→ Mr Turnbull No.10

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P Wynn Owen Esq
PS/Chancellor of the Exchequer
HM Treasury

Your reference

Our reference

Date 28 February 1985

Dear Phillip,

As discussed, I attach copies of Paul Volcker's testimony before (a) the House Banking Committe and (b) the Senate Foreign Relations Committee this week.

Yours ever,

Harry

H G Walsh

c. with attachments

R G Lavelle Esq
HM Treasury

T Lankester Esq
HM Treasury

CH/EXCHEQUER
REC. 11 MAR 1985
MR LITTLER
MR UNWIN
MR TURNBULL (NO.10)

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

February 26, 1985

I appreciate this opportunity to appear before you to present the Federal Reserve's monetary policy objectives for 1985. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve was transmitted to you earlier. That report reviews in detail economic developments and monetary policy in 1984, and sets forth for 1985 the plans for policy by the Federal Open Market Committee. This morning I would like to discuss the Committee's decisions and the outlook for the economy in the context of some important unfinished business facing all of us responsible for economic policy.

## The Economic Setting

The familiar objective of monetary policy is to foster sustained economic growth and employment in a context of reasonable price stability. Stated so generally, that objective can hardly be challenged; it indeed encompasses the broad goals of economic stabilization policy generally.

Measured in those terms, there is clear reason for satisfaction in the performance of the economy last year. In summary, with real gross national product up by 5-1/2 percent over the year, and by about 12 percent in two years, we have enjoyed the strongest expansion since the Korean War period. On top of the gains in jobs in 1983, employment increased by over 3 million last year. The unemployment rate fell one full percentage point to 7.2 percent at year-end. Real incomes for the average American are up.

Prospects for sustained growth and productivity over time rest importantly on success in achieving and maintaining an environment of greater stability of prices and financial markets. In that light, it is encouraging that, contrary to widespread earlier expectations, the strong growth of 1984 took place without inflation increasing appreciably from the sharply reduced levels of 1982 and 1983. Specifically, the consumer price index increased around 4 percent last year, little changed from the previous two years, and prices of most goods (in contrast to services) at the wholesale and retail levels rose by less than that. While the evidence is less tangible, there are also encouraging signs that chronic expectations of future inflation have been damped.

The behavior of actual prices and nominal wages, which by some measures rose more slowly in 1984 than in 1983 despite expanding demands for labor, may in some part reflect those changes in attitude. Businessmen and workers no longer seem so preoccupied with a need to anticipate inflation in their pricing and wage decisions. And declines in bond yields after midyear seemed to reflect, to some degree, less fear of future inflation.

To be sure, a number of factors that may not be lasting have helped to hold price increases down. The continuing appreciation of the dollar and strong competition from imports have placed strong pressures on prices and wages in some manufacturing and mining industries. Widespread declines in

commodity prices cannot persist indefinitely. Unemployment is still higher than we would like to see. But it is also true that progress against inflation, as it is prolonged, can potentially feed on itself by encouraging restrained price and wage behavior.

As we start 1985, the immediate economic outlook appears reasonably favorable in these respects. Projections of Federal Open Market Committee members that I will be reviewing later in my testimony broadly parallel those of the Administration, the Congressional Budget Office, and many other observers; economic growth is expected to remain strong enough in 1985 to produce some further decline in unemployment, with little if any pickup in inflation.

But we must not be beguiled by those tranquil forecasts into any false sense of comfort that all is well. If the enormous potential of the American economy for growth and stability -- not just for 1985 but for the years beyond -- is to become reality, we need a sense of urgency, not of relaxation.

For one thing, with the general price level still rising in the neighborhood of 4 percent a year -- and with prices of services that today account for so much of the economy rising more rapidly than that -- we should not confuse evidence of progress against inflation with ultimate success. Indeed, the more favorable price expectations I noted a few moments ago

could prove fragile -- highly vulnerable to any indications that public policy is prepared to accept and accommodate to inflationary forces. That must be of particular concern in the conduct of monetary policy.

Perhaps more immediately, despite the strength of the overall expansion, some important areas of the economy are under strain and there have been recurrent international and domestic credit problems. Those strains and pressures are aggravated by underlying imbalances that, unless dealt with effectively, will undercut the long-term outlook.

One of those imbalances was highlighted by the slowdown in GNP growth we experienced in the third quarter. Such a "pause" is not an unusual feature of an expansion period. Demand does not grow smoothly, and occasional inventory imbalances will develop that require production adjustments. What was unusual last summer was that the slowing of demand growth was accompanied by a surge in imports, magnifying the effects on domestic producers. That summer import surge was reversed by year-end, but the underlying trend toward higher imports is clear. Our trade deficit increased to about $110 billion in 1984, far higher than ever before, and the entire external current account deficit -- counting both goods and services -- has deteriorated by about $100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

The rising trade deficit helps account for the failure of a number of important sectors to participate at all fully in the expansion. Agriculture, heavy capital equipment producers, and the metals industry, all of which face difficult structural problems in any event, are examples. They are further pressed by interest rates that, as you know, remain historically high, both in nominal terms and relative to recent inflation.

Looking abroad, growth in many industrial countries remains sluggish amid continuing high levels of unemployment, and depreciation of their currencies vis-a-vis the dollar seems to be one factor inhibiting more expansionary policies. Important developing countries are still struggling to restore stability and maintain growth while laboring under heavy debt burdens. In this interdependent world, these difficulties feed back on our own prospects.

