of the year was, "It looks like we are now settling down to a GNP growth rate that is more sustainable." I said, "What is sustainable?" He said, "We were running 6 or 6.5 percent and most economists would say that's not sustainable. It should be about 4.5 percent." I said, "Well, would that be sustainable?" He said, "Well, I wouldn't like to be held to that. It's something like that."

I mean, if you think the market somehow can rely on that sort of inventory, you certainly have a lot greater faith in the ability of individuals than I do. I think they are confused as much as politicians are confused, and is that a healthy environment for the economy?

Mr. KAUFMAN. No; I don't think so. I always believe that more information available to the public is better than less information unless there's some danger to the security of the United States. I believe that releasing the minutes, or at least the directive of the Open Market Committee on the day that it's adopted will benefit and stabilize the economy.

Representative LUNGREN. Is there anything wrong with us in a sense requesting from the Fed the rationale for their decision?

Mr. KAUFMAN. Well, as you mentioned earlier, almost all economists differ, though I think the disagreements are not so great within the community, and it's not too difficult to build hypothetical models that would show the economy would fall apart if you released that information. I'm just fearful that if you ask for this kind of report you might very well get back a model that justifies what the Fed did. It's very simple to build economic models to justify almost anything.

Representative LUNGREN. Well, I understand, but as elected officials—you could have two elected officials or two people espousing to the same elected office and both being equally persuasive and under our system we require the voters to make a decision, and they do make a decision. By and large, I think they make some correct decisions and they make some bad decisions as well, but we require that sort of information to be put in the public domain and I have yet to find an economist to suggest that, in fact, he is involved in an exact science, and that is that economists can disagree and disagree regularly. And what is wrong with requiring them to at least put out there in the public domain what it is they are thinking about when these economists have been given a very important part in the decisionmaking responsibility?

Mr. KAUFMAN. I couldn't agree with you more. I believe that, providing this information as soon as possible to the market as a whole, while it might produce some unemployment among Fed watchers, could only benefit the economy as a whole and stabilize it and, more importantly, it would permit everybody to start at the same base. It would provide the same amount of knowledge to everybody in the market rather than having it filter down from people who are specialists in this area being the first to know. I agree with you fully.

Representative LUNGREN. One of the things that disturbed me not too long ago is the fact that one member of the Fed gave a speech—I forget where—and sort of suggested what, in fact, they were doing and he was criticized by the rest of the Fed for letting that information out. We have a strange situation where you are not allowed to give that information to the American public.

I am not, Mr. Kane, I believe, involving myself in Fed-bashing. I am an incumbent politician. But frankly, I couldn't care less if we didn't have anything to criticize the Fed for. Your suggestion that incumbents revel on the political benefits of Fed-bashing is interesting, but a lot of us up here are just trying to figure out what the Fed is doing and trying to figure out what the proper relationship between the government of those who are elected and the Fed ought to be, and frankly, I am not sure that we all know at this point.

What institutional reforms would you suggest that we might embark upon so that we get away from the idea of Fed-bashing?

Mr. KANE. Well, I think the most important thing would be to establish clearly who is to be the Fed's boss—either Congress or the President. What's hard about our system of government, as compared to most others, is that we raise a kind of Chinese wall between the legislative branch and the executive branch. We don't have a parliamentary majority party that takes executive responsibility for economic policies. This leaves our central bank floating in the middle. Congress has been unwilling to give up its right to control the Fed, but in repeatedly asserting this right without taking firm control, Congress has actually increased the President's influence on Fed officials. Basically, what is needed is to make a structural choice as to where we are going to put political responsibility for monetary policy. Once this issue has been decided, voters can blame or applaud the politicians to which the Fed is accountable for the policies that we have.

Representative LUNGREN. Well, let me ask you this. Short of doing that, is there a standard, is there a direction is there a single goal or two goals that we could give the Fed as opposed to giving them a multiplicity of goals which in their response to our questions indicates to me gives them no goal whatsoever?

Mr. KANE. Well, I agree that Fed officials chase too many goals today, but these impossible goals were assigned to them. They are contained in the Employment Act as it has been amended over the years.

Representative LUNGREN. I understand that. That's what I'm asking you, whether——

Mr. KANE. I've been a staunch critic of asking the Fed to do everything. By giving the Fed a set of contradictory goals, you simultaneously give them a builtin excuse for failure and license everyone to criticize them for whatever happens to go wrong in the economy.

Representative LUNGREN. If there was a single or just a couple of goals that you would think would be the appropriate goals for us to give to the Fed that would not be taking them entirely into the executive or the legislative branch, what would those goals or that goal be?

Mr. KANE. Well, if you were going to give them just one goal, the preferable goal would be price stability. But such an assignment would greatly affect the rights of incumbent politicians. They would no longer be able to criticize Fed officials for taking action to slow the rate of inflation and continuing that action even as the rate of inflation slows and unemployment becomes serious, a right that many Congresspersons and some administration officials exercised advantageously during the last couple of years. Incumbents in one branch or the other would have to confess that the buck stops there.

Representative LUNGREN. Well, how do you define the price stability?

Mr. KANE. Price stability to me is the absence of price inflation.

Representative LUNGREN. Which would be essentially maintaining the value of the currency.

Mr. KANE. The purchasing power of the currency.

Representative LUNGREN. Of a single unit of currency.

Mr. KANE. Yes. But you can see why politically it's a very difficult thing to tell the Fed to concern itself exclusively with price stability when the Fed has the power in the short run to help the Nation attain other desirable goals. When one sees the suffering that unemployment causes people who become unemployed, it is hard not to want to use monetary policy to relieve their distress. But such a switch in emphasis amounts to assigning contradictory goals to the Fed again.

Representative LUNGREN. So you're suggesting that those who say that employment and lack of inflation are contradictory goals are, in fact, correct?

Mr. KANE. Pursuing both goals requires contradictory actions in the short run. There's no doubt that these goals conflict in the short run. By "short run" I mean over periods as short or shorter than electoral cycles of 2 or 4 years. However, over longer periods of time such as decades, price stability and full employment are not contradictory goals. The problem is whether politicians are willing to stand around and wait for well-conceived, but painful policies to have a salutary long-run effect.

Representative LUNGREN. I wonder if sometime if we could do a study to show, for instance, in the cycle of recessions and recoveries that we've had since World War II, we have apparently come out of each cycle with a higher inflation rate and a higher unemployment rate. If you take that and suggest that if we had some sort of stable monetary policy, some price stability, which would affect that in some major way, that the overall unemployment, as taken across the board, would be less than what it in fact was, you could build a political base for supporting the goal of price stability.

Mr. KANE. I think you could. To explain the upward drift of unemployment, we must acknowledge that the decline of educational productivity in this country and the rise in the minimum wage have had important effects, too. For several decades, the educational establishment in this country has neglected math, science, and writing skills. This has made the labor force less productive than it could be.

Representative LUNGREN. I agree on those points as well.

Professor Kaufman, if you were to give a goal or two goals to the Federal Reserve as opposed to a multiplicity of goals, what would they be? How would you express them?

Mr. KAUFMAN. It would be very similar to what you just stated—price stability. What we mean by price stability would be determind by Congress—2 percent or 3 or 4—but some limit given the nature of the economy at the time and knowing it can be modified. Certainly it could not be zero as in the old days. It would be difficult to lower it to zero. But maybe 2 or 3 percent, and hold the Fed to that over a 2- or 3-year period, and that would be in a popular price index. Most of them tend to move together more or less. Have a maximum range or maximum rate of inflation that would be determined by Congress and the administration.

Representative LUNGREN. Then require the Congress and the executive Branch to accept the responsibility for other elements in the economy as they interplay with a given, which would be price stability?

Mr. KAUFMAN. Yes, sir.

Representative LUNGREN. Because Mr. Volcker couldn't answer it, maybe you two gentlemen can't answer it, but could you tell me, as you view it from the outside, what is the driving force or the predominant goal that the Fed is pursuing at the present time?

Mr. KAUFMAN. I'd say it's very difficult to quantify. Obviously, they are trying to do their best I think to achieve some sort of mix between low unemployment and a low rate of inflation, plus all the other pressures that are put on it for keeping interest rates low and making sure that certain sectors of the economy—the automobile sector and the agricultural sector—do not deteriorate sharply.

I think it's a multiplicity of goals and they sort of reach a compromise in seeking what is the path of least resistance.

Mr. LUNGREN. Professor Kane.

Mr. KANE. I would say that the Fed's primary goal today is not to give up the gains it has recently made on inflation. It's very concerned that it helped to put the economy through a wringer and that people who suffered the medicine of unemployment should not see a quick dissipation of the salutary macroeconomic effects their suffering permitted. That's Fed officials' major goal.

At the same time, they are very concerned, as they have to be, about maintaining the stability of our financial system. Many thrift institutions are barely hanging onto existence. Rapid increases in interest rates would aggravate the trouble they are experiencing. Less-developed countries and many energy companies are finding it a difficult time to service their debt. As interest rates rise, much of the increased distress these borrowers and thrifts experience passes through to the banking system. Many banks are in a precarious condition.

Representative LUNGREN. Let me ask you one last question and address it to both of you. The Chairman of the Federal Reserve told us, as I said, it looked like we were going to have a more sustainable rate of growth this year, somewhere around 4 or 4.5 percent. Instead of 6 percent or so the first quarter, It was 8.3 or something like that.

How can we accurately make calculations as to what is a sustainable rate of growth when we're in a recovery that's coming out of one of the toughest recessions we've had, when even with the tremendous improvement in unemployment we have had over 18 months we're now down to 7.5 percent which is where we started and which traditionally is extremely high, when as a politician I go back to my district and I see a lot of small business folks and they tell me, "Hey, we're just beginning to feel the recovery." When we look at the productivity figures, they still appear to be pretty good. We don't seem to be developing any bottlenecks that some suggested we would have in the economy by this point if we had this rapid GNP growth.

How do we determine what is in fact a sustainable—I mean, other than an after-the-fact evaluation—how do we anticipate that and if in fact we can't anticipate that very well, how is that then a guide that can be used by the Federal Reserve in determining what it is they are going to be doing?

Mr. KANE. First, I believe that Mr. Volcker was merely trying to use marketing or advertising skills to announce that the rate of growth in the economy had slowed. It is not unusual for unpleasant news to be reported as if it were good news. In the long run, sustainable growth depends on growth in the Nation's productive resources and in the productivity of these resources. Coming out of a recession, the economy has the additional and temporary possibility of increasing greatly its utilization of idle resources, just as you observed. This is why at this time our economy could probably take 8-percent real growth for a couple of quarters without reigniting double-digit inflation.

Representative LUNGREN. The question I have is you've got the head of the Federal Reserve saying that we are going to have a sustainable growth rate of 4 or 4.5 percent because 6 or 6.5 percent is unsustainable and leads to inflation and so forth. What's the signal to the market when 2 months later or 3 months later the figures come out that we had a growth rate of 8.3 percent? Isn't that the fear of inflation then? People say, "My God, the Chairman of the Federal Reserve said 3 months ago that we should have half this rate of growth because otherwise we would go to inflation. We've got twice it now. This must mean the Fed is going to do something." And then you have inflationary expectations. Is the cat chasing its tail in that situation?

Mr. KAUFMAN. I think this points out the difficulties of having short-range goals and then not being able to—perhaps it's impossible for the Fed or Congress or anybody—given all the forces in the economy that we are not able to control—to meet those short-term goals.

I suspect that if we had been sitting here in 1976 that we would have had much the same conversation. We were coming out of a deep recession at that time, the rate of inflation had slowed, interest rates were starting to rise, and we wondered why we can't speed up and reduce unemployment faster. We followed that policy. Interest rates rose to record levels again and unemployment rose even further. I think we can't expect the economy to do too much. We can't expect miracles overnight.

I personally believe the best way to reduce unemployment on a continuing basis is to do it at a moderate rate. If we speed up and accelerate the real growth in the economy, I think we will ignite inflation and then we go back to the stop-and-go cycle. We have to be patient and I understand how very difficult it is for you to go back to your States and districts and ask for patience because you may not be around when the good things come about.

Representative LUNGREN. I don't care about that. I care about all those people that don't have jobs. What do you tell the small businessman? The Federal Reserve is doing it behind closed doors and when I tell them that we're concerned about this economy overheating too badly right now, the guy has just begun to hire back the people that he laid off.

Mr. KAUFMAN. I agree. I think one thing you could do immediately to put pressure on the Fed is to pass legislation to release the directive as soon as it's adopted. That would equalize the knowledge. It may be that the Fed will react in such a way that what they release will be less valuable than what they provide now because after all they are human beings and if someone pushes them one way they will push back the other way. But I think that's a good beginning.

The other thing I would warn about is that we can't expect overnight miracles. A reduction in unemployment to be lasting and sustained has to be at a slower rate than some people would like to see.

Mr. KANE. May I speak to that? I think this line of questioning overvalues the macroeconomic role of official pronouncements by the Fed. Everything anyone says should be taken in context. Let's think of lawyers in a court case. In one context, they espouse one principle and, in another case, they feel free to espouse an opposite principle. Something like this happens with the Chairman of the Fed. He has many goals. When he's speaking to you about an economy that is coming out of a recession, he's effectively presenting his case in a particular way. I recognize his power to say things that influence the stock markets. But his power to interpret the behavior of volatile variables such as the rate of growth of the money supply or GNP, which jiggle up and down endlessly, is limited by well-recognized uncertainties. It is hard to know how to adjust monetary and GNP growth rates for the season of the year, the state of the business cycle, or technical change. However, such variations can be sorted out by the market as long as market participants are confident that they understand the overall intentions of the Federal Reserve and how Fed policy instruments operate.

While it's useful to ask the FOMC to report the reasoning that underlies changes in their directive, we must understand that if Fed officials don't want to publish this information in a clearly digestible way, they can find words that will make it hard for outsiders to decode their intentions and policy procedures. People who were unsure of what was going on in the past can be kept relatively unsure about what's going on, particularly when Fed targets are formulated as a wide range of numerical values and when Fed officials fail to be embarrassed about missing even these loose targets in the short run.

Representative LUNGREN. Thank you.

Senator JEPSEN. Thank you. Do either of you have a closing statement—anything for the record you'd like to make?

Mr. KANE. I would like to return the question of whether we should give the Federal Reserve only one goal and whether that one goal should be price stability. I want to make it clear that, as a matter of rational political behavior, I don't think that Congress will give up its right to say sometimes it's concerned about the tradeoff between the Fed's single goal and various other goals. That's why I don't think just giving the Fed one goal and letting it run as it has operated in the past would lead to better policy. I think better monetary policy can be brought about by making the Fed responsibility for the same choices it's responsible for now but making it accountable to a designated set of politicians who—in Harry Truman's famous words—cannot pass the buck.

Senator JEPSEN. Thank you very much, Professor Kaufman and Professor Kane.

I would now welcome Mr. Frederick Deane, the chairman and CEO of the Bank of Virginia; Mr. James Evans, in the machine tool business, L.G. Evans & Co., Lombard, IL; and Mr. Steven Givot, member, Chicago Board Options Exchange.

You each have an important insight into the economic environment in the past decade. Also, you each have what I suspect is an interesting insight about how monetary policy contributes to a poor business climate. We would be interested in your views as well as your opinions on what policy priorities Congress should establish to prevent the recurrence of stagflation which business can ill afford.

Your prepared statements will be entered into the record and you may proceed in any manner you so desire. We will start with Mr. Deane.

STATEMENT OF FREDERICK DEANE, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BANK OF VIRGINIA CO., RICHMOND, VA

Mr. DEANE. Mr. Chairman, it's a pleasure to be here this morning. I'm sure that to read another statement in its entirety might be a little too much and therefore, with your permission, I will just summarize it and be happy to answer any questions that you may have at the conclusion of the presentation.

Senator JEPSEN. We appreciate that.

Mr. DEANE. I also, after listening to the other gentlemen up here, would like to say that although sometimes Fed-bashing may appear to be popular, I really don't think that politician bashing is something we ought to get into this morning. I have for many years been personally acquainted with all 10 Congressmen and both Senators from the State of Virginia and I can say with some degree of satisfaction that they all seem to me to be very fine people and are doing the best they can. That's not to say that now and then we don't have our differences of opinion.

To set the stage a little bit, I have been with the Bank of Virginia for 31 years and its chief executive officer for 10, and our bank is not a little country bank in Virginia but, on the other hand, not a money center bank, it's about the 85th largest bank in America. So therefore, we fit somewhere in the middle range of regional banks and I bring that perspective to you.

Having said that, I'm very honored to be here and I think that a lot can be accomplished by additional legislation that may emerge from the hearings of this committee.

The basic question, obviously, as you just said, Mr. Chairman, is, Can we eliminate stagflation and at the same time get rid of this very undesirable financial volatility we have been living with? I honestly think the answer to that is yes, if we would get around to getting our priorities straight and improve our procedures a little bit.