(ii) It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits -- deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

Government deficits can be relatively benign and even useful in boosting incomes and purchasing power in the slough of recession and when private investment and credit demands are weak. It is also true that our growing volume of imports

over the last two years has provided an impetus for growth in other countries when other expansionary forces were weak. Moreover, the kind of obvious squeeze on, or "crowding out" of, domestic housing and investment that many anticipated as the expansion has developed has not been apparent.

We have been able to reconcile high deficits, sharply rising imports, and strong investment mainly for one reason: we have been able to attract an enormous amount of savings from abroad to supplement our own. The net capital inflow approached $100 billion last year, and it will probably need to be still larger this year. Domestic net savings -- by individuals, businesses, and state and local governments -- are running at about $325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

That same inflow of funds has encouraged a very strong dollar. The strong dollar, in turn, contributes importantly to the huge and growing trade deficit. Our policy dilemma is simple but perhaps not fully understood. We cannot logically welcome the capital inflow from abroad in one breath and complain about the trade deficit in the next. They are two sides of the same coin.

We are managing to finance the deficit and maintain housing and investment expenditures with the help of imported

capital. At the same time, the exporter, those competing with imports, and the farmer are being "crowded out."

Looking ahead, the stability of our capital and money markets is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets. So far, they have been not only willing but eager to do so. But we are in a real sense living on borrowed money and time.

It is up to all of us to make constructive use of both the money and the time. In essence, that is the challenge for all of us -- for monetary and fiscal policy, and for all the other policies that can contribute to a productive, growing economy.

## Monetary Policy in 1984

As you will recall, the economy was expanding particularly rapidly during the early part of 1984, and demands for money and credit -- and for bank reserves to support monetary growth -- were also strong. By early spring, data available at the time showed M1 increasing at rates well into the upper portion of its range for the year, which targeted growth at 4-8 percent.* At the same time, driven by the financing needs generated by rising levels of private spending and by the Federal Government,

*The data in this testimony for the monetary aggregates reflect recent seasonal and benchmark revisions. While the changes for the year as a whole were small, the revised data for M1 for the first half of the year are lower, and the second half higher, than reported earlier.

M3 and non-financial credit were expanding around or above the upper end of their long-term ranges.

The strong expansionary forces in the economy were reflected in some limited upward movements in interest rates in February and March, and early in the spring the Federal Reserve began to exert some additional restraint on reserves being supplied through open market operations. Consequently, depository institutions were forced to rely increasingly on borrowing at the discount window to satisfy demands for reserves. With credit demands and the economy continuing to expand strongly, and with markets concerned about the possibility that inflationary forces might reassert themselves as the period of strong expansion lengthened, interest rates moved noticeably higher in the spring. In April the Federal Reserve increased its discount rate 1/2 of a percentage point to 9 percent to bring this rate into better alignment with market rates and to discourage reserve adjustment at the discount window.

In May, a liquidity crisis developed in one of the largest commercial banks in the country, growing out of continuing concerns over weaknesses in its loan portfolio. The Federal Reserve, the FDIC, and the primary supervisor of the bank, the Comptroller of the Currency, worked closely together to support the orderly functioning of the institution while more permanent recapitalization and other elements of a long-term solution could be developed. Nonetheless, that incident, together with continuing concerns about international debt problems, for a

time contributed to uneasiness in banking markets, and interest rates on short-term private credit instruments rose appreciably above those on government securities.*

Demands for money slackened after midyear as the economic expansion slowed. Long-term interest rates began to drop from the higher levels reached in the spring as inflation concerns moderated. With the problems of the Continental Illinois Bank contained and progress made toward restructuring the debts of some important developing countries, the abnormal interest rate spreads began to narrow, but the money markets as a whole remained under some pressure. By late August and September, with M1 growth moving toward the midpoint of its range and M3 expansion slowing toward the upper end of its range, and with some evidence that economic growth had slowed, the Federal Reserve began to ease pressures on reserve positions.

That process continued through the fall, and borrowing at the discount window fell steadily from September through January. Late in the year, total and nonborrowed reserves began to grow rapidly. Short-term interest rates declined between 2-1/2 and 3-1/2 percentage points over the last four months of the year. Reacting to these declines, and to an extent facilitating them, the Federal Reserve in two half-point steps reduced the discount rate to 8 percent, the lowest level since 1978.

*Attachments I & II summarize these and related developments, and the Federal Reserve response, more fully.

Several additional factors influenced judgments about the appropriate degree of easing of reserve positions during the fall. The dollar remained exceptionally strong in foreign exchange markets, potentially increasing pressures on some sectors of the American economy and a source of growing concern among some of our trading partners experiencing depreciating currencies vis-a-vis the dollar. At the same time, relatively favorable incoming data about prices and wages tended to allay concerns about actual and potential inflationary pressures. In fact, prices of many sensitive commodities were falling appreciably. In these circumstances, reserves could be provided more liberally, and growth in the money supply more actively supported without providing a basis for a destructive rise in inflation expectations.

The fall in interest rates and the more generous provision of reserves in the context of some increases in economic activity led to a rather strong revival of M1 and M2 growth around year-end, bringing both aggregates relatively close to the mid-points of their respective ranges. As monetary and credit growth continued at a relatively rapid pace into January, the easing process came to an end.

Unlike the pattern during much of 1982 and 1983, when M1 grew more rapidly than nominal GNP (that is "velocity" slowed), the income velocity of M1 rose 4 percent last year. That is broadly in line with cyclical experience in the past, taking

into account both the pattern of interest rate movements and income growth. M2 velocity also increased, rising around 1-1/2 percent following two yearly declines.