In that connection, it's sort of like the cartoon which I'm fond of—and I hope you are too—of Peanuts, when Lucy now and then appears as psychiatrist and sometimes the psychiatrist is in and sometimes is out and one time she gave a little lecture to Charlie Brown and said, "In the cruise ship of life some people put their deck chair in the bow to see where they are going and some people put it in the stern to see where they have been. Where is your deck chair, Charlie Brown?" To which he replied, "I can't get it unfolded." [Laughter.]

I really think that's about where we are in connection with setting the appropriate priorities for the Federal Reserve and modernizing their procedures.

So having said that, I would say that in my judgment the appropriate priority for the Federal Reserve at this time should be the one single one of stable prices. That is an absolute must if we are to have the sustained growth and the full employment that that sustained growth brings over a long period of time.

As the Congressman said a minute ago, it is only over a long period of time that we can judge this. But the makers of monetary policy need to know that they have one objective only, and that is to produce stable prices.

In my business, we operate on a program known by most consultants as management by objectives. We set the objectives and at the end of the year we see how the people did, and it seems to me that this is exactly what the Congress needs to do with the Federal Reserve, which is their creature. It needs to set the objective of stable prices and then it needs to measure the Federal Reserve against that objective.

The real facts are that this has never been clearly set forth in the law or in the rhetoric, and the time has come, it seems to me, to do that.

Now there have been lots of other reasons why we may not have achieved all the objectives we would have liked to have achieved in this great Nation of ours. In the 1950's and 1960's there was a tremendous outcry for all kinds of services and there was lots of stimulative legislation that was enacted and that caused unbearable pressure on limited resources.

On top of that, we obviously had some terribly bad luck. We had two severe oil shocks and we had a worldwide collapse in agricultural products. But because of a lack of clear direction to the monetary authorities, during that period of time they pumped money into the economy and funded what we now know was the worst inflationary binge this country has seen since the early 1920's—not because they were evil people or poorly intentioned, but because they were not given a single clear assignment and measured on that assignment.

The results have been bad in many ways, but perhaps the worst part is the high degree of public uncertainty about what's going on, which many of the prior witnesses have mentioned and your questions have been directed toward. The public understands that classic mathematical formula called the Rule of 72, which is very simply the number into which a compound rate maybe divided to find out how long it takes the base to double. So that if you have a compound rate of inflation of 12 percent and you divide that into 72, it tells you that the price structure doubles every 6 years. If you have a compound rate of 6 percent, which is what some of the economists are estimating inflation may be running by the end of this year, then that means prices will double every 12 years.

The public may not understand that formula, but they understand what's going on and this uncertainty is in the public's mind, this feeling that there is no commitment to stable prices, leads to frightful decisionmaking. It perverts the investing and producing decisions of the Nation. Among other things, it makes that smart alec chief financial officer the king of the castle instead of the man who runs the production line that must produce what we all consume.

So if we do simplify these priorities and send the right messages, what has to be done?

Well, first of all, let's be honest. The Employment Act of 1946 and the Humphrey-Hawkins Act of 1978 say about 10 different things to the Federal Reserve all at once and, as was indicated here a minute ago, allows anyone to hide behind any bush that occurs to them at the moment. That needs to be changed. The state of the law is just about like Ring Lardner's famous comment on the futility of the law when he said, "Prohibition is better than no liquor at all," and that's kind of the way it is with the directions that are given by Congress to the Federal Reserve in my opinion.

If we are looking for price stability and balanced, sustainable growth over the years ahead and not just for brief periods in the cycle, such as right now with regard to inflation, we have to give this clear direction and, in addition, procedural changes are also in order.

First of all, I'd like to mention something that has not come up here before and that's the matter of tinkering or fine tuning. When you hire a large number of very intelligent, very capable people, they automatically feel obliged to do something, and they feel obliged over at the Federal Reserve to tighten this valve or loosen that one, month by month, week by week, and day by day. If you've ever been in the trading room in the Federal Reserve Bank of New York, you would know that behind the traders sit a bank of very intelligent, capable people who could not possible be expected, given the current circumstances, to just sit there. They have to tinker and tinkering is impossible in terms of achieving any of these objectives we're talking about in an economy that is as complex and difficult as ours is.

We need to assign the objective of stable prices over a long period of time and say directly and indirectly that tinkering is not part of what you expect. In addition to that, it just doesn't work. It simply doesn't work. As one of the other witnesses said, what you do today when you tinker affects the economy next year and that is not exactly the kind of action that we really need.

Second, I would say that the time for elimination of the secrecy problem is here—ought to be here. There really is no need for this business of delaying what goes on in the Open Market Committee meetings. There's even good argument for saying that the immediate release of public policy initiatives may in fact bring them about faster than keeping them secret does. So I would very much urge that that secrecy be eliminated.

So in summary, Mr. Chairman, I would say that I guess the time has come to help Charlie Brown unfold the deck chair and put it in front of the cruise ship, and by that I mean to give the Federal Reserve that clear and simple order that their primary and only objective at this time is stable prices.

Thank you.

[The prepared statement of Mr. Deane follows:]

PREPARED STATEMENT OF FREDERICK DEANE, JR.

Mr. Chairman, I appreciate the opportunity to appear at this hearing and offer my views on ways to improve economic policy making and performance. Unquestionably these hearings are addressing serious contemporary issues. At the heart of these issues is whether or not we can eliminate economic stagflation and financial volatility. From my perspective, the key to achieving stable economic growth is to reset our economic policy priorities and procedures. Price stability must become paramount since it is an essential ingredient of sustained growth and full employment. At the same time the makers of monetary policy need to be clearly aware of this priority. They also must produce stable money growth and resist the temptation to fine tune the policy levers. Increased independence to implement more stable monetary policy is a prerequisite.

Simultaneously, accountability must become clearer and firmer.

Without a doubt there are opportunities for positive changes at the Federal Reserve. It is not accurate though to describe recent economic problems as monetary failures. Policy miscues by the Federal Reserve are only one of many forces that have caused stagflation and volatility. Loudly articulated public preferences for low unemployment and rapid growth in the 1950's and 1960's produced too much highly stimulative legislation. The Federal Reserve has never been in a position to ignore such preferences. For the most part it has been explicitly accommodative.

ECONOMIC CONDITIONS

After two decades of relative economic stability following World War II, sharp fluctuations occurred duing the 1970's and 1980's. Output growth has ranged between −9 and +9 percent; inflation rates have been between 2 and 15 percent; and interest rates have risen or fallen by as many as ten percentage points inside 6 months. Although arcane economic explanations are extant, it seems clear that public priorities, policy shortcomings, and bad luck are the principal causes.

An inflationary bias has emerged in the U.S. economy as the public has placed ever increasing demands on limited resources. Congressional actions to meet the far reaching demands of a wide range of public preferences have shown little regard for resource availability. These actions range from unnecessary emphasis on employment to a pro consumption bias in the tax laws to anticompetitive regulation. As a result, we have seen substantial imbalances that have led to inflationary price increases. These shortcomings of fiscal policy have been compounded by generally accommodative monetary policy. It is apparent that the Federal Reserve has pumped money into the economy with something other than price stability as its number one priority. Exacerbating these conditions were three pieces of bad luck: during the 1970's two whopping increases in energy prices and major weather related crop failures.

Behind the obvious negatives of high inflation, high interest rates, and high unemployment, there have been other unfavorable results. Public uncertainty has risen to a post World War II high. Specifically, decisions to consume and invest are driven more by an urge to hedge against inflation than by critical fundamentals such as production efficiencies, market opportunities or relative costs. Impaired in this process are savings flows, capital spending, and productivity growth. The ability of the economy to supply the burgeoning demand for goods and services has been stunted. Even in the face of consistenty positive economic news, the economy remains dominated by uncertainty.

Another unfavorable result of the economic conditions of the last 15 years have been the problems of depository financial institutions. Savings and loan associations are the extreme example but commercial banks have also been adversely affected. It has long been thought that high interest rates were a bonanza for banks. The reality is starkly different. Rapid and large increases in interest rates raise the costs of bank liabilities more quickly and by larger amounts than they do the yields on bank assets. Bank of Virginia was caught in that squeeze in 1980–81 when nearly 20 percent of its $2-billion plus in assets were at a huge negative spread. Only if the bank made all floating rate loans could it be protected from another rate run-up. That, however, would be another decision driven more for inflation protection than for the long-run interests of the public and banks.

POLICY PRIORITIES

In the years following World War II the American public and Congress were still highly sensitized to the conditions of the Great Depression. As a result, priorities ran toward full employment and rapid economic growth. Those were desirable priorities at that time. But by the early 1970s conditions had changed dramatically. Rapid growth was achievable with only minimal policy assistance. The most devastating economic effects of recession and unemployment were mitigated by numerous assistance programs. The real challenge for policy had become stable growth and stable prices. Whether the policy restraint required for stability was politically feasible at that time is a moot point ten years later.

What is not moot today, however, is that the dominant economic policy legislation in this country continues to be the Employment Act of 1946 and the Humphrey-Hawkins Bill of 1978. The problems with this legislation are twofold: one, they are not relevant in the 1980's and two, they impose conflicting goals on the Fed that are too many steps removed from its range of influence.

Today we need to address price stability and balanced, sustainable growth. Such growth cannot come from government spending and monetary policies that stimulate aggregate demand beyond the reality of limited resources. This statement is not an argument in favor of supply side economics per se but rather a recognition of the need for policies to seek balanced growth between both the consuming and producing sectors of the economy.

For decades economists and others have argued about the trade offs between inflation and unemployment. Is an increase in unemployment the only cure for inflation? Will too low an unemployment rate cause inflation? In my estimation, these questions miss the crucial issue: sustained growth and high employment can be achieved only in an environment of price stability. Not just low inflation rates at certain points of the cycle, but the expectation on the part of everyone that prices will be stable over long periods of time.

MONETARY POLICY

The formulation and implementation of monetary policy by the Federal Reserve is a process that has evolved and changed over seven decades. Early on the Fed relied on the Real Bills Doctrine which called for the district banks to supply reserves to the banks in response to the volume of commercial notes available to discount. The effect was to put policy in a passive position that reflected the EBB and flow of bank commercial lending. The catastrophic result of this policy was the huge decline in the money supply in the early 1930s that turned a serious recession into a full blown Depression.

During World War II policy was driven by the Treasury's need to finance huge sums at low rates. Thus only after 40 years did the Fed achieve a measure of independence and policy activism. In the 1950s and 1960s concern for low and stable interest rates dominated policy. Although this was a basically flawed approach, the flaws were not manifest until the mid 1960s when the Fed unwittingly generated inflationary money growth as it tried to hold down interest rates. The Fed maintained this approach until late 1979. At that time it was announced that henceforth policy would focus on money and bank reserves instead of interest rates. During the last 4½ years however, money growth, interest rates and economic conditions have fluctuated violently.

Several conclusions are evident. One, the Federal Reserve has never been a truly independent body removed from near term social and political pressures. If it were, monetary policies beginning in 1951 would have focused on the long-term relationship between money growth and price stability. Two, Fed policymakers have not mastered the extraordinarily difficult task of knowing what to do today to achieve a desired result the day after tomorrow. Three, fine tuning is counter productive. Over the years the Federal Reserve System has built a large staff of very competent professionals. The natural tendency of such a group is to work actively and fervently. In many cases that is a productive approach. In the case of monetary policy, however, that approach has led to considerable fine tuning that has caused greater, not reduced, fluctuations. Our ever changing and complex economy does not lend itself to day-to-day manipulation of the policy levers.

Fourth, a deep and well meaning concern that a small segment of the financial markets could profit from knowledge of monetary policies has led to the Fed's penchant for secrecy. If ever correct, that line of thinking is certainly outmoded by today's large, broad and electronic markets. Although the research is contradictory in some respects, there is wide support for the notion that public knowledge of policy would facilitate its accomplishment. Five, the Federal Reserve is not held accountable for its actions in any consistent and predictable manner. The current process that requires money growth targets and quarterly appearances before Congress by the Chairman is a superficial, highly politicized process that principally provides grist for the news media.

In summary, the institutional framework for contemporary policy making does not meet the needs of our society and economy in the 1980s. From the perspective of the business and banking communities I offer some suggestions for improvement.

CHANGES AND SOLUTIONS

The first area for change is policy priorities. Clearly, the public remains concerned about unemployment, particularly in highly industrialized regions and among the poor and minorities. Those problems are real and must be addressed. But they are reflective neither of widespread economic conditions nor the majority view. Price stability is our most critical policy priority and should be recognized as such. New legislation to replace the Employment Act of 1946 and the Humphrey-Hawkins Bill and to reset priorities is essential immediately.

An important component of such legislation must be the transmittal to the Federal Reserve of price stability as its number one priority. No institution can function effectively without clear direction. The Constitution assigned responsibility for integrity of the currency to the Congress, who in turn created the Federal Reserve to manage this function. The clearer that Congress can be about its priorities and expectations, the more effectively will the Fed be able to perform.

Once Congress has called for price stability, the Fed must be allowed to pursue that end free of political encumbrance. Institutions function best in an environment of clear direction coupled with autonomous and independent operation. That principle is especially important in this case. The daily or monthly concerns of 500 legislators and 220 million.

Persons cannot be imposed on monetary policy if it is to produce the desired result.

At the same time that Congress is coming to grips with realistic policies the Fed must also recognize its limitations. The evidence of the last two decades overwhelmingly calls for the elimination of fine tuning and interest rate targets. Instead the Federal Reserve must seek stable prices through stable money growth. Annual or longer money growth targets cannot be shunted aside every time the economy or financial markets hiccup. Since the 1950s the Fed has been concerned with maintaining stable financial markets on an almost daily basis. The result has been an accommodation and magnification of the economy's inflationary bias. Over the past few years we have learned that the financial markets are extremely resilient. Moreover, if the Fed remains committed to its long-term goals and the financial markets become so convinced, their actions will be driven by expectations of stability, not instability. In all likelihood, the result will be reduced short-term fluctuations.

If the Congress wants the Federal Reserve to concentrate on achieving sustained price stability through stable money growth, the accountability process cannot be dominated by short-term concerns. Annual presentations would be frequent enough to avoid focusing on the latest unemployment rate or price index growth rate. The discussions should be directed toward the Fed's designated responsibilities, not semi-related matters. At the same time, the Chairman, Governors and Presidents must feel accountable for achieving their specified goals.

CONCLUSION

Today, I have shared with you my views regarding the sources of our economic problems as well as some ideas for resolving those problems. My solutions have purposely been broadly defined in the hope of generating an immediate and broad consensus. Only after such consensus has been reached, can the details be negotiated. Near term action is highly desirable.

Great strides have been made since 1982 in controlling inflation. Capital spending has shown unusual strength for this stage of the cycle. If these gains are lost, stagflation will dominate, undermining our economic competitiveness and social fabric. Alternatively, new priorities and procedures can lay the foundation for sustained economic growth and social development.

Senator JEPSEN. Stable prices?

Mr. DEANE. Stable prices.

Senator JEPSEN. Stable money growth, is that part of what you must have to get stable prices?

Mr. DEANE. In my judgment, a sustainable rate of growth without inflation in the United States would be something that would arise from a combination of how fast the labor force is growing and how fast capacity is growing, because if you outrun either the capacity of your labor force or the actual, real capacity of your factories, you set off an inflationary spiral.

It is, as I understand it, the consensus that the sustainable rate of growth, given the current growth in our labor force and the current growth in our capacity, is somewhere around 4 percent. If that is the case, then it would seem that the thing that the Federal Reserve ought to do is to feed in about a 4-percent increase in the money supply year after year, assuming that velocity doesn't make huge changes.

Now you can't get from where we are right now to that growth rate overnight without some difficult dislocations; and as you obviously know the targets now run as high as 8 percent for M-1 this year, but that's down from last year's target. And Mr. Volcker, although he does tend to hedge his statements, talks about a time in the future when they would supply about 3.5 percent or 4 percent money growth each year in order to have a sustainable rate of growth.

Senator JEPSEN. James R. Evans, of the L.G. Evans & Co., Lombard, IL, you may proceed.

STATEMENT OF JAMES R. EVANS, L.G. EVANS & CO., LOMBARD, IL

Mr. EVANS. Thank you, Mr. Chairman. I appreciate the opportunity to testify on a subject so critical to our Nation's economic future.

I am not a professional economist, although I have authored two books on the philosophy and principles that underlie a free market economy and hence a free and ordered society.

I don't believe that I'm a monetarist, a supply-sider, nor a Keynesian. What I am, I believe, is a pragmatic businessman who has run his own company for more than 30 years. During that period I was also privileged to spend some 15 years on the board of directors of a major publicly-held American corporation. I am a past president of the American Machine Tool Distributors Association, which is the distribution arm of the machine tool industry.

I would like to, with your permission, take a little different tack on this problem because I do not believe that you can separate the actions of the Federal Reserve from the other conditions in which business functions.

The negative effects on the business community of all kinds of governmental policies impacting on taxes, interest rates, inflation, and wage levels have been evident for some time and today in particular it seems that those policies, both in place and threatened, are more virulent than ever. But I think sometimes we have to go back to square one and remind ourselves of the true makeup of American business and what it does and how it does it, particularly if we agree on something which I'm going to repeat several times, and that is, whether we like it or not, if there were no employers, there would be no employees; and if there were neither, we would have no deficit because we would have no income in Washington. So whether we like them or not, these businessmen are the geese that lay the golden eggs.

I think it's often forgotten that less than one-half of 1 percent of all the businesses that produce products and services in the United States have more than 500 employees. Roughly 96 percent of all the functioning businesses out there have fewer than 100 employees. Some 30 percent have about 20 employees or less, and they provide—these small businesses—more than half of all of the employment in the United States and the value of the goods and services of these businesses with under 100 employees is the fourth largest economic power in the world in terms of that production, led only by the United States as a whole, Soviet Russia, and Japan.

I mention that because all business is important, but the reaction of that small segment is a bit different. There are also a number of studies which indicate that these small businesses provide the great bulk—certainly more than half—of all inventiveness and innovation.

At the risk of poetic license, I would like to for a moment remind us that these entrepreneurs—Henry Ford was one—they all started with one or two men—were those rather questionable characters who said at some point, "You know what I'm going to do? I'm going to start a business and I'm going to furnish all the capital required, jobs for employees, raw materials, salable products. I'll advertise them. I will sell them. I'll do the accounting. I'll pay the operating expenses and I will do this fully realizing that I have one chance in five of surviving"—according to the chamber of commerce—"and if I'm fortunate enough to be profitable and successful, I will use most of those profits to reinvest in additional equipment and facilities to create more jobs; and if I'm successful, I'm still going to pay my employees 19 times what I pay myself and I'm going to pay the various levels of Government three times what I pay myself." And that kind of entrepreneurial insanity is a little hard to understand, except that it has created the highest standard of living the world has ever seen.

What does business really do? And I will come around to the Federal Reserve position in a moment. It makes it possible for a man earning $5 or $6 an hour moving dirt with a shovel to suddenly earn $15 to $20 an hour because somebody provides him with a 3-cubic-yard Caterpillar earthmover. Gentlemen, that is not inflationary at all. That Caterpillar earthmover is the source of his productivity and his drastically improved standard of living, and the source of that piece of equipment is the capital that's been provided almost totally through corporate profits and savings and private savings.

The same example applies to the necessary acquisition of computer numerical controlled machine tools of all varieties, computers, office automation equipment, and a myriad of other "tools" which make it possible to achieve productivity, jobs, higher "real" wages, and a constant flow of new and better products and services.

Now, although it is not the subject of discussion today, I cannot resist reflecting on the fact that American business, large and small, has been eminently successful, in spite of the fact that for four decades we've been double-taxing corporate profits as well as the interest on savings, which is a direct onslaught on the seeds that have made the country successful. But the taking of risk does require prospective reward, and lest we labor under the delusion that there have not been deleterious effects on our productivity—which incidentally is the major method of defeating inflation—please bear with the following analogy.

There seems to be a constant assumption that spreads through everything we read and even hear here this morning, that growth automatically means inflation. It doesn't. Let's assume for a moment—and I'm not going to take a position on this analogy because it's the way it is, whether we like it or not. If you're a student and you study very hard for an examination and receive a grade of 90 and a fellow student, either due to ignorance or laziness, receives a grade of 60, it makes little difference, between you, you have produced about 150 points of intellectual product. Now, the professor advises you that he feels the arrangement is unfair because one of you is smarter and worked harder so he's going to take 15 points from your grade and give it to the other student so you will each have 75. You have still produced a total of 150 points of product, but two very interesting questions arise. How hard are you going to study for the next examination knowing that they're going to take some away, and how hard is the other student going to study knowing that he's going to get something for nothing? The point is, the next year you're going to produce 140, and then 120, and about at 100 the Japanese or someone else are going to look over the horizon and say, "Hey, guys, we're producing at 150. Let's go over and beat their economic brains out."

Gentlemen, that's what happened in the 1970's and that's where a good percentage of this inflation we talk about came from.

Now in order to put all of this in context, relating it to monetary policy, we need once again to remind ourselves that business, whether we like it or not, is government's only source of income, and any directive, any aim of the Federal Reserve, aside from all of these economic details, has got to maintain to some extent a strong business climate. Otherwise you lose your tax income and deficits go through the roof.

Within this already difficult environment the American businessman has found himself assailed over the past several years, and with increasing frequency and intensity, with pronouncements and economic forecasts from the Fed, both official and leaked, from the Treasury Department, the Office of Management and Budget, Members of Congress, and a multitude of bank economists with various credentials creating an almost Alice-in-Wonderland atmosphere. This tends to leave the businessmen with the feeling that they have almost no control over their own futures. The reason is that most of what they hear seems to bear little relationship to common sense—and an extremely high percentage of the forecasts prove to be dead wrong. Of course, of equal or greater significance has been the roller coaster ride of instability created by the vacillating Federal funds rates.

Over the past 4 years businessmen have watched the prime interest rate plunge from close to 20 percent to 11.5 in one single 90-day period and then bounce up to almost 20 and back down to where it now sits at 12.5 with threats in the paper every day of rises as high as 15. Most of the above, frankly, courtesy of the Federal Open Market Committee.

While reeling from that, the businessman is then told that the economy has grown at more than 8 percent during the first quarter of 1984 with reduced inflation and what used to be good news is now bad news and so the Fed really feels they are going to have to increase interest rates and encourage Congress to increase taxes in order to slow the economy down. And probably the most mind-boggling entry into that myriad of rainbows that the businessman is trying to deal with is the realization that much of the tax policy is based on the forecasts of the Office of Management and Budget on future deficit projections one year ahead, which interestingly enough, over the last 13 years have an average error rate of 254 percent a year. I cannot imagine anybody basing legislation or anything else on that.

So I can assure you that the surest way to put the brakes on the ecomomy is to provide the businessman of all sizes with increased doses of the three most difficult problems he ever faces. These apply to all businesses of all sizes, but are particularly critical to the small businesses. High interest rates, high taxes, and economic instability which makes intelligent planning near impossible.

I think the key point is it should be obvious that the most effective method with which to increase deficits in one big hurry is to kill off the government's only source of income.

The machine tool industry, the one that I've been part of for so many years, one that is very critical to our national defense, has been literally decimated over the last 2 years as a consequence of fluctuating interest rates, tax rates and the inability of our industry and its customers to plan ahead. While the Japanese have walked in and taken, in the areas of Computer Numerical Controlled Machining Center and Turning almost 60 percent of the market, of course, interestingly enough, they're taxed at less than half of our levels and they have no capital gains tax.

Now I do not believe that the Federal Reserve should be dominated by the administration. Neither do I believe that it should be responsible to no one. Some form of congressional oversight, along with guidelines that can help eliminate the instability, is in order. I guess the details I would leave to you in the Halls of Congress who are much brighter than I am in those areas, but I would endorse measures that would include once again the Secretary of the Treasury as a member of the Open Market Committee, ex officio or not. I think you need it for liaison and I think it at least removes the confusion. Certainly measures that require the Federal Reserve to announce their decisions at the time they are made, and perhaps even the realignment of the term of office of the Federal Reserve Chairman to run concurrent with that of the President. It would seem that some congressional bipartisan influence is necessary to ensure that the Fed's policies regarding interest rates bear some resemblance to the attitudes of the Congress and the people it represents.

I can't find anyone in the United States that wants high interest rates, but we seem to be getting them. But it is fundamentally important, above all, that we constantly remember that it is the business community, both small and large, that provides all of the funds; and an environment that encourages its success is as impressive as the continued efforts to reduce the size and expense of a government that is still out of control. I think we must constantly keep that in mind as we attempt to solve the problem.

Thank you, Mr. Chairman, for permitting me to participate.

[The prepared statement of Mr. Evans follows:]

PREPARED STATEMENT OF JAMES R. EVANS

Mr. Chairman and members of the committee, I appreciate the opportunity to testify on a subject so critical to our Nation's economic future.

My name is James R. Evans. I reside in Wheaton, Illinois. I am not a professional economist although I have authored two books on the philosophy and principles that underlie a free-market economy and hence, a free and ordered society.

I am not a monetarist, a supply-sider, nor a Keynesian. What I am, I believe, is a pragmatic businessman who has run his own Company for more than 30 years. During that period I was also privileged to spend 15 years on the board of directors of a major publicly held American corporation. I am a past President of the American Machine Tool Distributors Association, the distribution arm of the American machine tool industry.

The negative effects on the business community of governmental policies impacting on taxes, interest rates, inflation, wage levels and other contributors to fluctuations in economic activity have been evident for more than two decades. Today, the consequences of those policies—both in place and threatened—are more virulent than ever. To understand them, however, we must remind ourselves of the true makeup of American business as well as what it does, how it does it, and what its real contributions are.

It is often forgotten that less than one half of one percent of America's corporations have more than 500 employees. Approximately 96 percent of our corporate entities have fewer than 100 employees and roughly 30 percent fewer than 20 employees. These small businesses provide more than half of America's private work force and the value of the goods and services they produce makes them—alone—the worlds fourth greatest economic power, led only by the United States as a whole, Soviet Russia, and Japan.

These same small businesses provide, by far, the major percentage of new jobs as an economy is emerging from a severe recession. In addition, a variety of studies indicate that small firms and their individual inventiveness account for more than 50 percent of all our innovation in terms of products and high technology.

At the risk of poetic license I should like to point out that these are that great cadre of entrepreneurs who have said, in effect, "I am going to start a business. I will furnish all the capital required, jobs for new employees, raw materials from the far corners of the world; I will devise salable products and advertise them, sell them, do the accounting, pay all the operating expenses and assume all of the risk. I will do this fully realizing that I have one chance in five of surviving for more than 5 years. If I am profitable, I will use most of those profits to invest in additional equipment and facilities with which to provide more jobs and productivity even though I will be paying my employees approximately nineteen times what I pay myself, and the various levels of government three times what I pay myself". The consequences of this entrepreneurial insanity have been the creation of a standard of living previously unimagined and without historical precedent. What else does business do? It makes it possible for a man earning little more than a few dollars an hour for moving earth with a shovel to find himself earning fifteen to twenty dollars per hour because he has been provided with a 3 cubic yard Caterpillar earthmover with which to accomplish the same job. That Caterpillar earthmover is the source of his productivity and his drastically improved standard of living, and the source of that piece of equipment is capital that has been provided almost entirely through corporate profits and savings.

That same example applies to the necessary acquisition of computer numerical controlled machine tools of all varieties, computers, office automation equipment and a myriad of other "tools" necessary in order to achieve productivity, jobs, higher "real" wages, and a constant flow of new and better products and services at prices that Americans at all economic levels can afford.

Although it is not the subject of discussion today, I cannot resist reflecting upon the fact that American business, large and small, has been eminently successful in accomplishing these ends in spite of the fact that we have seen fit for several decades to double tax corporate profits as well as the interest on savings. This obviously constitutes a direct onslaught on the basic seeds of capital that make all these good things possible. The taking of risk, however, requires prospective reward and lest we labor under the delusion that there have not been deleterious effects on our productivity (the major element in defeating inflation) please bear with the following analogy.

Assume that you are a student who has studied very hard for an examination and received a grade of 90, but that a fellow student—due either to a lack of intelligence, effort, or whatever—receives a grade of 60. Between the two of you, you have produced 150 points of intellectual product. When your professor advises that he feels that the arrangement is unfair and he is, therefore, going to take 15 points from your grade and give it to the other student so that you will each have 75, simply ask the following questions:

(a) How hard are you going to study for the next examination?

(b) How hard is the other student going to study for the examination?

The answers are obvious. You are certainly going to produce less on the next test, knowing that your efforts are going to be redistributed to another who will also study less knowing that he will receive unearned benefits. The net result is that the next year the two of you together will produce perhaps 140 points of product, and the following year perhaps 120—and when your productivity gets down to about one hundred points, someone (perhaps the Japanese and others) will look over the horizon and realize that in view of the fact that their productivity is one hundred and fifty it would seem propitious that they come over and literally beat out our economic brains. It has been, and still is, our tax policies that tend to limit our growth as well as our ability to compete in world markets.

Finally, in order to put all of this in context prior to relating it to monetary policy and federal reserve activity, we need to remind ourselves that business is, whether we like it or not, government's only source of income. If there were no risk-taking employers, there would be no employees and, in turn, no deficit problem as there would be no income from which to generate spending.

Within this already difficult environment the American businessman has found himself assailed over the past several years, and with increasing frequency and intensity, by pronouncements and economic forecasts from the Fed (both official and leaked), the Treasury Department, the Office of Management and Budget, Members of Congress, and a multitude of bank economists with various credentials creating an almost Alice-in-Wonderland atmosphere that tends to leave businessmen with the feeling that they have almost no control over their own economic futures. The reason is that most of what they hear seems to bear almost no relationship to common sense, and an extremely high percentage of the forecasts prove to be dead wrong. Of even greater significance has been the roller coaster ride of instability created by vacillating Federal Funds rates.

Over the past four years businessmen have watched the prime interest rate plunge from 20 percent to 11½ percent in one single 90-day period and then bounce up to 20½ percent and back down to 11 percent by August of 1982, and now in May of 1983 at 12½percent with threatened rises to as high as 15 percent before year end—all of the above courtesy of the Federal Open Market Committee.

Still reeling from that roller coaster ride, the businessman is then told that because the economy has grown at more than eight percent during the first quarter of 1984 with reduced inflation that what used to be good news is now bad news and the Fed will further increase interest rates and encourage the Congress to increase taxes in order to slow down the economy. Even more mind boggling is the discovery that much of the Congressional consideration relative to tax raises is based to some degree on the Office of Management and Budget deficit projections which, interestingly enough, have an average error percentage over the past 13 years of 254 percent!

I can assure you that the surest way to put the brakes on the economy is to provide the businessman with increased doses of the three most difficult problems he ever faces (these apply to all business, but are particularly critical to the small businesses we have been discussing). They are: (1) high interest rates (2) high taxes (3) economic instability which makes intelligent planning near-impossible.

It should be obvious that the most effective method with which to increase deficits is to kill off government's source of income!

The machine tool industry, for example (an industry most critical to our national defense), has been decimated over the last 2 years as a consequence of interest and tax rates and particularly the inability of our industry and its customers to plan ahead while riding the interest rate roller coaster. The Japanese (who are taxed at less than half of our levels) have captured almost 60 percent of the CNC Machining Center and Turning market and 36 percent of the entire domestic machine tool market.

I do not believe that the Federal Reserve should be dominated by the administration. Neither do I believe that it should be responsible to no one. It is obvious that Congressional oversight of some sort, along with guidelines that will eliminate the serious monetary instability that we continue to experience, is much in order. The details I would leave to the Congress, but I would strongly endorse measures that would include the Secretary of the Treasury as a member of the Open Market Committee; measures requiring the Federal Reserve to announce its decisions at the time they are made; and the re-alignment of the term of office of the Federal Reserve chairman to run concurrent with that of the President. It would seem that some Congressional bi-partisan influence is necessary to ensure that the Fed's policies regarding interest rates bear some resemblance to the attitudes of the Congress and the people it represents.

It is important, however, that we constantly remember that it is the business community, both small and large, that provides all of the funds; and an environment that encourages its success is as imperative as continued efforts to reduce the size and expense of a government that must still be classified as "out of control".

Thank you, Mr. Chairman, for permitting me to participate in these hearings.

Senator JEPSEN. Thank you, Mr. Evans.

Steven Givot, member of the Chicago Board Options Exchange, you may proceed.

STATEMENT OF STEVEN I. GIVOT, MEMBER, CHICAGO BOARD OPTIONS EXCHANGE

Mr. GIVOT. Thank you, Mr. Chairman. I do appreciate the opportunity to appear today.

Rather than review my prepared statement, I'd like to add a few things and highlight a few things if I may.

I attached my résumé to the statement to give you some interesting information about my background. I am one of the few surviving insane entrepreneurs that Mr. Evans referred to. I began in business 10 years ago. The business I started now has 10 employees and we do approximately $400 million a year in business. I think I can bring to this forum some insight into the difficulties of starting and operating a new business, particularly in the environment that exists today.

My business is centered on the Chicago Board Options Exchange which is the second largest securities exchange in this country. The exchange began in 1973 and in the 11 years since it was created it has not only become the second largest exchange but as recently as a week ago it traded the equivalent to 75 million shares of stock in terms of options that is—options covering 75 million shares of stock.

It is easy to understand why the Chicago Board Options Exchange has prospered, because the business of the options exchange is providing people a way to hedge risks, risk, instability, and volatility are all the same thing and that is the purpose for which we are meeting today.