These developments provide some support for the view that velocity trends over time, as well as cyclical changes for these aggregates, may be returning to patterns more along the lines of earlier experience. In contrast, in 1982 and 1983, during a period of rapid transition to deregulation of deposit interest rates and substantial economic uncertainty, those earlier patterns had been disrupted and velocity had declined appreciably.

The rise in M3 and credit during 1984 exceeded expectations at the start of the year, and both measures exceeded by a considerable margin the upper limits of their ranges over the year as a whole. In fact, credit increased at its most rapid pace over the entire post-World War II period, both in absolute terms and relative to nominal GNP. Debt growth of this magnitude would appear to be much faster than consistent with the long-run health of our economy and financial system. It reflects to some degree the imbalances in our economy I emphasized earlier.

For example, the budget deficit led to expansion of federal debt of 16 percent, an unprecedented rate of growth in the second year of a business cycle. The growth of the debt of non-federal sectors, at nearly 13 percent, also was

high relative to past experience. A portion of this growth in private debt -- perhaps around 1-1/2 percentage points -- can be attributed to a huge volume of mergers, leveraged buyouts, and stock repurchases by businesses which had the effect of substituting debt for equity. Despite some sizable sales of new stock, non-financial corporations on balance retired about $70 billion of stock last year.

Whatever the circumstances and justification for the particular companies involved, a financial structure that tends toward more debt (and shorter debt) relative to equity becomes more vulnerable over time. More cash flow must be dedicated to debt servicing, exposure to short-run increases in interest rates is magnified, and cushions against adverse economic or financial developments are reduced. These are factors that prudent lending institutions should take into account in evaluating new credits, and reports suggest that some banks did in fact review their policies toward mergers and leveraged buyout financing as the year wore on.

While the effect cannot be isolated, the rapid growth of debt relative to GNP may also reflect the fact that domestic <u>spending</u> increased appreciably faster than domestic production, which is what the GNP measures. A new machine, for instance, will require financing, whether purchased at home or abroad, and sharply increasing amounts of capital equipment have in fact been imported. As I indicated earlier,

directly or indirectly, that financing may be supplied from abroad, alleviating the pressures on our market. But the debt burden inevitably rests with the borrower.

Monetary Policy in 1985

At its meeting last week the FOMC agreed to some small changes in some of the ranges for the monetary and debt aggregates tentatively set out last July. The modifications are in response to analysis of information now available and do not represent any change in policy intentions. As shown on the attached table, for M1, the Committee reaffirmed the lower tentative range it adopted last July of 4 to 7 percent growth from the fourth quarter of 1984 to the fourth quarter of 1985. M2 is targeted to grow between 6 and 9 percent, the same range as used in 1984. The upper end of that range was increased by 1/2 percent from the tentative range for 1985 set in July. That small adjustment reflects a technical judgment -- based on assessment of recent developments -- that M2 could expand more in line with income growth this year, in keeping with the historic record of little trend growth in its velocity.

The upper end of the new M3 range of 6 - 9 1/2 percent was also set 1/2 percent higher than tentatively agreed in July. The associated monitoring range for credit was set at 9 to 12 percent, a percentage point above the 1984 range. Adjustments in both target ranges still contemplate a considerable slowing in these two aggregates from what actually occurred

in 1984. Even so, credit growth, fueled in part by the budget deficit, is expected to be quite strong, significantly exceeding the rate of expansion of GNP for the third consecutive year.

The Committee does not anticipate that growth of debt within the targeted range would necessarily pose significant new risks for the economy or the financial system in the year immediately ahead. However, a healthy financial structure will in time require more restraint on borrowing relative to the economic growth that, in the last analysis, provides the wherewithal to service the debt. One continuing problem in that respect is the extent to which the current tax structure tends to favor debt rather than equity financing, a point addressed in the Administration's reform proposals.

The ranges for growth in money and credit are expected by FOMC members and non-voting Reserve Bank Presidents to support another year of satisfactory economic expansion without an acceleration of inflation. Forecasts of real GNP growth centered around rates of 3-1/2 to 4 percent from the fourth quarter of 1984 to the fourth quarter of 1985 -- rates anticipated to be sufficient to reduce the unemployment rate to around 6-3/4 to 7 percent by year-end. Inflation, as measured by the GNP deflator, was expected most frequently to be in a range of 3-1/2 to 4 percent over the year, about the same rate as prevailed in 1984.*

*These projections, now regularly set out in our Humphrey-Hawkins Reports, should not be interpreted as indicating "targets" for real growth or inflation in the short or longer run. As discussed in Attachment III, the Committee does not target a specific long-range growth path for the economy.

In view of the necessarily tenuous nature of any judgment about the outlook for exchange rates, FOMC members in preparing their projections assumed that the dollar would fluctuate in a range encompassing its level of recent months. They also assumed that the federal budget deficit would be reduced significantly in fiscal 1986 relative to base line projections, a development that would help damp both interest rate and inflationary expectations. Obviously, those assumptions suggest some of the important risks inherent in the outlook.

As I indicated in discussing 1984 developments, we entered 1985 with the various monetary aggregates growing relatively rapidly. The targets for this year take, as usual, the actual average for the fourth quarter of the previous year as a starting point (or "base"). Consequently, we are starting the year with the levels of the aggregates above the target ranges as they have been conventionally illustrated -- that is by so-called "cones" starting at a point late the previous year and widening through the current year. (See Charts I to IV.)

That conventional and widely used "picture" is essentially arbitrary. Interpreted rigidly (and wrongly), the narrowness of a cone in the early part of the year -- literally narrower than some <u>weekly</u> fluctuations in the money supply -- would attach policy importance to levels or movements in the various aggregates that in fact have no significance.