Certainly instability has been characteristic of the period in which the exchange has existed. In my particular business, instability is good for me in that it generates the need to hedge risks. On the other hand, I can only profit if I predict which way things are going to be unstable successfully. For example, a 1-percent error in my estimate of interest rates over the course of a year can cost my firm $200,000. That's approximately eight times what we made in our best year.

When Professor Kaufman refers to the market as the judge of various things, I am one very infinitesimally small component of that market, so perhaps if you have some questions as to how the market operates I could be of some help there as well.

I am not here today to address the subject of the performance of the Federal Reserve. I am here to address the subject of the existence of the Fed. Other knowledgeable speakers have and will continue to address the many shortcomings of Fed policies and actions. They will offer their recommendations for changes in these policies and actions. They implicitly and sometimes explicitly predicate their recommendations on continued existence of some sort of central bank. For example, in today's hearings no one has even questioned whether or not the Fed should continue to exist and whether or not we might be better off with some other organization or lack of organization altogether.

I believe that the shortcomings and failures of the Fed that have been discussed today are inherent in any central bank arrangement. While it is possible to attempt to make things a bit better and keep the Fed in business, it is not possible to achieve the best solution for this country while that agency is still in existence.

I believe that there is no possible change in the policies of the central bank that will provide the tremendous degree of improvement that we would have if the system were abolished altogether.

I would liken this, if I may, to something I found most interesting when I was in high school. I learned that the State of Utah was unique in that it offered people on death row a choice between being shot or hung. As a citizen, I feel somewhat like the fellow whose mother has been murdered and the murderer is on death row. Gentlemen, I don't care if he's shot or if he's hung, it doesn't solve my problem.

The problem is that the system is wrong and that the use of an agency such as the Fed can't work.

I believe this is true for a number of reasons which are outlined in my prepared statement one of which is the fact that any entity as large as the Fed and as dominant as the Fed in a marketplace is inherently destabilizing. I'd ask you to consider what it would be like having 40 men in a lifeboat of a sunken ship. If everyone weighed the same amount, 100 pounds, people could move about somewhat. They may jostle the boat but it wouldn't tip over. But ask yourself what it would be like if one of the people in the lifeboat weighed 1,000 pounds and all the rest weighed 100. It might be possible to move everyone around so the 1,000-pound person could move across the boat once or twice, but without an enormous amount of coordination and planning this would almost certainly sink the boat. In fact, that's what's happening in the markets today.

I would propose that the Fed be abolished. I think that the question of price stability, which most of us have agreed is the primary issue, can best be dealt with by keeping the Government out of the business of deciding how much inflation we have. In fact, there's an advocate for returning to a stable currency and returning to a commodity-based currency in the Congress, that being Congressman Paul from Texas. The Government should foreswear any further intervention into this marketplace forever. Each bank should be left to decide what reasonable reserve levels it should have in its portfolio and we must allow each bank to purchase private deposit insurance which consumers would demand from whichever company it chooses.

I gave two examples in my prepared statement and I'd like to deal with them somewhat. The first example strikes close to home for Mr. Evans and myself—Continental Illinois National Bank, which was mentioned earlier. I think it's quite clear that if the Continental Bank were insured privately that that private insurer would have made substantial limitations on the riskiness of Continental's portfolio and that the Continental situation never would have gone to the point where it did.

The fact that the Federal Reserve Board recently indicated that 5 percent of assets is adequate capitalization for a bank is clearly disproved by the fact that Continental had the problems it had. The activities of the Fed certainly did not stop the Continental situation from arising and probably helped it to exist by creating a lack of accountability.

The second point I'd like to deal with was also in my prepared statement. It relates to the financing of the Federal deficit. I think it's important that this whole concept be put in the most simple terms to understand it. The Federal Reserve Board receives the deficit. It does not create it. I'm sure everybody agrees with that. The Federal Reserve Board has only two possible actions available to it. Either it monetizes the deficit, which directly causes inflation, or it does not monetize it, which directly leads to a rise in interest rates. Nothing could be more simple.

When Congress passes to the Fed a deficit, the Congress is forcing the Fed to choose between inflation or higher interest rates. As Mr. Kaufman and Mr. Kane both said earlier, it appears that there is a lack of accountability. I would suggest that if the Fed were abolished that accountability would fail directly where it belongs—on the Congress and the President. It directly deals with the issue of accountability by requiring that those that create the deficit determine how much of it will be inflated and how much of it will result in higher interest rates. If we really want price stability, we will not monetize the deficit. We will not inflate. Then Congress can directly bear the heat for the high interest rates that we have seen. If we do wish to inflate, Congress can then expect to feel the results that voters feel as a result of that issue. But in neither case is there a good argument for keeping the Fed around.

That concludes my testimony.

[The prepared statement of Mr. Givot follows:]

PREPARED STATEMENT OF STEVEN I. GIVOT

My name is Steven Givot. I am not here today to address the subject of the performance of the Federal Reserve Bank. I am here to address the subject of the existence of the Federal Reserve Bank. Other knowledgable speakers will address the many shortcomings of Federal Reserve policies and actions. They will offer their recommendations for changes in those policies and actions. They implicitly, and sometimes explicitly, predicate their recommendations on the continued existence of some sort of central bank. I believe that shortcomings and failures are inherent in my central bank system. There is no possible change in the policies of the central bank that will provide the improvement which will be realized when the position of the central bank is abolished.

Before I comment further, I would like to describe my daily involvement with the Federal Reserve System in my normal business—that of a securities and commodities trader. The Federal Reserve Board's policies affect my business in two distinct ways: first, and foremost, the Federal Reserve Board's actions in attempting to provide monetary stability and otherwise manipulate the economy and the perceptions which people have about those actions, have a direct impact on the direction and degree of movement of security and commodity prices. This should come as no surprise to any of you. Second, the Federal Reserve Board directly regulates the availability and indirectly regulates the cost of capital which is employed in my business. As such I have a daily interaction with both the results of the Federal Reserve Board's action and the results of various interpretations and guesses as to the Federal Reserve Board's actions.

What is stability? Systems dynamics tells us that a system is in a stable equilibrium when any change in the system inherently generates a force which pushes back toward the equilibrium point. If not need return to the original equilibrium point, just be pushed back toward that point. Unregulated economic markets tend to be very stable because exogenously generated changes in the market (weather changes, technological changes, etc.) generate price changes which affect both producers and consumers back toward the original stability. A decrease in the supply of one good will generate an increase in price which will encourage greater production and smaller consumption pushing the unregulated market back toward the pre-change equilibrium point. This is a stable market.

What destroys stability in a system? Many things can, but generally in economic systems it is the presence of a participant large enough to be able to individually affect market price. Without such a participant, the actions of any single party will have no material effect on the actions of other in the market. Everyone will be a market taker, no one will be a market maker. The existence of such a market maker has a very perverse effect on the stability of the market. If the sellers in the market anticipate that the market maker is going to sell and drive prices down, they will try to sell first, before the price has changed. Buyers, on the other hand, will try to postpone their purchase in anticipation of lower prices in the future. Either of these groups, buyers of sellers, acting unconsciously in concert would have moved the market price. Acting simultaneously they will completely destabilize the market. Prices will plunge. The anticipation of action by the market maker can generate forces which move the market away from equilibrium, not back toward equilibrium. The perverseness of this situation is that the market maker need not do anything—in fact it may not have planned to do anything. But its very existence destabilized the market.

The Federal Reserve Bank is such a destabilizing force in money markets. Its actions, inactions, shifts, signals, and pronouncements as interpreted by legions of Fed watchers and tea leaf readers is by far the biggest factor in money markets. Its purchases and sales of government securities represents 25 percent of the entire market. In its regulatory capacity it controls every bank, savings and loan, and every credit union in the country. If such an agency were run by an omniscient and omnipotent being, it would still be a destabilizing factor in money markets for the reason given previously. As it is, run by well-intentioned human beings and subject to overwhelming political pressure, it is the loose cargo in the hold of a ship—always rocking the boat and threatening, in rough weather, to sink the ship.

What is the alternative? Abolish the Federal Reserve Bank immediately. Reestablish a dollar based on a commodity standard. Allow the market to establish the proper price level for the currency, and foreswear any government intervention in the market ever! Allow each bank to decide what constitutes a reasonable reserve level for its portfolio, and allow each bank to purchase deposit insurance from whichever private insurance company it chooses.

These changes will go further toward stabilizing the monetary system than any changes which could be made to the policies of the Federal Reserve. It is not the policies which are destabilizing; it is the very existence of the Federal Reserve Bank.

Before I conclude, let me address a few topical examples of life without a central bank. Continental Illinois National Bank and Trust Company is a very important institution in my community and to me personally as a trader. Although I am not a customer of that bank, Continental provides substantial credit and banking for my industry. Conventional wisdom in Chicago and in the financial markets nationwide says that we are all very fortunate that the Federal Reserve bailed out this failing institution. This begs the much more critical question of whether Continental would have gotten into this mess if there was no central bank available to bail it out. Conventional wisdom says that a capitalization rate of 5 percent of assets is sufficient for a bank. It was reported in the press that the Federal Reserve recently "encouraged" those institutions below this level to bring capitalization up to 5 percent. In a free market is 5 percent sufficient? What other business is considered well capitalized with a debt/equity ratio of 19 to 1? My own opinion is that 5 percent was not sufficient for the riskiness of Continental's loan portfolio, but my opinion is immaterial. What is material is the opinion of the business which would write deposit insurance for banks in a deregulated environment. With their money at risk, you can be sure that the insurance underwriters' opinions would be well-informed and would be material. In such an environment banks would be much more careful about where they invested their money, and the risks of a bank the size of Continental abruptly going out of the business would be non-existent. Long before Continental got in as deep as it is now, private insurers would have forced the bank to liquidate assets and raise capital. Continental would be both smaller and sounder in a free market.

Another topical question concerns funding the federal government. Without a central bank to act as purchaser of last resort, could the government reasonably expect to find a market for all of its debt? Speaking as a trader, I assure you that there is a rate of interest which will allow the government to sell any amount of its securities. The more important result would be that the Federal Reserve would no longer be available as a whipping boy for recalcitrant Congressmen and Senators who repeatedly refuse to balance revenues and expenditures. Neither would there be the possibility of Congress inflating its way out of the debt it creates. The Federal Reserve has accommodated the government by financing 70 percent of the last 15 years cumulative deficits by new money creation. With a commodity-based currency, this would be impossible. People would see directly where money was coming from and where it was going. Without the hidden tax of inflation. The net benefit would be to all those in the country who are paying more tax dollars as they watch their standard of living decline.

In conclusion let me quote from Milton Friedman's "To Promote Prosperity".

"To summarize this 69-year-old record: two major wartime inflations; two major depressions; a banking panic far more severe than was ever experienced before the Federal Reserve System was established; a succession of booms and recessions; a post-World War II roller coaster marked by accelerating inflation and terminating in 4 years of unusual instability—the whole relieved by relative stability and prosperity during the two decades after the Korean War. Granted, the Fed alone is not to blame for this dissmal record. Yet it is—to put it mildly—hardly an impressive performance compared to either our nation's experience before the Federal Reserve System was established or to the record of some other nations with a different monetary structure. It is time for a change."

Senator JEPSEN. I thank you.

The panel might note on the charts to your right, a volatile M1 money growth leads to volatile patterns in spending. The chart shows that two quarters growth rates of gross national product has followed 6-month growth rates of M1 by a lag of about 4 months. Now that chart implies that monetary contraction produced the recession in 1981-82 and the monetary expansion contributed to the strength of the recovery in 1983.

Would that be your interpretation?

Mr. GIVOT. Senator, I think that I would interpret it that if you increase the money supply you can lead to short-term growth, yes, but at a price.

Senator JEPSEN. Would this imply that the Fed should be encouraged to maintain a stable money growth? I'm asking any of the three of you. I've heard you and you think the Fed ought to be abolished.

Mr. GIVOT. I would like to respond, if I may.

Senator JEPSEN. Yes, sir.

Mr. GIVOT. I believe that if we dealt with issues Mr. Evans talked about, that if we allowed productivity to cause economic growth rather than try to artificially create it through printing worthless paper money, that we would have some meaningful growth. That's the way it should grow.

Mr. DEANE. If I might be directly responsive to your question and also indirectly comment on my neighbor's to the right testimony in reverse order, I'd like to say that he might be right. I really would sort of doubt it, but it reminds me of Lloyd George's famous remark. He said, "Nothing is more dangerous than leaping a chasm in two bounds," and I tell you to abolish the Federal Reserve System at the moment might be a sort of a two-bound leap over that chasm.

Anyway, to respond directly to your question, Mr. Chairman, I think that that chart is a good example of what I said ought not to happen and that is that the Federal Reserve ought not to tinker, that they ought to be in the business of providing a steady, moderate increase in the money supply in sufficient amount to allow the economy to have a sustainable rate of growth, instead of doing what one of the earlier witnesses said, waiting until they see the whites of your eyes and then tighten up or loosen it up in a hasty way.

The volatility that you see in that chart has been disastrous, absolutely disastrous for this country, in my opinion. The inflationary bias that is now set into the public's mind and will take a very long time to go away is also disastrous. One of the reasons interest rates are as high as they are now while inflation is as modest as it is now is because people do not yet believe that inflation will stay modest because they don't believe that the signal has been given to the Federal Reserve that the primary target is stable prices. Therefore, you get all kinds of disruptive decisions being made.

So that kind of volatility is bad news and the Federal Reserve ought not to tinker and that's an answer to your direct question.

Senator JEPSEN. Do you believe that the Federal Reserve or the formula that's used by either the financial community or the Federal Reserve or any other group of individuals dealing with our economy have adequate formulas or methods of measuring the money supply, given the deregulation and change in the money markets and the changes in character?

Mr. DEANE. Well, Mr. Chairman, I think that as of now things have settled down from the deregulation confusion so that the money aggregates are probably again reasonably reliable. There was a period in there of about 18 months when it was disastrous. I agree with that.

Senator JEPSEN. Do you think that's reflected anywhere there, anything in the chart that might have been amiss? I questioned Chairman Volcker pointedly publicly and privately on how do you know what the money supply is and why can't you keep this stability and how do you measure it, and in my opinion, I have never quite gotten an answer other than if I could try to describe what I think I was told, it is that it's very difficult, given the changes.

Mr. DEANE. Mr. Chairman, I really believe that part of the difficulty of his response arises from the lack of clarity of the charge given to the Federal Reserve. They clearly are under pressure to worry about unemployment. They clearly are under pressure to worry about the level of interest rates. They clearly are under all kinds of pressures, given the legislation that it now outstanding.

Furthermore, they are required to report on all these things in the very short run, and I think that is is impossible to conduct sensible monetary policy on a 60-day basis or a 90-day basis. For example, the central bank of Switzerland has an absolutely excellent record in meeting its monetary aggregate targets year after year after year. Within any 1 year, they can be way over or way under as they go through the year and no one in Switzerland gets particularly upset about it. But by the time the year is over, you will find that the central bank of Switzerland is right in there very close to where they said they were going to be.

I think it's entirely possible and in fact probable that if you clarify the charge to the Federal Reserve System and do not hold them to targets of a 30-, 60- and 90-day basis but perhaps an annual basis, that they can come very, very close indeed.

Mr. EVANS. The tinkering I think that you referred to is particularly important, but you cannot separate the monetarist approach, good, bad or indifferent, from the rest of the tax structure. In other words, you can put yourselves into the shoes of the man who listens to St. Paul who suggested that we've got to raise taxes to get rid of the deficit at the same time that interest rates are high, and even the non-economist-minded tool and dye maker with the 20-man shop that is providing an awful lot of goods and services along with all of his friends says that that just doesn't make any sense because the only way we are going to get rid of the deficit is to create enough GNP to pay some of it off.

Obviously, the first rule is to get rid of Government expenditures or get them down, but that doesn't seem to be possible. I happen to agree with—I'm with illustrious company—I agree with you and Milton Friedman, that probably we would be better off without the Federal Reserve. But on the other hand, I'm a pragmatist and I'm not just sure how you do that without taking two jumps, as you suggested. But it is just absolutely disastrous if you talk to these men who run all kinds of businesses of all sizes—some are a little sophisticated and some not at all—but they are producers and they just put their heads down. But what is their reaction in the middle of a volatile period such as we have right now when they once again hear that good business is bad news and therefore we're going to slow it down? They dig in their heels and stop. There goes your income. There goes the deficit. And it really doesn't make any difference what the Federal Reserve does. It's a very serious problem.

Mr. GIVOT. I'd like to comment on the question of measurements and their accuracy. I don't think the measurements are accurate from time to time. Obviously, over the long haul the errors tend to wipe each other out. But in the short term errors of plus or minus 10 percent can exist, for example, from one reporting period to another and you might get a 20-percent measurement, but over a year you probably have a much smaller error.

A clear analogue is that I don't think we would have sent Senator Glenn up in the space capsule if the best guide you could give him was to stick his finger out to find out which way he was going.

Centralizing authority in a single monetary authority which is 25 percent of the activity in the money markets right now is that heavy man in the lifeboat and I think that is a major destabilizing factor.

Senator JEPSEN. Representative Lungren.

Representative LUNGREN. Mr. Evans, I'd like to ask you a question because we often hear from the big boys—IBM, General Motors and so forth—whenever we make a decision, and you point out very persuasively the impact of the small or medium business community on employment in this country.

What does it do to a person in your position, or someone similarly situated, with respect to the employment prospects of either maintaining your employment force or making a decision to increase your employment force when you have to deal with a volatile money growth policy which gives you one 6-month period of time a fear of inflation and another 6-month period of time a fear of deflation in a sense?

Mr. EVANS. Well, I think, fortunately, I almost don't have to make that decision. My customers make it for me. That really is the story of the American economy. In the big companies—and I found this when I spent a good number of years on the board of directors or a large corporation—you're responsible to stockholders. That's a completely different thing than in the small company where you're responsible, unfortunately, to run your business with your heart as well as your head, so you keep people employed even though you are perhaps losing money and so forth and so on because you don't run it all with your head, and also, when you require funds you're dealing with the situation where a few interest points—a manufacturing concern, large or small size, will purchase and finance a piece of sophisticated equipment that will create both productivity and jobs at maybe, in one case, 11-percent prime rate, and he stops dead in his tracks at 13. So they kind of follow that. If you ask them what the Federal funds rate is, they don't know.

There's a little short story and I'd like to take just a minute to tell it that I think illustrates the way the economy works better than any other and it's the story of the marine private during World War II by the name of Izadore Gisselman and he was the worst Marine that the Corps had ever experienced. He was never in the right place at the right time. He kept losing his rifle and ammunition. Finally, in frustration, his platoon lieutenant transferred him to another platoon. Sixty days later, Private Gisselman received the Navy Cross and Distinguished Service Medal for heroism in action, wiping out a couple enemy positions and saving some comrades under fire. And in total frustration, his former platoon lieutenant saw his current commander and he said, "What in the devil did you do to Gisselman?" The response was, "Absolutely nothing. He was everything you said he was. I couldn't stand him either. I called him in the office and said, 'Gisselman, here's an M-15 rifle, 500 rounds of ammunition, a dozen hand grenades. You're in business for yourself. Report back in 30 days.' "

Now think about it. That is what makes the system go. A fellow by the name of Mott and a fellow by the name of Durant started General Motors that way and the only reason it got big is because it's capital intensive. Your business is not capital intensive, so you can run large volumes with small numbers of people. We run what used to be a $15 million business with about 20 people, but in the machine tool industry, which is critical to our national security, as is steel, we have an industry that's been down—and don't believe your statistics because statistics are interesting but they aren't exactly accurate—I don't mean yours; I mean those that you read in the Wall Street Journal. That industry has been down 75 percent for 2½ years. It's lost 40 percent of all the people in it. As someone said, "If Costa Rica declared war on the United States of America, Jimmy the Greek might put his money on Costa Rica," because we won World War II with production. So we've got some very big problems and this is part of it and the tax system. They all go together. When can anyone convince the people in Congress to get away from the politicizing on a simple little thing that would double their money? Never has the Federal Government ever taken in more than 9 percent of its income from corporate income taxes. If they abolished them tomorrow, they would double their income overnight and we would probably have to begin to import outside labor to fill all the new jobs.

But it's a political thing. All of these hinge together and it's difficult to separate them. But I still think it comes out to one thing, you have to remember where the bloody taxes come from.

Representative LUNGREN. Mr. Deane, if I could ask you some specific questions on this, as I understand it, you would approve of the idea of casting a little sunshine on the Federal Reserve.

Mr. DEANE. Oh, yes, sir. I think that the guessing game that goes on now is very unproductive and that in fact if the Open Market Committee minutes or a summary of them were released the same day or the next morning that we would probably be far better off.

Representative LUNGREN. What about making the Secretary of the Treasury at least an ex officio member of the governing board?

Mr. DEANE. Well, I can see pluses and minuses to that. I think probably on balance it's a plus from the point of view of liaison.

Representative LUNGREN. At least we would have more coordination than we have now?

Mr. DEANE. Yes. I think that as a nonvoting member that it would probably be very helpful to have that kind of liaison.

Representative LUNGREN. Another question which could take us many, many days but one at least I'd like to get your opinion on, is the means by which we achieve price stability. Many would suggest that a dichotomy exists between trying to achieve price stability through a money growth rule versus a price rule. There is a movement afoot in the Congress that suggests that maybe we ought to go back to a price rule where we control—if not be a gold standard, some commodities market basket standard. Again, I know it's a very complex issue, but could you comment on that?

Mr. DEANE. Well, to think about it in terms of going back to an absolute gold standard, for example, I really think that the world has become too complex a place to abdicate your ability to increase or in fact decrease the money supply of the United States and hand it over to the whim of the public whenever they might become disturbed for one reason or another to demand payment in actual gold. In fact this is what happens if you go back to the gold standard as is advocated by some.

Representative LUNGREN. Well, what if we go to a market basket commodity? The reason is, essentially that then the market establishes what the value of something is? We like to talk about the money growth rule here and so forth. We've talked about the fact that we've had trouble defining what in fact the money was and is it necessarily an improvement over trying to get a more accurate reflection of what the market sentiment is with respect to the value of something that is in a sense not political?

Mr. DEANE. Well, Congressman, I'm really not at all clear about how you would implement such a program. My frank opinion is that we would be much better off to proceed under the current arrangements with better direction and more accountability, given that that accountability ought to be on a little longer, rather than a little shorter basis as it is now, and set the money targets and meet them.

Representative LUNGREN. But set the money targets based on a goal of price stability as opposed to a multiplicity of other things?

Mr. DEANE. Based on the goal of price stability. At the moment, we have money targets higher than those necessary to achieve absolute price stability because to go from the kind of inflation rate we had to a zero inflation would have been too much of a jolt for the economy; but the stated objective of the chairman is that he would like to move from the current targets to one of about 3.5 or 4 percent in a few years, which is their current judgment as to what it would take to have a noninflationary stable growth rate.

Let me comment if I may, in addition to that, on the matter of unemployment versus prices, which is always a big problem. You yourself said a minute ago that as we've gone through these cycles we've come out with higher rates and more unemployment each time.

I do believe, as you said, that if the mandate were given to have stable prices, that political support for that already exists. I think the majority of the people of the United States are now prepared to support that as the No. 1 objective.

Once you get a conviction on the part of the public that stable prices are going to be with us, then you get people again willing to buy long-term bonds which finance small as well as larger business, and I fully agree with these comments, by the way, about small business. Small business has produced all the new jobs in the United States virtually in the last 15 years—all of them There have been no net new jobs created by the Fortune 500 companies. By the way, there have been no net new jobs created in Europe in the same period of time—none. The United States has created millions of jobs in spite of the troubles we've had and there have been none created in Europe.

Senator SYMMS. Is the rate of taxation higher in Europe than it is here?

Mr. DEANE. Well, it's a little hard to tell because what people actually pay and what the stated rates are, sometimes are very, very different.

But one of the problems appears to be that business activity in Europe is centered in very large units. It's centered in either little mon-and-pop affairs or in very large units, a large number of which tend to be socialized, and if large units don't create net new jobs in the United States, then the same thing is likely to be the case in Europe.

On the other hand, Asia is an entirely different matter where this entrepreneurial spirit he's talking about is just everywhere. If you go to Japan or Taiwan or Hong Kong or Singapore or anywhere in Asia that is relatively free, jobs are being created every day by just this kind of thing.

Senator SYMMS. Well, I'd like to pursue this question a little more. Mr. Evans, you mentioned that if we would abolish corporate income tax that we would have to start importing more people to fill the jobs. I happen to agree with that and the interesting thing about it is the President also happens to agree with that and he's told me personally that his long-term goal would be to abolish this demogoguery of the corporate income tax. He made an off-hand comment about it up in Boston when he gave a speech and before he got off the podium the apologists at the White House are telling the press, "Well, the President really didn't mean that."

What are you doing as businessmen in terms of trying to help get some economic understanding to the people who write in the newspapers so that the demogogues don't always carry the day? Because the big word around here is we're going to tax more corporate income tax next year, as you all know. I think the President will be reelected and I hope he will, but whoever is elected President, I think there's going to be a big effort for tax reform in the Nations's Capital next year. You can see the seeds of it growing.

So what that really means is that Congress doesn't have guts enough to cut spending, so they are going to have tax reforms so that they can raise taxes by some methodology here of saying that we're going to have a broader based flat-rate income tax. What it will end up being is a tax increase if we're not careful.

Now you've got a President in the White House who believes we shouldn't tax dividends or the interest on savings and that we shouldn't tax corporations double taxation because it's basically dishonest and it's anticapitalistic and it's antiproductive and it's antipeople because people pay all the taxes anyway.

So how are we going to get the word out to the public when you have a news media that just runs completely opposite with the basic general bias against capitalism in the news media today in America? What do you do as businessmen?

Mr. EVANS. Boy, that would take a big hearing to cover that.

Senator SYMMS. Do you teach your employees about capitalism and the virtues of it?

Mr. EVANS. To the extent that I can, yes. Of course, some of us are not typical. I spent part of my time lecturing at colleges doing this and the following year was at the study institute and so forth, but most of the small businessmen——

Senator SYMMS. I notice you have a gold bug on your tie there.

Mr. EVANS. It seems to be. Mr. Lipsett told me if I came out with that I would be in trouble.

Senator SYMMS. The reason politicians hate gold is it would make the banking system be honest down here.

Mr. EVANS. Today is Adam Smith's birthday. That's the reason for that.

Senator SYMMS. I should have had mine on today.

Mr. EVANS. You should have. You'll be fined.

Senator SYMMS. Well, I will compliment you as a banker, Mr. Deane. You bankers did something that I thought was outstanding when you mailed out mailings to all your accounts to tell them what Congress is trying to do to their savings accounts.

Mr. DEANE. I hope you tell Senator Dole that.

Senator SYMMS. I told him that. I said it on the floor of the Senate, that for once, they did something right and then the Republicans attacked them, and I couldn't understand it. For once, they did something intelligent and then they got criticized for it.

Mr. DEANE. I'll tell you, this has turned out to be a lovely morning.

Mr. EVANS. At the risk of being flippant because this is in your bailiwick and not mine, the thing that's disappointing is when you look at the members of the Joint Economic Committee, the ones that ought to be hearing this, even though we fully recognize that we aren't going to change the world this morning, are not here. And that's what's distressful to me, but that's because they have other things to do I guess.

Senator SYMMS. Well, one of the things I found out that I like about the Joint Economic Committee is we don't have any legislative authority so we can't mess anything up. We can have hearings but we can't hurt anything, and most people that are here want to pass laws so they're off to committees that are meeting to pass laws to further screw up things.

The fact is, if we just stopped, I think the business community could adjust to what we have now. If we wouldn't let anybody touch anything for 10 years, we could survive it.

Mr. EVANS. It might be amazing what we could do.

Senator SYMMS. We would learn how to use the present tax code to get around it but the Congress operates like a roller ball. Once people start to learn how to use the rules that Congress passes, then we change the rules. That's exactly what the IRS does. I notice that there's a story where they are now fining people for writing these smart aleck remarks on their tax returns and that just makes me sick to think that could be happening under a Republican administration, but somehow the Republicans try to make government efficient so they're going to run the IRS better than it was run in the past and go out here and harrass everybody a little bit more.

Mr. DEANE. What do you say to that?

Mr. EVANS. We are all in agreement.

Senator SYMMS. Have any of you studied the Hoover/Bush tax plan? You know, this is the one that the Hoover Institute has come up with and their plan—it's a little hard to oversimplify, but essentially they are interested in the flat rate tax also, but not so many of the more popular flat rate taxes that we hear about. They are really only affecting the personal income side. They incorporate everybody under the tent. It's a 19-percent rate and it's basically a tax on consumption because it taxes all income that is consumed once closest to the source that's used, so business gets involved in it also, but the rate is 19 percent and any dollars that would be plowed back in like in a small business, if you take a small business that wanted to expand their plant, whatever they're doing, if they took their earnings and invested it back into plant and equipment, there's no taxes on that. If people have money to put in their savings account, there's no taxes on that, no taxes on dividends, no taxes on interest received, but only taxes on money consumed. In other words, income that would be spent. And it would raise the same amount of money that we now have.

Mr. DEANE. It's indirectly a sales tax.

Senator SYMMS. What it would amount to is we would have a tax where people would be encouraged to work and save and invest and produce, instead of—right now our Tax Code discourages you from working and discourages you from saving and discourages you from investing. Essentially, over a period of 30 or 40 years, we've developed a bigger and bigger anticapitalistic Tax Code and then we have people at the Treasury right today that are down here in the Republican administration talking about ways that they're going to put more taxes on corporate income tax next year to help solve this deficit, and I think the business community ought to be informed of this and be aware of what's going on in Washington this year or what may happen next year which I think would be tragic if that happened. But if you ask the tax people at Treasury what they're talking about, they are talking about increasing taxes on corporations which is totally—it would be one of the most stupid things Americans could do.

Mr. EVANS. And the quickest way to increase the deficit.

Senator SYMMS. Because business hires people and people pay taxes.

Mr. DEANE. People pay all the taxes.

Mr. GIVOT. Our exchange has about 1,700 members.

Senator SYMMS. What is your business?

Mr. GIVOT. I'm in the securities business. I'm a member of the Chicago Options Exchange. These are people very close to the financial markets on a daily basis.

Mr. EVANS. Risk takers.

Mr. GIVOT. We are risk takers. We really have benefited and prospered very much from all the volatility that Washington has created for us in the last couple of years because we sell essentially insurance on the price of stock. And you've seen the stock market and that is the result of some of the stuff that's going on here.

I don't speak for them formally, but overwhelmingly, the impression is—and these are businessmen—that there are revenues and there are expenditures in the Government just as there is in their business, but the Government only wants to talk about the revenues and not about the expenditures. It's as though by lowering the revenues or allowing them to be lowered, the deficit can be created, and it's sort of off to the side and it doesn't matter. I think their view, overwhelmingly, is, let's not worry so much about revenues. Let's get at the real source of the problem, what is really forcing revenues up in the past couple years? That's the expenditure side, and certainly that's the place where either House of Congress can stop it. They don't see either House stopping it or the President stopping it in a definitive, absolute way. That is the root cause of price instability. There's no question about it. As I said before you got here, the Fed is handed the deficit and it has two choices. It monetizes, which we call inflation as the end product.

Senator SYMMS. Counterfeiting.

Mr. GIVOT. Alternatively, if they don't monetize, we see high interest rates. Those are the only choices they have.

Mr. EVANS. Don't you think the Fed created about half the deficit in the 1980's?

Senator SYMMS. Well, I think the Fed overreacted, but historically, they will always overreact. They are overreacting probably right now.

Mr. DEANE. That's why we need to have less tinkering.

Mr. GIVOT. Or get rid of them.

Mr. EVANS. How do the two of you feel about—because you're in these areas—of Milton Friedman's idea of inflationary index bond. In other words, the creation of a bond that simply would be both long and short term?

Mr. DEANE. Well, I really think that it would further undermine any will we might have to try to eliminate inflation. You make it easy by doing that to live with inflation. When you make it easy to live with inflation, the pressure is not on and Brazil is a classic example of that. They made it easy to live with inflation by indexing everything and now they're in a fix. So I'm against that.

Senator SYMMS. On the bright side of this, there is one—there was an editorial yesterday in Barron's by Bob Blyberg about the bright side of the bond picture. You may have read that. Senator Boschwitz of Minnesota did an op-ed piece for the New York Times about 2 weeks ago where he pointed out that in the last 6 months Government revenues have actually gone up by 10 percent, where spending has only gone up by 4 percent. So this is the first time this happened and even as meager and paltry as this deficit reduction package is that's before the Congress it's the first time Congress has ever done anything like this in an election year. As bad as I think the bill is because it does have tax increases in it, I would have to say, because of the psychology I think, if it didn't pass it would probably be an unmitigated disaster because the market makers, Mr. Givot, that you work with would be in a state of near hysteria if something would happen and this bill wouldn't pass. It's like the money supply figures. I think the Fed—one thing they have done that's smart is release the money supply figures on Thursday instead of Friday so you don't have all these bond traders worrying all weekend about what's going to happen. They should do it so it gets absorbed and taken into account in the market before anybody can worry about it. It's just we all are hysterical—you know, the people who are in the markets, the Congress, and the politicians—the press fan the thing on too because they get wrapped up in it. We all share some of the blame, but there's an overreaction to everything and part of it I think is because of instanteous—they can hit you over the head 50 times with a news release is what I'm saying—bang, bang, bang—on television every day with something that's happening which could be a tragedy. It makes people believe it after a while. But the budget deficit actually is running about 20 percent less than for the same period in fiscal year 1983.