We have sometimes considered, and others have suggested, a better "pictorial" approach would be to illustrate the targets

by a different (but also necessarily arbitrary) convention -- parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period, as shown in the charts attached. The target range is then portrayed as maintaining the same width throughout the year. The current levels of the aggregates, as you can see on the charts, are within such parallel lines.*

As a matter of economics and policy, rather than graphics, the Committee is not disturbed by the present level of M1 and M2 relative to its intentions for the year. It contemplates that, as the year progresses, growth will slow consistent with the target ranges.

Consistent with that approach, as I indicated earlier, the progressive process of easing reserve positions undertaken in the latter part of 1984 ended. The provision of reserves through open market operations is currently being conducted a bit more cautiously to guard against inadvertent "overshoots" in supplying reserves. Any further change in approach will, as always, depend upon assessments of the trend of monetary growth in the period ahead, evaluated in the context of the flow of information on the economy, on prices, and on domestic credit and exchange markets.

The annual target ranges for M1 and M2 assume that trends in velocity are returning to a more normal and predictable

*Attachment IV addresses the different but related questions of the appropriate "base" used in setting and illustrating targeted growth ranges.

pattern. However, there is some analysis that suggests the trend of velocity over time may be a little lower than the trend of 3 percent or so characteristic of much of the postwar period when interest rates were trending higher. Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee anticipates that those aggregates might end the year in the upper part of their ranges. The lower part of the M1 range would be consistent with greater cyclical growth in velocity than now thought likely. As usual, these ranges will be reviewed at mid-year, in accordance with Humphrey-Hawkins Act procedures.

## The Challenge Ahead

The approach toward monetary policy that I have outlined for 1985 is designed to promote, as best we can, our common objectives of sustained growth and stability. We can build on the strong progress of 1983 and 1984. There is forward momentum in the economy. The public at large seems to sense a greater degree of control over inflation than for many a year -- and I sense some chance of further progress toward price stability this year even as the economy grows.

Happily, despite the strength of the economic advance and the financing of a huge deficit, interest rates are today little above those of two years ago. The threats of financial dislocation growing out of the debt problems of much of the

developing world, or from more purely domestic financial pressures, have been well contained. Points of strain will, without doubt, require continuing attention this year. But, in the context of a healthy economy, they are capable of resolution.

By encouraging appropriate growth in money and credit, in discharging our supervisory responsibilities, in performing when necessary the essential functions of lender of last resort, and in our general surveillance of the financial system, the Federal Reserve can help build on that progress. We aim to do so.

But it is equally important to understand clearly what monetary policy and the Federal Reserve cannot do.

The progress against inflation, the strength of the dollar and the competition from abroad, and some margins (if diminishing) of capacity and manpower have provided a certain degree of flexibility in the conduct of monetary policy. But that limited flexibility would be abused at our collective peril. Credibility in the effort to deal with inflation is a precious thing. The lesson here and abroad, now and through history, is that, once a sense of price stability is lost, it can be restored only with pain and suffering.

The Federal Reserve can theoretically run the modern equivalent of the printing press -- we can create more money. But more money is not the same as correcting the gross imbalance

between our ability to generate real savings and the demands for those savings posed by housing, by investment and by the federal deficit.

To create money beyond that needed to sustain orderly growth would be to invite renewed inflation -- damaging incentives to save in the process. In contrast, to encourage savings from income would be to provide more of the real resources we need for future growth -- and it would help spur productivity and reduce price pressures in the process.

If that route isn't open to us -- and as a practical matter we probably can't do much right now to change ingrained savings behavior -- then the only constructive alternative is to attack the problem from the other side of the ledger by reducing the federal deficit.

For the time being, capital from abroad has been readily available to close the growing gap between our domestic savings and the demands upon them, moderating pressures on interest rates. Indeed, the money attracted partly by perceptions of our strength has come so freely we have an exceptionally strong dollar. But that same strong dollar contributes to a massive trade deficit that strains key sectors of industry and our agriculture, aggravating structural problems.

No doubt bad monetary policy could drive the dollar down -- a monetary policy that aroused inflationary expectations, undermined confidence, and drove away foreign capital.

But then, how would we finance our investment and our budget deficit?

Nor is the process of money creation adapted to relieving particular sectoral strains within our economy. We can and will, in our administration of the discount window and in our actions as lender of last resort, protect the essential financial fabric by supporting credit-worthy depository institutions faced with extraordinary needs.

But the evident problems of particular sectors, in the last analysis, will yield only to measures that support their efficiency and broaden their markets. That in itself is a large agenda, for government and those involved alike. And the process will be much easier if we at the same time address the basic imbalance between our capacity to save and our need to invest and to finance the government that I have emphasized today.

## Conclusion

I fully appreciate the difficulties of the decisions before you as you collectively approach those excruciating budgetary choices. As you do so, I know that you are aware of the priority that progressive reduction of the deficit deserves. That, indeed, would provide the most fundamental kind of reassurance that growth <u>can</u> be sustained in an environment of greater stability.

For our part, in the conduct of monetary policy, we in the Federal Reserve will be sensitive to both the opportunities and the dangers before us. We believe the approach I have outlined with respect to the monetary targets and our implementation of policy sensibly reflects and balances the concerns I am sure we share.