Mr. DEANE. I read that article.

Senator SYMMS. But you never hear that in the news media. You never hear that. It's silence. It's absolute silence. They would rather focus in on what they consider to be a hyped campaign of Jesse Jackson or something that somehow that's got more interest in it to the public—and maybe it does have—than what the economy is doing, but the economy feeds on momentum and we just go on and part of this is psychological, there's no doubt in my mind, and I think part of the budget deficit has been overstated.

For whatever we think about it, the budget is balanced. I mean, they are borrowing the money to do it, but their checks still cash and people forget that. The problem is we spend too doggoned much money and we're spending 25 percent of GNP and who wants to raise taxes by 30 percent? Certainly not me and not anybody else that I know in the Congress want to raise taxes by 30 percent because that would destroy us.

Mr. GIVOT. Senator, if the Congress would vote not to raise expenditures next year or cut them back to the point where revenues would equal them, would you get news coverage?

Senator SYMMS. Well, if Congress would do it. I think the news would report it.

Mr. GIVOT. There's your problem.

Mr. EVANS. Of course.

Senator SYMMS. But Congress is not in the frame of mind to do that right now.

Mr. GIVOT. I recognize that.

Senator SYMMS. My hope is that maybe after Reagan gets reelected, well, then there's no tomorrow and he can fire all his polltakers and his political hacks down there who want to be sure they advise him to do everything to make everybody happy, and then he can do what's right for the country—my personal opinion is that the best politics is to be pragmatically principled, that it would have been easier for Reagan to get reelected if he would come in here and wants to reduce the rate of increase proposed than it would be to have a $200 billion deficit because he would have had a more credible consistent position. But that has not been the conventional wisdom of the White House and I have argued with them until I'm blue in the face down there. They don't agree with that. I personally feel that that's the fact. The public is way ahead of Washington in terms of what has to be done and you talk to many, many people, the receivers of COLA's, for example, pensioners and so forth, and they keep asking the question at the town meetings around the country, "Why are you raising our stipend every month? Why are you raising it if we're really in deficit?" Now 44 percent of the budget goes to senior citizens right off the top, 44 percent of it, and unless we're willing to talk about that problem you can't solve the budget problem. Everybody has been afraid of that. Who better to do it than a 74-year-old President? So maybe after the election we'll get some results on this, I hope. If we don't, I think surely what will happen is we'll have to go through the wringer. We will have a depression with hyperinflation all at the same time and have monetary chaos and then the tools of production will still be in place so we will pick up the pieces afterward and start over. But it's very frightening to think about that happening.

Mr. DEANE. As a banker, it's very frightening.

Senator SYMMS. Well, we could end up with a military dictatorship if something like that happens. People don't seem to realize how critical stable money and stability in the economy is to a capitalistic economy and to our form of Government and with all of this intervention that's going on it's not very helpful, in my judgment, to stability.

We certainly appreciate your contribution to our series of hearings on this. The Joint Economic Committee is able, as I mentioned, to explore some of these areas without the threat of legislation being the main thing. The legislation comes out of other committees and it sometimes, I think, gives us a forum where people can speak freely about the ideas without having the ideas compromised in the actual passage of legislation because we certainly have a lot to benefit in this economy if we could have stable money, reasonable tax levels, and a sound fiscal policy. Personally, I don't believe that we can get lasting monetary reform that would do any value to the economic system without fiscal reform and a fair tax policy along with it because if you try to use a gimmick like monetary reform and still have basically an immoral fiscal policy, it confiscates the earnings from the people who earn it and give it to the people who don't earn it, which is basically a dishonest system—and that's what's going on now with this chain letter we have where we take the money from the workers and then transfer it over to the nonworkers under the guise of security—if we allow that to continue on, there's no kind of monetary reform that will work. I don't care if we got on a gold standard. The Congress would have to meet the change in gold once a week to keep up with it and that won't work either. So we have to get an honesty involved in the fiscal policy and the tax policy and the monetary policy, all three together, and then this economy could really take off.

I don't personally think the Asians could even compete with us if we would have the same set of rules to work under. I believe we could produce more and we could produce it better and even what we have done in the little meager attempts in our automobile industry, look at the improvement in American automobiles to meet the market in the past 5 years and just with a little bit of help from the UAW and they haven't gotten that much help but they've gotten a little bit of compensation and look how much better they've done. So I think Americans really can do better than we do.

The committee is adjourned.

[Whereupon, at 12:10 p.m., the committee adjourned, subject to the call of the Chair.]

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

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College of the Liberal Arts
Department of Economics

June 1, 1984

The Honorable Roger Jepsen
Chairman, Joint Economic Committee
U.S. Congress
Washington, D.C. 20032

Dear Senator Jepsen:

In view of the hearings you are holding on the Federal Reserve, I thought you would be interested in the enclosed paper. Having testified before the JEC and other Committees before, and read some of the draft testimony to date, I believe the Committee is one of the few forums where such issues can be constructively discussed and that the current hearings are off to a good start.

Sincerely,

Raymond E. Lombra
Professor of Economics

REL:ng
Enclosure

Revised 1/15/84

Monetary Policy: The Rhetoric vs. the Record

by

Raymond E. Lombra*

I. INTRODUCTION

For decades the makers of U.S. monetary policy have gathered every 4-6 weeks in Washington to make monetary policy. All the rhetoric, including periodic Federal Reserve reports to the Congress on monetary policy decisions and even minutes of the policymaking meetings, indicate a fervent, abiding desire by policymakers to make policy both less inflationary and less procyclical. With the record of the 1950s and 1960s disappointing to policymakers themselves, it is not surprising, given such desires, that by the early 1970s, the Fed (and a number of other central banks) came to believe that formulating and implementing an improved monetary policy would be facilitated by altering the basic interest-rate strategy guiding policy decisions. In particular, it was argued that by shifting policy guides so as to stabilize and lower the growth of the money stock, and the various monetary aggregates more generally, a less inflationary and more stabilizing policy performance would emerge.

Good intentions aside, the 1970s were characterized by outcomes that differed considerably from announced plans and objectives and thus

*Professor of Economics, Pennsylvania State University. I would like to thank Tom Fox, Tom Havrilesky, Jim Herendeen, Tom Mayer, Marv Rozen, Fred Struble, Mike Wasylenko and seminar participants at Penn State and the Federal Reserve Bank of Kansas City for helpful comments on an earlier draft.

a remarkably low correlation between the rhetoric and the record: the trend rate of monetary growth rose, the variations around the trend remained quite procyclical, and the inflation and unemployment rates both rose, on average. Some ascribe these outcomes to "bad" policy, while others attribute them to bad luck (e.g., oil price "shocks", a "mysterious" decline in productivity growth, and the weather). Beleaguered policymakers, quite unwilling to plead guilty to malpractice, downplay their powers and responsibility by emphasizing the complexity of the economy, the apparent breakdown and unreliability of important structural relationships (e.g., the money demand function), the monetary control problems created by financial innovation, the lack of fiscal discipline, and bad luck.

That much has been written on these issues in recent years is testimony both to the importance of a professional "sorting out" and to the lack of a broad-based consensus on the causes, and hence the cures, of our economic malaise. Against this background, the present paper provides a largely diagnostic and positivistic analysis of the policymaking process (there being no shortage of normative analyses). The resulting "field guide" to policymaking should help to explain the low correlation between the rhetoric and the record and thus contribute to a narrowing of the gap between theory (political and economic) and practice. The central theme developed is that uncertainty, the short time horizons of policymakers and their constituents, and the associated tendency to discount both forecasts and the longer run cumulative effects of current policy actions, represent fundamental impediments to substantial sustained progress which can not be analyzed or understood in purely economic terms.

II. PROXIMATE VS. ULTIMATE CAUSES OF ECONOMIC DEVELOPMENTS

Since economic instability persists, it is natural to ask whether actual policy has been an aggravating or moderating factor. The answer to this question, despite thousands of computer printouts and volumes of analysis, remains elusive. Policymakers argue they "lean against the wind", while others argue they often "lean with the wind". William McChesney Martin, for example, a former Fed chairman, once reportedly likened the Fed to someone who removes the punch bowl at a party just as the fun begins. In contrast, Edward Kane argues, "The Fed has come to function like a chaperone at a fraternity party. It legitimizes the process without changing it very much" (Kane, 1982a, p. 212).

In general, alternative views of what drives policy and enhances or limits its effectiveness, are rooted, at least implicitly, in various competing theories of inflation and stagflation. The alternatives may be usefully classified, for our purposes, as essentially nonmonetary or monetary. The nonmonetary theories usually emphasize one or more of the following as driving forces behind the trend (or underlying) rate of inflation and fluctuations around the trend: oil price shocks; productivity shocks; agricultural price shocks; fluctuations in money wages; fiscal policy instabilities; international linkages (openness); and rising aspirations and associated societal conflicts over the distribution of income. The common thread linking all such theories is that while monetary policy is understood to be potentially powerful and can from time to time be an independent source of alterations in aggregate demand, it is viewed as a mostly passive force, largely accommodating the financial requirements generated by the factor(s) believed to be the <u>ultimate</u> cause(s) of economic fluctuations.

Imploring the Fed to "do better" is thus misplaced and ineffective; monetary policy is largely endogenous and thus only a proximate cause of most economic fluctuations.

As Ira Kaminow (1982) has forcefully argued, the problem with these nonmonetary theories of inflation and stagflation is that the nested hypothesis concerning the conduct of monetary policy, and thus the process linking the money stock to the "exogenous" ultimate cause(s), is usually unspecified and untested, and, therefore, incomplete. Mindful of this missing link, statistical analysis of the relationship between nonmonetary variables and variables influenced by or controlled by monetary policymakers (e.g., monetary growth, reserve growth, and changes in short-term interest rates) has begun to appear (see, for example, Beck, 1983; Willett and Laney, 1982; Barth, Sickles and Wiest, 1982; Havrilesky, 1979; and the references cited therein).

The other class of theories shares the common bond of monetarism. Major economic fluctuations and sustained inflation are ascribed to the Fed's unwillingness to stabilize monetary growth around a lower trend. When, in response, the Fed argues that such a policy is difficult to implement in the face of financial innovation and shifting economic and financial relationships, the debate shifts to technical matters of monetary control; how can the Fed change its regulations and its procedures to tighten its control over money and, therefore, improve its ability to deliver a more stable policy? In effect, according to monetarists, the Fed is a key proximate and ultimate cause of economic fluctuations and inflation.

I have long found the resulting literature on reserve requirements, reserve accounting, discount window policy, and nonborrowed reserves vs.

monetary base vs. federal funds rate approaches to monetary control, somewhat of a puzzle. It is generally agreed within this literature that these issues are important in assessing and improving the degree of short-run (week-to-week and month-to-month) monetary control. Accordingly, and without denying the usefulness of adopting various changes in Fed procedures and regulations, it is extremely doubtful that the secular rise in inflation in the 1970s and associated secular decline in monetary discipline can be attributed to technical aspects of policymaking or to defects in the "plumbing" linking Fed actions to monetary growth. Even though most would agree that the current set of procedures and regulations are suboptimal and inefficient, the available research clearly suggests that the Fed could still control monetary growth within a relatively narrow range over 6-12 month periods. Perhaps monetarists, facing Fed intransigence, and the truism that the long run is nothing but a series of short runs, simply want to keep the Fed's feet to the fire in an ongoing "war of attrition". Alternatively, it may be that the plumbing gets more attention than it deserves because the political-sociological factors are harder to handle, it is easier to get agreement on technical issues, and research dealing with noneconomic factors may be considered less "scientific" and hence attract less attention to an author's work. Whatever the motivation for such research, the fact that such control has not been consistently exercised and that policymakers have been reluctant to adopt reforms which could improve short-run monetary control, does raise some fundamental issues.

Despite the Fed's formal adoption of monetary aggregates as intermediate targets in 1970 and rhetoric proclaiming a commitment to control monetary growth, I would argue that the record--that is, the failure to consistently exercise such control--does reveal something about the Fed's thinking (preferences?) <u>and</u> the thinking (preferences?) of their principals (the President and the Congress). Examinations of the policy process (Lombra and Moran, 1980; Karamouzis, 1984) indicate that the Fed frequently vacillated on the analytical significance of the monetary aggregates; are the monetary aggregates (individually or collectively) important strategic variables to be controlled or information (indicator) variables to be used along with other data in setting policy instruments? Distinguishing clearly between these possible roles for the aggregates, and the associated scope for policymaker discretion, would seem to be crucial and logically prior to the formulation and implementation of policy. If the aggregates are to be controlled, policymakers should respond to a divergence of actual monetary growth from target by resetting their instruments accordingly. If, in contrast, the aggregates are information variables, then a deviation of actual monetary growth from target might be tolerated. Absent an analytical consensus, the resulting ambiguity and vacillation frustrated communication among policymakers and their principals and contributed to inconsistencies and circularities in policy formation. The periodic widening of target ranges for the monetary aggregates, proliferation of targets, shifting emphasis accorded particular aggregates, several redefinitions of the aggregates, and adjustments to the base periods from which target paths are computed, however technically motivated, are manifestations, in part, of the shifting role of monetary growth in guiding policy decisions as the U.S. economy undergoes change.

A basic theme of this paper is that such behavior by policymakers cannot be analyzed or understood in purely economic terms. To blame only the Fed for the evolution of policy and associated economic outcomes, is to accept the dubious proposition that the Fed is independent and/or omnipotent. It will be argued below that the proximate causes of monetary control problems are not independent of the constraints (actual or perceived) generated by the political and economic environment within which policymakers operate.

III. THE ROLE OF ECONOMICS AND POLITICAL SCIENCE IN POLICY ANALYSIS: SOME FIRST PRINCIPLES

Since economics and political science are both social sciences broadly concerned with behavior, it is not surprising that members of both disciplines devote considerable effort to analyzing the behavior of policymakers. Unfortunately, such efforts by one discipline are often viewed with considerable disdain by the other, if not ignored completely. (How many economists read the American Political Science Review?) Turf problems aside, it is unlikely that our understanding of the policy process is enhanced by such professional squabbling.

At the conceptual level, Beck has suggested a starting point for understanding how economics and political science can play complementary roles in policy analysis: "The discipline of economics can deal with the question of how different economic policies lead to different economic outcomes, but it cannot explain the basis for the rankings of the various economic outcomes" (Beck, 1983, p. 1). Simply put, policy actions would comprise the exogenous variables for economists and the endogenous variables for political scientists.

While specialization and a division of labor are usually desired developments destined to increase efficiency and productivity (economic and intellectual), it can be argued that policy analysis needs more integration. The problem with an unduly narrow conception of policy for economics has been aptly summarized by Hirsch and Goldthorpe: "Confronted by political and social disturbances, economists...have slid easily and often unthinkingly into the assumption-cum-conclusion that the non-economic factors are the extraneous variables that can be expected in the end to adapt to an overriding and objective economic reality. Technical remedies are available and adequate; all that is necessary is for them to be accepted at the political and popular levels" (Hirsch and Goldthorpe, 1978, p. 2). A discomforting result of such an approach, which emerges from at least one branch of economic analysis relevant to the present examination, has been identified by Maier: "Monetarism focuses on keepers of the printing press and summons them to abstinence, but rarely explains what pressures sustain or overcome their resolution" (Maier, 1978, p. 39).

Proceeding on the premise that a more pluralistic approach to policy analysis will yield a more complete understanding of "what they do and why they do it," the following sections examine the role of and interaction among political and economic forces bearing on the monetary policy process.

IV. POLITICAL ASPECTS OF U.S. MONETARY POLICY

In the process of making policy, the Fed must implicitly or explicitly select quantitative goals (e.g., 6 percent unemployment and 5 percent inflation) and choose a method or procedure (e.g., a monetary aggregates approach or an interest rate approach) for pursuing its goals. Then, in executing policy, the Fed's manipulation of its instruments (open market operations, reserve requirements, and the discount rate) is guided by the operative set of goals and procedures. Making such decisions independent of political considerations is difficult to imagine (see, for example, Acheson and Chant, 1973).

On a normative level, the incongruity between apolitical policy and our democratic form of government is obvious. Ideally, one would expect elected officials to specify the goals (ends) that the Fed should pursue. The Fed might then be left considerable discretion in selecting the means to achieve such ends. On a positivistic level, since the set of goals, procedures, and instrument settings comprising a given policy strategy has nonneutral effects on the body politic, it is not surprising that "enlightened" self-interest leads individuals or groups to rank policies differently. As Kane argues, "Some opinions are better informed and less self-serving than others, but all of them are affected by the owner's perspective as an interested member of various political and economic groups. Perspectives on macroeconomic issues [including policy] differ markedly between creditors and debtors, between workers and employers, between job holders and the unemployed, between landlords and tenants, between a product's producers and its consumers, between bureaucrats and the public that pays their salaries, between Fed staff economists and their counterparts in academe, and between incumbent politicians and those seeking to unseat them" (Kane, 1982a, p. 222).

The different perspectives and the alternative policy rankings which flow from them constitute ongoing sources of pressure which policymakers seek to selectively fend off or embrace. That monetary policymakers engage in such political activity is undeniable. How it affects policy decisions per se is somewhat less obvious.

Goal Selection

The selection of economic goals and the weight each is to receive is presumably logically prior to the formulation of policy. But where do the goals and weights come from? Few would argue that the deliberately vague and often contradictory directives (suggestions?) contained in various pieces of legislation in any serious way guide or constrain policymakers. While the resulting ambiguity and lack of specificity imparts an incompleteness and thus indeterminacy to the policy process, some argue such ambiguity and incompleteness is a necessary part of and actually facilitates policymaking: "We have a political process precisely because people have multiple goals that somehow must be reconciled into a single course of government action. The resultant course of action may be called a policy, but that term is misleading if it is regarded as implying one mind, one will, and one theory. Legislation requires ambiguity in the statement of goals so that coalitions can be formed in support of it, and each group can believe that the legislation serves its own special purposes" (Rein and White, 1977, p. 123); "The first role of the successful political process is, 'Don't force a specification of goals or ends.' Debate over objectives should be minimized partly because ends and means are inseparable. More important, the necessary agreement on particular policies can often be secured among individuals or groups who hold quite divergent ends" (Schultze, 1968, p. 47).

Succinctly stated, the economist's ideal, scientific approach to policymaking--specify objectives, develop alternatives, assess costs and benefits of options, chose policy--is viewed as unreasonable, unnecessary, and unattainable (Lindblom, 1979; Wildavsky, 1978); within the context of complex problems, all analysis will be incomplete. Thus, "disjoined incrementalism"--a kind of enlightened "muddling through"--is perhaps the most that can be hoped for, and calls for complete policy processes are naive.

If "good" policymaking consists only of being able to make decisions, the virtues of ambiguity and incompleteness follow. However, if the standard against which policy decisions are to be judged is defined in terms of the economic outcomes such actions help to produce, then ambiguity, a shifting compromise among multiple goals (Knott, 1983), and the associated confusion of means and ends would seem to impede rather than facilitate the making of "good" policy.

A careful reading of the Memorandum of Discussion from Federal Open Market Committee (FOMC) meetings--a nearly verbatim transcript available through March 1976--makes it painfully obvious that the FOMC, as a group, did not have a specific set of ultimate objectives guiding the formulation of monetary policy. Of course, everybody was for "low" inflation and "low" unemployment and individual members no doubt had quantitative income, employment, and price objectives in mind as they each spoke and voted on the policy options under consideration. However, the failure to flesh out the specific objectives, weights and trade-offs conditioning each FOMC member's policy preferences contributed to FOMC decisions where it was not clear to the policymakers themselves in which direction policy was moving or why.

The November 1970 FOMC meeting is a typical example. The Committee was of two, diametrically opposed minds. Some felt monetary restraint should be exercised to slow inflation, while others favored a more stimulative policy stance that would give priority to reducing the unemployment rate. Faced with such conflict, the usual practice was to modify the wording of the Directive--the set of instructions guiding open market operations, transmitted by the FOMC to the manager of the Fed's portfolio of securities--and/or adjust the various policy alternatives slightly so as to generate unanimous or near-unanimous approval. Despite a nearly even split of policy views at the November 1970 meeting, a directive was agreed to by an 11-1 vote. Unfortunately, it was not clear to the policymakers themselves whether the actions approved would, over the near term, have a greater tendency to slow inflation or to stimulate the real sector of the economy. Divided over the appropriate direction for policy, the consensus reached may in fact be a reflection of a type of policy paralysis which frustrates achievement of both objectives and contributes to stagflation over time.

The policy process in place at the Fed, and the unspoken disagreement it facilitates, is successful in the sense that policies are adopted. However, the ad hoc approach to goal selection (and policymaking) has not consistently produced economic outcomes satisfactory to economists, large segments of the body politic, or to policymakers. To avoid misunderstanding, it is important to emphasize that eclecticism is not the issue. With a committee making decisions, eclecticism is probably inevitable. Moreover, given uncertainty and some nonzero probability that various competing theories are "true", it may well be optimal to pursue a policy that blends theories so as to minimize the maximum error. The use of more than one theory or objective to guide policy is not the central issue; eclecticism implies a fleshing out of theories and implications which did not generally occur. As Benjamin Friedman has argued, "Policymakers must first determine what they are doing and why, before they set about doing it" (Friedman, 1977, p. 100). The alternative is inherently self-defeating.

Intermediate Target Selection

As is well known, the Fed, and other central banks, employ an intermediate target approach to policymaking, the basic features of this approach, along with the evolution of Fed policy over the past 30 years, are depicted in Figure I. The advisability of employing such an approach, and the case for and against certain interest rate and monetary aggregate variables typically considered as candidates for intermediate targets, has spawned a voluminous professional literature (see, for example, Bryant, 1980, 1983, and the literature cited therein). Considerably less attention has been accorded the role that political factors play in influencing such decisions.

Analytically, the failure to specify explicit quantitative goals, as outlined above, renders the selection of a "dial setting" for a particular intermediate target variable problematic. Such incompleteness or indeterminacy is deliberate. In addition to facilitating decision making internally, it helps shift the focus of policy discussions externally away from politically sensitive goals (ends) to more technically-related issues regarding means. Since everyone is for "sustainable, noninflationary growth", the basic issues to be decided involve the procedures and tactics to be utilized in pursuing this ill-specified goal.

Despite numerous hearings and other exchanges on monetary policy, it is obvious that the Congress and the President have not pressed the

Fed to adopt a more complete and explicit strategy. The reason, as argued persuasively by Kane, is that "overseeing a complete strategy would undercut Fed 'independence' and implicate incumbent elected officials in monetary policy before the fact" (Kane, 1982b, p. 193); "Whenever monetary policies are popular, incumbents can claim their influence was crucial in their adoption. On the other hand, when monetary policies prove unpopular, they can blame everything on a stubborn Federal Reserve and claim further that things would have been worse if <u>they</u> had not pressed Fed officials at every opportunity" (Kane, 1980, pp. 206-07). Given the internal and external payoffs yielded by incompleteness, its continued existence is hardly surprising.

Politically, the choice of specific intermediate target variables is not independent of the public's perception of what the Fed's proximate role is. As Kane argues, "in the popular mind and in the financial press, the Fed is a politically beleaguered institution whose chief task is to act as the arbiter of nominal interest rates" (Kane, 1980, p. 200). This perception, along with the distributional effects of changes in interest rates, and the continuing tendency to link "high" interest rates with "tight" policy and "low" interest rates with "easy" policy, generates an understandable desire by policymakers to put some distance between their actions and fluctuations in interest rates. Such considerations have undoubtedly played an important role in central banks' adoption of various monetary aggregates as intermediate targets (Bouey, 1982). Frank Morris, President of the Federal Reserve Bank of Boston, confirms this conjecture: "We know that in targeting interest rates the Federal Reserve is subject to a lot more political pressure than it is in targeting a variable which is not politically sensitive, such as the money supply;...this is the kind of political sheltering which we should not want to give up" (Morris, 1982, p. 14).

Policy Execution

Grandiose or not, plans, however formulated, must eventually be transmitted into actions. How much is lost in the translation has been the subject of an expanding empirical literature attempting to link movements in various variables under the Fed's control to a fairly long list of economic variables (e.g., the inflation rate, the unemployment rate, wage growth, the budget deficit, oil prices, etc.) and political variables (e.g., political party in office, proximity of an election, etc.). Recognizing the possible interdependencies among the various economic and political variables, and the possibility that policymaker responses to such variables may be somewhat idiosyncratic instead of systematic across time, application of an increasingly sophisticated arsenal of statistical techniques has become commonplace.

Taken together, the results of these statistical studies (see, for example, Beck, 1983; Barth, Sickles and Wiest, 1982; Willett and Laney, 1982; and the literature cited therein), and some thoughtful and insightful case studies (Mayer, 1982a, 1982b), are consistent with the notion that Fed actions, consciously or not, are primarily the joint product of a complicated confluence of short-run, domestic, political and economic forces (see Woolley, 1984, for an illuminating examination of these and related issues). However, the sensitivity of the empirical results to the time periods, variables, and techniques employed, suggests that the Fed does not follow simple rules in reacting to such forces. Rather the Fed is "flexible". Such flexibility is the political fruit borne by the incompleteness of the Fed's strategy; it serves to "stabilize" the short-run political environment while running the risk of destabilizing the economic environment over the longer run. Free to respond flexibly to various political and economic pressures in the short-run, the resultant actions of policymakers have been characterized as myopic. However, if those affected by policy--the electorate and thus incumbent politicians--are themselves myopic, as the (mis)management of fiscal policy, for example, clearly suggests, long-run destabilization is not perceived as an actionable problem. Thus, imploring the Fed to "take the long view" is politically naive. Failing to come to grips with an abiding focus on the short run, proposed changes in procedures, even if adopted, may alter the form of policymaking, but not the substance.

V. ECONOMIC FACTORS CONDITIONING U.S. MONETARY POLICY

Whether motivated by the pursuit of economic, political, or social goals, policymakers must confront certain economic realities. First, policy operates with a lag; actions taken today initiate a dynamic process of adjustment and reaction in the financial and real sectors of the economy. The resulting passage of time between policy actions and their several effects requires one to distinguish analytically between the short-run period of time (say a year) encompassing the enactment of policy and its initial effects, and a longer run period characterized by the gradual emergence of the more enduring effects of policy. Such a conceptualization leads directly to the second point, the short-run effects of policy on the financial and real sectors of the economy can differ markedly from the longer run effects. In the short run, for example, a stimulative policy (particularly if unanticipated) will usually lower interest rates, stimulate aggregate demand, and lower unemployment. Over the long run, such a policy stance will raise the inflation rate, inflationary expectations, and all nominal magnitudes (e.g., nominal interest rates and nominal wages), and have little or no effect on real magnitudes (e.g., real output and employment). How long it takes for such "policy neutrality" to emerge is, of course, the central focus of ongoing research on how rational economic agents form their expectations and how such expectations affect behavior.

Third, uncertainty is pervasive. More specifically, policymakers' (and economists') knowledge of key structural relationships (such as the slope and stability of the short-run Phillips curve), despite an ever growing empiricism in policy analysis, is severely limited. As recently summarized by an emenient econometrician, "the theoretical model and empirical results under discussion do not, unfortunately, lead to any simple resolution of the main disputed points in macroeconomics" (Sims, 1982, p. 137). The apparent fragility of received empirical work, and associated forecasting errors, imply that the effects of policy on the economy, especially in the short run, are somewhat unpredictable.

Fourth, the openness of an economy has a fundamental influence on the effectiveness and proper conduct of monetary policy (Frenkel and Mussa, 1981). No open economy is immune from foreign disturbances, many of which may be inherently unpredictable and whose effects may be difficult to analyze. Domestically, the effectiveness of interest rate ceilings, reserve requirements, and other policy instruments are weakened by the widening of the opportunity set available to borrowers and lenders which accompanies international financial integration. In addition, exchange rate fluctuations influence the short-run effects of policy on real output and prices. More generally, openness increases the difficulties associated with determining the size, source, and duration of disturbances and thus tends to weaken the ability of policymakers to measure, assess, and react to emerging developments.

Given knowledge deficiencies, openness, and associated uncertainties concerning the lagged effects of policy on the economy, how do policymakers make policy? To begin, however uncertain policymakers are, they must still have some basic underlying view of the determinants of economic activity and thus of how policy (monetary and fiscal) effects the economy. Understandably reluctant to be pinned down on their precise views--another manifestation of the Fed's flexibility--the Fed's "model" is not published in any official release. Rather, it must be gleaned from various documents the staff prepares for FOMC meetings, containing analyses of past, present, and perspective economic developments, and from policymaker discussions contained in the minutes (Memorandum of Discussion) of FOMC meetings.

The consensus view of the relationship between policy, inflation and unemployment prevailing within the Fed in the 1970s (as outlined in Lombra and Moran, 1980; and Karamouzis, 1984) followed a mainstream, closed-economy, Neo-Keynesian track (see Gordon, 1981). Presumably, an ongoing "rational" evaluation of the scientific evidence influenced this view over time. As Wallich notes, however, even here politics apparently plays a role: "Monetarism has enjoyed a considerable vogue among politicians, understandably, since it tends to absolve them from responsibility for the consequences of poor fiscal policy. In that view, most of the responsibility rests with the Federal Reserve, which therefore tends to acquire some Keynesian leanings [including an emphasis on fiscal policy] in self defense" (Wallich, 1982, p. 243).

In general, assuming the economy was operating below its potential, it was believed that policy-induced alterations in aggregate demand first affected inventories, production, capacity utilization and unemployment; with a lag, these "real" effects, and associated changes in labor market conditions, affected wage demands and, therefore, unit labor costs; changes in unit labor costs, in turn, explained systematic, "underlying" variations in the inflation rate, as opposed to transitory, shock-induced variations. Changes in interest rates, operating through wealth, cost of capital, and availability channels, are the cutting edge of monetary policy within this view of the transmission mechanism. Moreover, given the long lag believed to exist between policy actions and inflation, and thus between policy and a change in inflationary expectations, short-run, policy-induced changes in nominal interest rates are equated with changes in real rates.

Given the above view of the transmission mechanism linking Fed actions with inflation, policy decisions, and the analysis and forecasts which underlaid them, were conditioned by the belief that current policy actions would not materially alter the near-term (4-6 quarter) inflation outlook and that real output and employment would bear the brunt of restrictive policies in the short run. Therefore, fighting inflation was viewed as "costly" in the short run in terms of lost output and employment. An unmistakable implication has been suggested by Wallich: "Differences on the relative evils of inflation and unemployment are wide, and they tend to be associated with different evaluations of the cost of dealing with either. It would be a rare advisor [or policymaker] who believes inflation could be dealt with at moderate costs but prefers expansion, or who sees the cost as enormous but nevertheless proposes to incur them" (Wallich, 1982, p. 243).

However sensible this general Neo-Keynesian view may be, an unfortunate characteristic of the specific forecasts produced by the staff was that the projection errors were large over the 2-4 quarter horizons one would normally expect to dominate policymaker deliberations. In addition, the forecasts were biased in the sense that real GNP tended to be overestimated, while inflation was underestimated. A failure to take adequate account of policy-induced changes in inflationary expectations, and an attendant failure to distinguish between changes in nominal and real interest rates in the formulation and execution of policy, is consistent with the tendency to overestimate the real effects of policy and underestimate the nominal effects.

The size of the errors led policymakers to discount the forecasts heavily. This imparted a short-run bias to policy discussions and a resulting focus on current rather than projected economic conditions in selecting among policy alternatives; that is, policymakers acted as if no lag existed between policy actions and effects. Given the actual lagged effects of policy actions, such a focus undoubtedly contributed to procyclical policies.

The biasedness of the forecasts, reflecting the staff's inability to pin down the slope of the short-run Phillips curve, and the short-run focus resulting from the size of the errors, contributed to an emphasis on the real output effects of various policy actions which dominate in the short run, rather than the price effects which dominate over the longer run. Such an emphasis in turn contributed to a failure to adequately assess the longer run cumulative effects of policy actions on prices.

Taken together, the size and biasedness of the errors, and the underlying analytical framework they reflected, reinforced the tendency of policymakers to give considerable weight to short-run developments in formulating and implementing policy--a tendency already firmly rooted in the system of political arrangements within which the Fed continues to operate. That the resulting confluence of short-run political pressures and economic considerations contributed to procyclical policies in the short run and inflationary policies over the longer run is difficult to refute.

The Fed has, of course heard much of this before. The typical response has been to point to knowledge deficiencies and limitations to what monetary policy can itself accomplish. Operationally, it is argued that such considerations point to the need for caution, illustrate the wisdom of eschewing bold, decisive action, and emphasize the benefits of being prepared to respond flexibly to emerging developments (Wallich, 1982). Superficially appealing, a critical problem with "successive approximation" or "Micawberism" is easily illustrated. Early in a recovery, for example, we typically observe that the unemployment rate is relatively high, the inflation rate is relatively low, the economy is expanding fairly rapidly, interest rates have fallen and monetary growth has accelerated. Amid arguments that the economy is operating well below its potential, that the recovery is fragile, and that inflation has been dealt a decisive blow, policymakers are understandably reluctant to slow monetary growth and encourage a rise in interest rates. After all, uncertainties do exist and a prudent person, it is

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alleged, should at this stage of the cycle be prepared to err on the side of doing what is necessary to sustain the expansion. Yet, since policy operates with a lag, engineering a "soft-landing" for the economy, characterized by sustainable, noninflationary growth, requires policymakers to "throttle back" on the degree of stimulus being provided well before available data point unambiguously toward the need for such an adjustment of policy. That this has seldom occurred needs no documentation. Moreover, it is not obvious that such deft adjustments could be consistently engineered in the short-run-oriented political environment within which the Fed operates, even with very reliable forecasts.