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Chart 1

## M1 Target Ranges and Actual

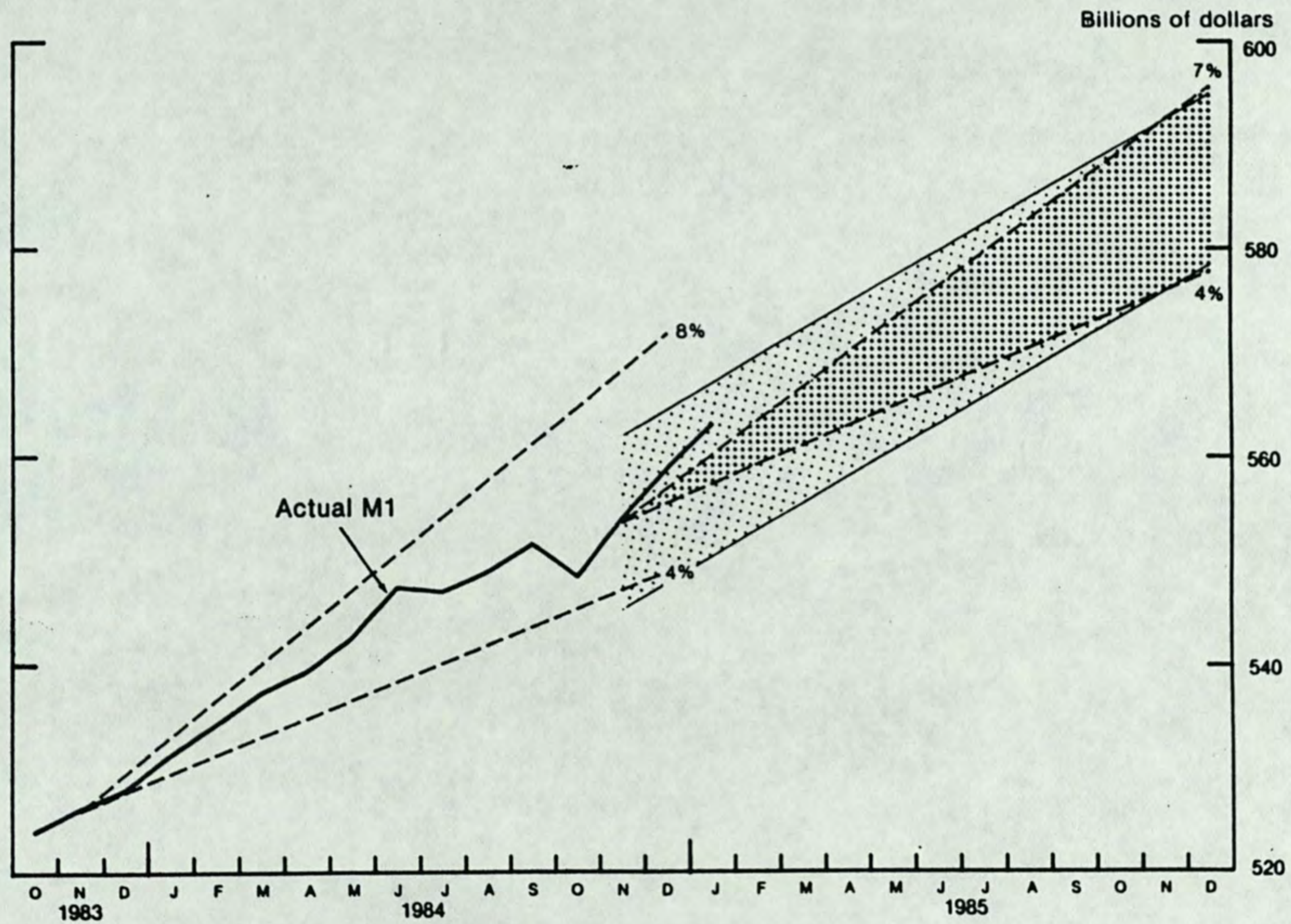


Chart 2

## M2 Target Ranges and Actual

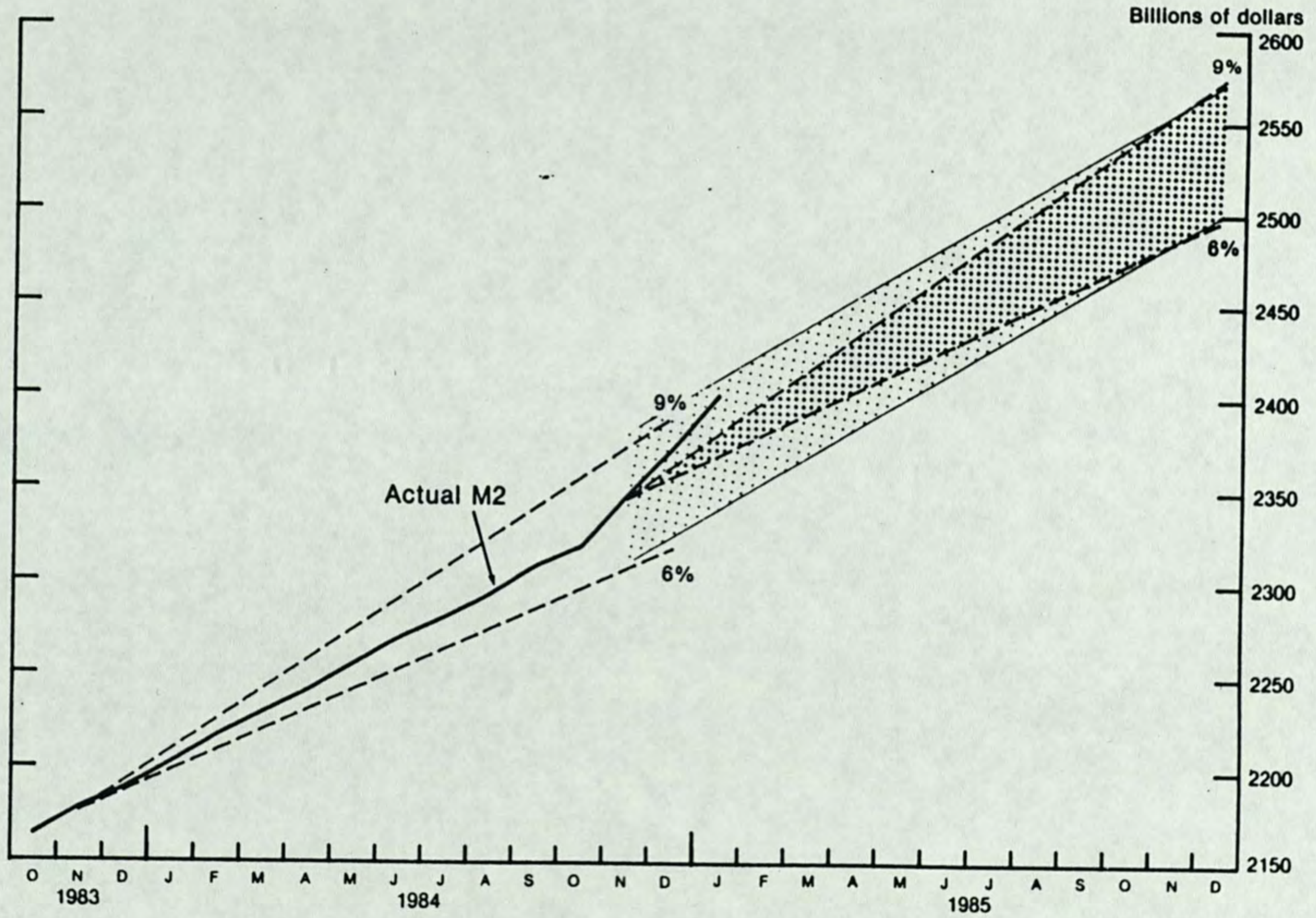


Chart 3

## M3 Target Ranges and Actual

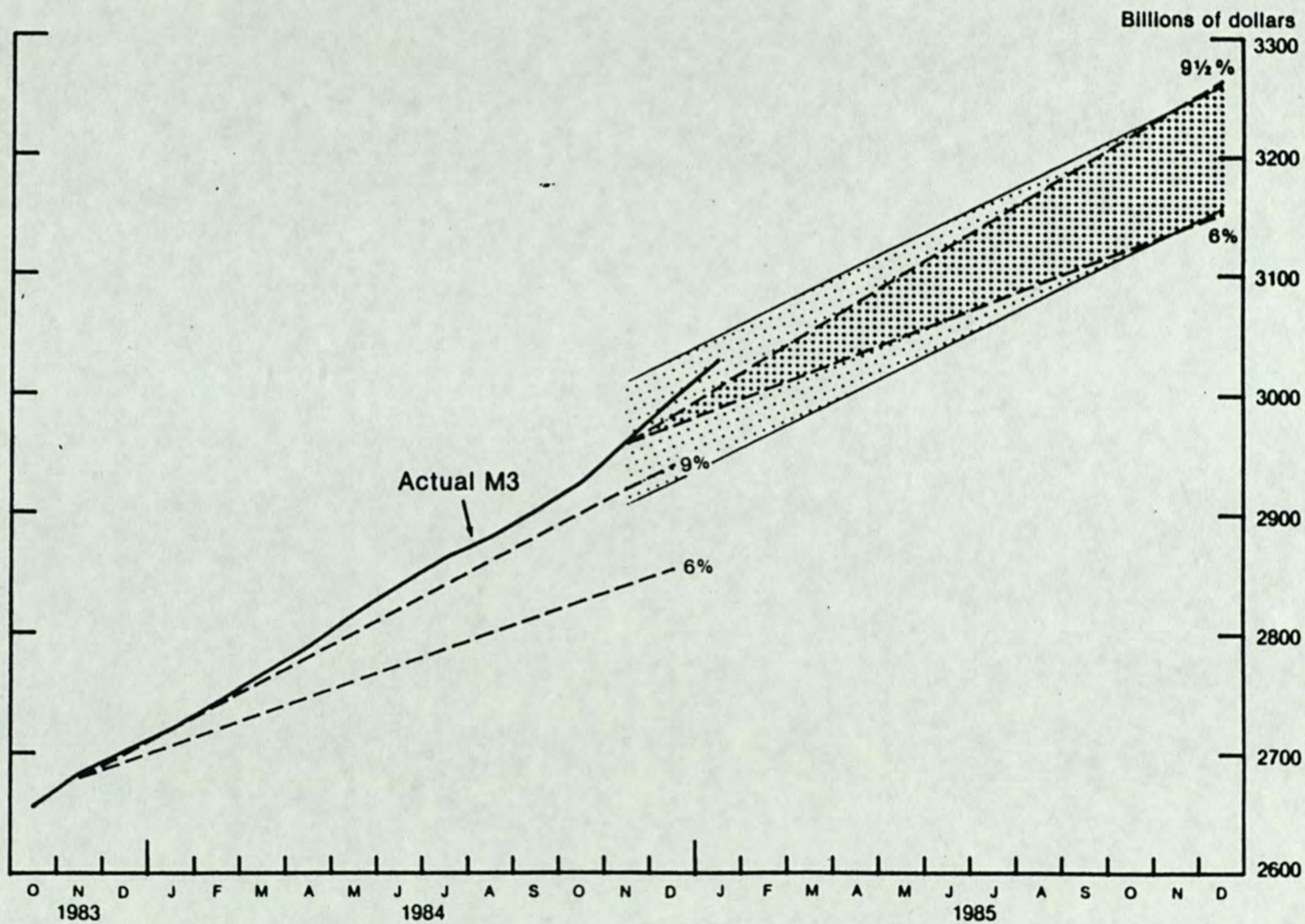
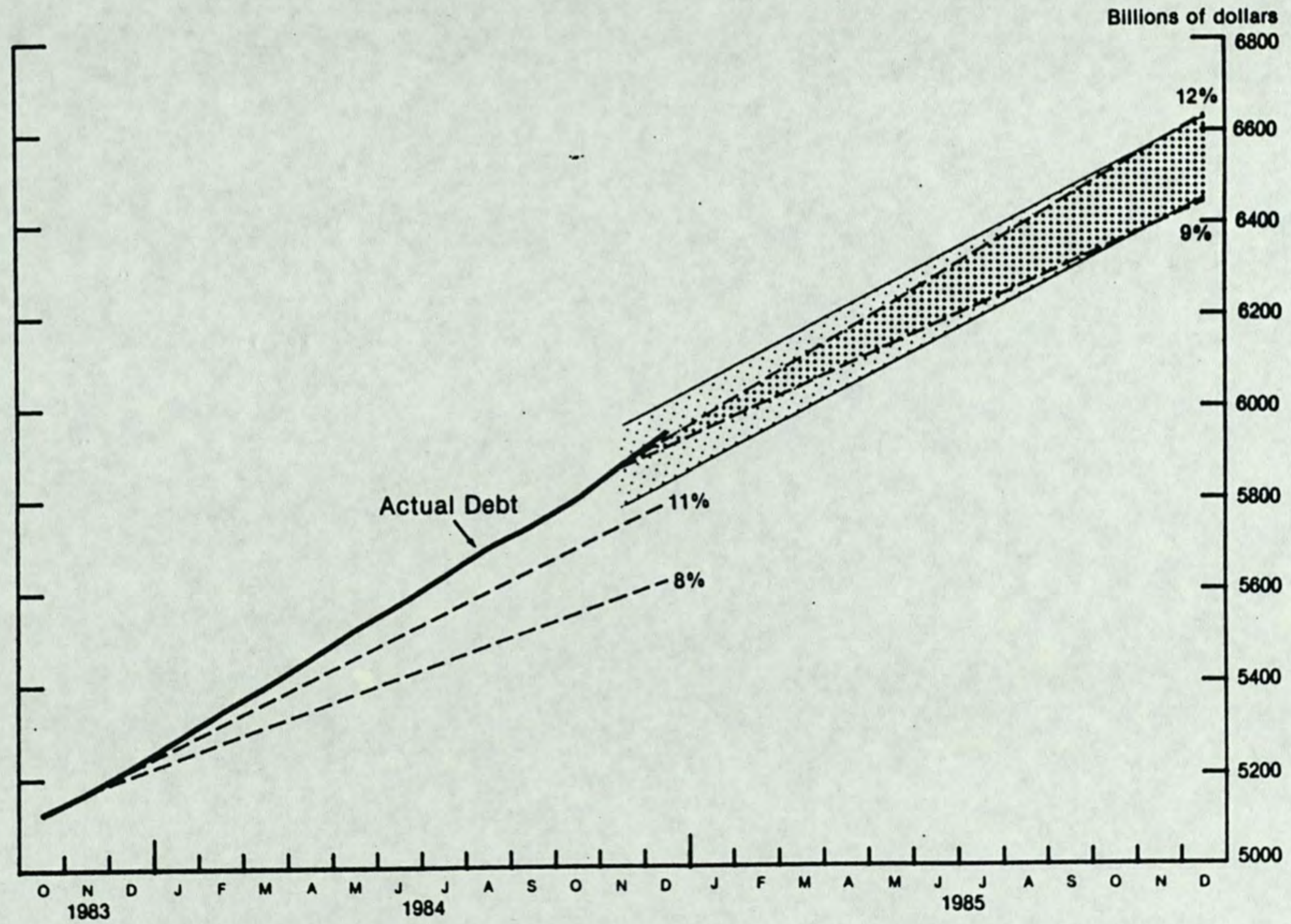


Chart 4

## Debt Monitoring Ranges and Actual



## Attachment I
## The Implications for Monetary Policy of the Near Failure of the Continental Illinois Bank

The condition of the Continental Illinois Bank -- the seventh largest in the United States at the beginning of 1984 -- had been a matter of concern to regulatory authorities and market participants for some time, particularly after the failure of the Penn Square Bank in the middle of 1982 brought to light large loan losses and weaknesses in credit policy. Continuing profit and loan problems culminated in rumors of possible impending failure and a liquidity crisis in May 1984, involving withdrawal or failure to renew billions of dollars of deposits in the bank over a few days.

The FDIC, the Federal Reserve, and the Comptroller of the Currency, with the cooperation of a group of major banks, developed arrangements to provide temporary capital and liquidity support pending more permanent solutions and reorganization. The Federal Reserve -- acting as lender of last resort -- provided large amounts of funds through the discount window to maintain the bank's liquidity. That lending rose irregularly from around $3 billion during most of May to a peak of more than $7 billion in August. During the autumn the amount of outstanding loans declined to much reduced levels.