VI. TOWARD A NARROWING OF THE GAP BETWEEN THE RHETORIC AND THE RECORD: SOME CAUTIONARY REFLECTIONS

Proposals designed to improve the Fed's performance (see, for example, the papers in this volume by...) are not in short supply. One class of proposed remedies is technical in nature, involving various reforms of the Fed's procedures and regulations. Broadly speaking, such suggestions share a common flaw; they ignore or downplay the political role the Fed plays within the current set of institutional arrangements and, therefore, the political factors which influence their actions. Simply put, it is quite unlikely that technical adjustments *alone*, however well grounded in economic theory, can sever or substantially alter the relationship between the proximate and ultimate causes of economic fluctuations. Kaminow's assessment of the Fed's October 6, 1979 announcement of a change in operating procedures (see Figure 1), designed to improve monetary control, nicely summarizes the relevant issues:

"If the fundamental cause of monetary excesses has been a technical inability to control money, then a technical solution of the sort adopted on October 6th may well succeed. The old money control procedures were extremely imprecise and a shift to control through bank reserves could easily improve precision and give the Federal Reserve added ability to slow money growth and inflation in an orderly fashion.

"But there are those that believe that inflation impulses go deeper than Fed technique. Economic aspirations are soaring past our ability to deliver. And when the political process directly or indirectly presses the Fed to chase unobtainable goals for economic growth, the central bank responds with the printing press. Political pressures of course need not be as obvious as direct orders from the President or Congress. Fed officials are hardly immune from the more subtle influences of the political mood and climate in the country.

"If excessive money growth has been a response to recurring political pressures for expansive policy, then the October 6th package did nothing to get at fundamental causes of inflation. It neither relaxed the pressures nor increased the Fed's ability to resist them. To the contrary, the package responds well to the political mood of the moment and so offers no particular hope that overexpansion is not again around the corner if the politics begin to push that way.

> "The Fed deserves high marks for moving toward better money control procedures on October 6th. That move has the potential for adding enormously to monetary stability. But it will do little to slow politically inspired inflation. To do that we need to more effectively insulate the money-creation process from political influence, and that's a bigger job than the Fed can be expected to do on its own" (Kaminow, 1979, p. 4).

Recognizing that purely technical reforms may alter the form but not the substance of policymaking, another class of proposals focuses on the political forces and administrative arrangements governing the conduct of policy. Such proposals range from calls for increased policy coordination of monetary and fiscal policy, to proposals requiring increased disclosure, specificity and accountability in the policymaking process, to legislative or constitutional remedies, including, for example, defrocking the Fed and making it part of the Treasury, and/or the enactment of a monetary rule.

The attractiveness of increased policy coordination is obvious. However, deeper reflection reveals some potential problems. Suppose we have two sets of policymakers (monetary and fiscal), neither has a corner on the truth and at a moment in time each has a different concept of what is best for society, different forecasts, different theories regarding how policy effects the economy, and, therefore, different preferred policies. Hedging bets and minimizing the possibility of major policy errors might well suggest less rather than more coordination. Moreover, as Alan Blinder has pointed out in an insightful discussion of policy coordination, "Dispersion of power is one safeguard against misuse of power, in economic policy as elsewhere. We know that checks and balances can sometimes lead to stalemate or to conflicts between different branches of government, but in many cases we view this as a reasonable price to pay for protection against abuse of power" (Blinder, 1982, p. 19).

The political argument can also be extended by noting that increased coordination would come perilously close to implicating fiscal policy-makers in monetary policy before the fact. The resulting erosion of the Fed's "scapegoat" role (discussed above) represents a real impediment to proposals calling for more coordination. Similar problems also afflict proposals designed to increase the specificity characterizing the Fed's formulation and reporting of its policy plans, and its accountability to the President and the Congress regarding the execution and effectiveness of policy. To whom is the Fed now accountable and how will proposed changes alter existing relationships (Knott, 1983)? More fundamentally, if the problem with Fed policy is simply that it does not pursue the goals and carry out the policies desired by its principals--the Congress and the President--straightforward remedies exist to increase the Fed's incentive to do so. I take the often amateurish "oversight" of monetary policy by the Congress and its attendant failure to require more disclosure, specificity and accountability, along with its free-wheeling violation of budgetary plans and resolutions, as a telling indicator of underlying preferences and perceived constraints.

Lest one be accused of being unduly negative, a degree of pessimism in these matters does not in my judgment necessarily render research on the policy process, technical or otherwise, nugatory. First, scientific work should not be tightly constrained by what appears politically feasible today; history is replete with examples of reforms (e.g., flexible exchange rates) previously thought unacceptable. Second, as Willett and Laney (1982) have argued, positivistic analysis which indicates that political forces have shaped policy does not imply that the only way to engender a less destabilizing policy is to deal directly with underlying political and social forces. It can be argued that the boundaries (constraints) defining the possible scope of Fed actions in the short run are neither unduly narrow nor wholly exogenous. Incentive structures can be altered and marginal improvements may well be possible. Moreover, institutional arrangements are not immutable over the longer run and learning does occur.

The notion that increased specificity plus increased accountability for the Fed and its principals will enhance the credibility of economic policymakers and contribute to improved policy performance is quite appealing and deserves to be pursued. More specifically, since disclosure is an essential element of accountability, the policy process needs to be opened up if we are to secure constructive policy discussions and assessments. The Fed has traditionally resisted more openness on the grounds that it would mislead the public and interfere with a free-wheeling, frank exchange of views among policymakers and between policymakers and their staffs. On the former, Havrilesky is surely correct: "Guesswork and possible misinterpretation by private market decision-makers is a reflection of Federal Reserve secrecy rather than an aberrant psychological proclivity by market participants to be mislead and to overreact" (Havrilesky, 1982, p. 262). As for the contention that less secrecy would inhibit discussion internally, the virtual absence of such exchanges under current arrangements suggests that the previously discussed relationship between ambiguity and flexibility is a better explanation for the Fed's reluctance.

The Fed does now report to Congress the range and "central tendency" of FOMC members' expectations for GNP, inflation, and unemployment for the period 12-18 months ahead. Further movement on this front would be most desirable (see House Banking Committee, 1983). Nonetheless, the profound difficulties emanating from what might be called "time inconsistency"--that is, the lack of congruence between the length of the time period linking policy actions and its several effects, and the relatively short time horizons of policymakers and their constituents--and the associated tendency to apply high discount rates to both forecasts and longer run effects of current policy actions, coupled with a dynamic econmy that is often changing in ways imperfectly understood,in my judgment, represent fundamental impediments to substantial progress.

VII. POST-1979 MONETARY POLICY: DRAMATIC AND DECISIVE IMPROVEMENT OR BUSINESS AS USUAL?

As this paper is being written (early 1984), the economy has been recovering for about a year and inflation has stabilized (temporarily?) at one half the rate prevailing over the 1979-81 period. Some, including the Fed, contend that inflation has been dealt a decisive blow and that sustainable, noninflationary growth is within reach _if_ the large budget deficits currently projected can be reduced dramatically. Central to this thesis is the notion that the Fed's 1979 change in procedures (see Figure 1), and the performance of policy since then, represent a watershed for U.S. monetary policy. The analysis developed above would lead one _a priori_ to be rather skeptical of such a conclusion.

The general features of the 1979 change in procedures, like many such reforms, were conceived earlier and born in a crisis setting. The perception of political and economic observers and policymakers was that inflation, and perhaps policy, were out of control. Focusing on the near term, the Fed, for its part, believed that a substantial rise in interest rates would be needed to brake (break?) the economy, slow down monetary growth, and reduce inflationary pressures and inflationary expectations. Viewed against this background, the change in procedures was a tactic to engineer a significant reduction in monetary growth and increase in interest rates, and, at the same time, put some distance between the Fed's actions and the financial and economic repercussions. Focusing on the longer term, the change can be viewed, in part, as another step toward finding "a better place to stand" (Bouey, 1982) so as to more effectively fend off expansionary pressures.

It is interesting to note that several members of the FOMC (in private communications with the author) have indicated that the details and full ramifications of the changes in procedures (especially the role of the discount rate and changes therein) were not clear to them nor, in their judgment, to most FOMC members at the time, or for months thereafter. Such contentions, along with the observable swings in policy since 1979, raise important questions about the real significance of, motivation for, and permanence of this, or indeed, any change in Fed procedures. As explained in Figure 1, actual (as opposed to announced) policy procedures in 1983 bore little resemblance to the October 1979 - late 1982 experience.

VIII. LOOKING AHEAD

We tell our students that policymakers are guided by "the" public interest. Of course, we know better; since there is no single public interest, policymakers, in effect, mediate among often competing organized interests. Admitting the existence (necessity?) of shifting compromises among multiple objectives, however reluctantly, greatly complicates policy analysis, whether positivistic or normative. As Woolley argues: "The Federal Reserve's relationships with other actors are marked by a tension between the nominal political independence of the Federal Reserve and the kind of tasks it is called upon to perform in the economic system. It is called upon to be politically neutral while regulating an economic system which is not neutral in results. It is expected to act on the basis of reflective scientific judgment in an environment which stresses political responsiveness. It is asked to make technically correct decisions despite conditions of economic uncertainty that make it difficult to avoid errors and despite a highly conflictual scientific debate as to what 'correct' policy is" (Woolley, 1984, p. 15).

Various shortcomings in the economic analysis underlying policy-making--e.g., the failure to take adequate account of inflationary expectations, forecasting errors, and frequent vacillation on the causal significance of the monetary aggregates--and technical defects in regulations and monetary control procedures, have undoubtedly contributed to an erratic policy record. That policymakers are forced to operate in an environment characterized by considerable uncertainty over structural relationships and the path of the economy is undeniable. However, the core issue, ignoring the political environment for the moment, is what is the "best" policy strategy to follow in the face of such uncertainty. A basic tenet of constrained optimization theory is that short-run policy reactions should become smaller and more cautious as the degree of uncertainty increases. Given uncertainty about supply and demand in both the real and financial sectors, the theory does not specify precisely what reactions should be reduced in the face of uncertainty. Nonetheless, the thrust of the theory, combined with the political pressure flowing from the perception that central banks are the arbiters of nominal interest rates, has led the Fed (and most other central banks) to optimize subject to perceived constraints imposed by the political and economic environment by stabilizing or moderating fluctuations in nominal interest rates in the short-run.

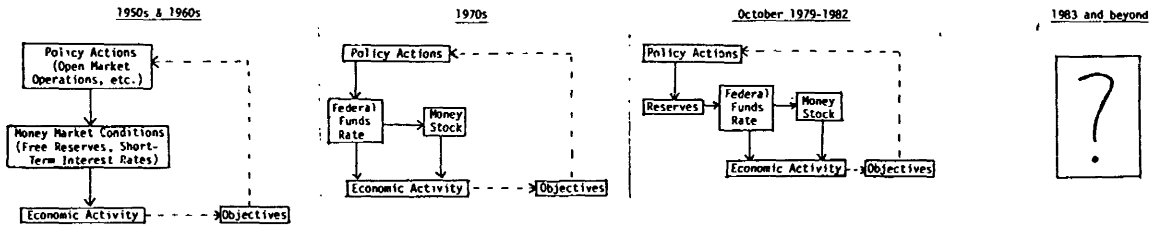
That the subsequent adjustments in interest rates have often been unduly delayed, contributing to an aggravation of cyclical fluctuations is well documented. Thus, despite the lip service and periodic commitment to reserve and monetary aggregate objectives, pervasive uncertainty and the confluence of political and economic forces, including the fact that the effects of policy actions tend to have more effect on real output and employment in the short run and prices in the longer run, pose a formidable barrier to far-reaching and lasting alterations in procedures and practices. Perhaps Lindbeck is correct: "The main problem is not that we are unable to understand analytically what is happening, but rather that the institutional and the discretionary policies that are necessary for macroeconomic stability seem to be politically difficult to implement" (Lindbeck, 1976, p. 18). Taken together, the Fed's scapegoat-lightning rod role, firmly embedded in the institutional structure governing the formulation, implementation, <u>and</u> evaluation of policy, and an abiding focus on the short run, go a long way toward explaining the low correlation between the Fed's rhetoric and the record.

Looking ahead, many have argued that a closer correspondence between the rhetoric and the record would enhance the "credibility" of policymakers and, simultaneously, through the salutary effect on expectations, reduce the impediments to achieving a noninflationary growth path for the economy. Unfortunately, designing <u>viable</u> reforms to produce or induce a closer correspondence appears quite formidable. Moreover, theoretical arguments aside, "credibility" is a slippery concept: "We do not know how to measure it, certainly do not know how to produce it, and have only the foggiest notion of whether or to what degree it is absent or present" (Cagen, 1982, p. 78); "The credibility of monetary policy with the public is damaged by comment from the profession implying that monetary policy is a simple matter that, with a little intelligence and goodwill, could reliably produce predictable results" (Wallich, 1982, p. 243).

The conundrums facing policymakers and policy analysts should now be clearer. Presumably, such a modest step is itself a good beginning.

FIGURE 1

THE EVOLUTION OF FED POLICY



The solid lines and arrows indicate the predominant direction of causation once policy actions are undertaken. The dotted lines indicate the monitoring and feedback which occur as policymakers observe incoming economic data and adjust policy in light of the objectives ("full" employment, price stability, etc.) being pursued. During this period, policy was framed in qualitative terms; policymakers would vote for an "easier" or "tighter" policy, decide to "lean against the wind", etc. Such intentions were translated into policy actions producing fairly modest changes in money market conditions. Critics argued that the strategy was vague and that its analytical foundations were weak. Many called for more quantification and for policymakers to give more weight to controlling the growth of the money stock in formulating and implementing policy. Policy outcomes in the last half of the 60s, ongoing research, and the ascendency of Arthur Burns to the Fed chairmanship led to the next stage.

Beginning in 1970, the money stock became an official "intermediate" target of, and therefore guide for, Fed policy. The term "intermediate" means that the money stock lies between the Fed's instruments and the ultimate targets (or objectives) in the transmission mechanism linking policy to the economy. Control over the money stock was exerted by manipulating the Federal funds rate; if money growth was deemed excessive (inadequate), the funds rate was raised (lowered). Selecting the correct funds rate--correct in the sense of being likely on average to be consistent with the Fed's money stock targets and final objectives--proved difficult for the Fed's forecasters. More fundamentally, policymakers seemed unwilling to move the funds rate sufficiently; as the solid line running from the funds rate to the economy indicates, most policymakers believed interest rates were the cutting edge of policy (the money stock was a useful way to "index", communicate and "discipline" policy). The tendency to delay or moderate rate movements, whether for political or economic reasons, contributed importantly to the continuation of destabilizing policies. Many argued that the form, but not the substance of policymaking had changed; policymakers were still preoccupied with money market conditions, as indexed by the funds rate.

Designed to improve the Fed's control over monetary growth, the volume of reserves thought to be consistent with the Fed's money stock target became the proximate guide for policy actions. Instead of deliberating the "appropriate" change in the funds rate whenever the money stock deviated from its target, adhering to a given reserve path in the face of such a deviation would lead to an automatic (and often large) adjustment in the funds rate. Simply put, if money and reserve demand rose, the funds rate--the "price" of reserves--would have to rise to equilibrate supply and demand. During the 70s, in contrast, the supply of reserves was usually adjusted to moderate the effect of a shift in demand on the funds rate. The automatic adjustment accompanying the change in procedure was in turn expected to lend to a quicker return of the actual money stock to its target path. Over the period, the variance of the money stock and interest rates increased, the economy experienced two recessions, and the inflation rate fell dramatically. As 1982 unfolded, it became clear that this mixed record and the murky domestic and international outlook was leading the Fed to rethink its procedures and basic policy stance once again.

Perceived weaknesses in the domestic and international economies led the Fed to ease policy significantly from mid-1982 through the spring of 1983. As monetary growth accelerated and interest rates declined, the U.S. economy recovered. With money stock growth (M1) exceeding its target by a wide margin, the Fed pointed to distortions introduced by ongoing innovations and deregulation, shifted target ranges, base periods, and the emphasis accorded various aggregates (M1, M2, M3), and argued for "flexibility" in responding to emerging developments in such uncertain times. That the Fed had again altered its approach to policy was clear. Given the relative stability of the Federal funds rate over most of the year, many argued the Fed had returned to the discarded strategy of the 70s. Seemingly engaged in "successive approximation", clear guideposts for the future conduct of policy were not in evidence as 1983 ended.

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