Provision of funds through the discount window has the effect of expanding total bank reserves, and unless otherwise offset, the lending to the bank would have had the effect of

expanding the money supply well beyond targeted ranges. To maintain consistency of reserve provision with FOMC intentions, essentially equivalent amounts of reserves were absorbed by open market operations. While the large borrowings necessarily involved some added technical difficulties and uncertainties in the conduct of open market operations, the Committee was able to achieve its reserve objectives.

At the same time, however, the liquidity crisis of Continental Illinois Bank, particularly in an environment in which international debt and other credit problems were attracting attention, generated concern about possible threats to the stability of other financial institutions. As a result, interest rates on banking liabilities rose appreciably relative to interest rates on Treasury securities during the spring. More cautious funding and lending policies by a number of banks appeared to have some effect on maintaining short-term interest rates at higher levels than might otherwise have been the case.

The extraordinary concerns in the marketplace dissipated as the year wore on, reflecting some sense of progress in dealing with both the international debt situation and points of domestic financial strain. Strong liquidity pressures at one of the largest savings and loan organizations during the late summer and fall, requiring sizable liquidity support by the Federal Home Loan Bank System, had lesser effects on market attitudes.

The experience of 1984, together with supervisory efforts and the strong continuing pressures on some sectors of the economy have underscored for depository institutions the importance of adequate capital and prudent lending policies, and other means of assessing and controlling risk. Substantial efforts have been made by many of the larger banking organizations to increase capital ratios and to review credit standards. In time, in the environment of a growing economy, these efforts should be reflected in stronger institutions and a reinforced banking system.

Attachment II
The International Debt Situation in 1984

At times during 1984, concerns about the external debt problems of key borrowing countries continued to be an important factor affecting attitudes in financial markets. As the year began, markets had substantial doubts about the viability of the Brazilian adjustment program, the programs of the new Venezuelan and Argentine governments were unknown, and there was some sense of weariness among the borrowing countries and their creditors. Tensions were aggravated by increases in dollar interest rates in the spring and early summer.

Subsequently, concerns in financial markets receded somewhat as interest rates moved lower, clear progress was recorded in narrowing some countries' external imbalances, and plans for long-term debt restructuring were developed for some of the largest borrowers.

The improvements in external accounts in Mexico and Venezuela in Latin America, and in Yugoslavia and Hungary in Eastern Europe, produced current account surpluses last year. Brazil's current account deficit was essentially eliminated, and a number of other countries had reduced deficits.

This progress was faciliated in many cases by significant increases in exports, particularly to the United States, and in most cases was accompanied by a recovery -- or at least a slower rate of decline -- of imports. Such developments,

coupled with continued moderate capital inflows, contributed to sizable increases in the international reserves of many of these countries and to the prospects of reduced demands for extraordinary external financing in the future. At the same time, most of those countries managed to achieve domestic growth.

Against this background, several of the major borrowing countries were able to move on to a second phase in their adjustment and financing programs. One important iniative, when warranted by progress in adjustment, has been planning for longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico and Venezuela; serious negotiations have begun with Brazil and Yugoslavia; and the financing package prepared for Argentina contains some longer-term elements.

However, it is also evident from developments in 1984 and the first months of 1985 that the process of adjustment which began in 1982 is far from complete, particularly on the internal side. Financial markets will remain sensitive to indications of progress or the lack thereof. Cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required. The need for imaginative and constructive solutions to the problems faced by individual countries is not over.

## Attachment III
## Targeting Real Growth

Questions sometimes arise as to whether the Committee's forecasts for real GNP growth or prices are in the nature of short-run targets toward which the Federal Reserve "fine tunes" policy, or whether the Committee has preconceptions about just how rapidly the economy can and should grow over the medium or longer run.

The answer to those questions is no. Monetary policy is, of course, broadly directed toward sustaining the growth process in a non-inflationary environment. But the Committee as a group has no preconceived notion as to just how rapid growth can or should be over a particular period of time, without straining our resources or giving rise to price pressures and imbalances that would make it ultimately unsustainable.

Our capacity for growth over time depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence. There are other policies, public and private, quite outside the purview of monetary policy that will influence both our growth potential and actual growth paths over time. There are debates in and outside the Federal Reserve as to some of these factors that affect economic growth, but annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run.

For instance, the Committee would presumably welcome faster growth than predicted for 1985 if that proved consistent with moderating inflationary forces, and indeed, less inflation than anticipated would tend to encourage greater growth, consistent with our monetary targets. Indeed, the relationship between money and economic growth at any point in time is sufficiently loose that many other factors bear upon actual performance.

In sum, policies are periodically reassessed in light of incoming information about prices, output, exchange rates and other variables bearing on our growth potential and prospects for inflation. In practice there is sufficient flexibility in our targeting procedures to accommodate information that might suggest greater or lesser growth potential over time.

Attachment IV
The Base for Monetary Target Ranges

Some questions have been raised concerning the "base" used by the Open Market Committee in deciding on targets for the monetary and credit aggregates for the calendar year. Consistent with the Humphrey-Hawkins Act procedures, the Committee's target ranges are specified each February as a range of growth from the fourth quarter of the previous calendar year to the fourth quarter of the current calendar year.

The convention that is usually used, is that the beginning point -- or "base" from which growth is measured -- is taken to be the fourth quarter average growth of a particular monetary or credit aggregate. Other "bases" could be used -- and occasionally have been used -- if the conventional base period is seriously distorted, by institutional change or otherwise.

During its recent meeting the Committee, as it has from time to time, discussed the issue of the desirability of choosing a base for 1985 for one or more of the aggregates other than the conventional one. It concluded that none of the fourth quarter averages for the targeted aggregates were distorted in a manner that strongly suggested the desirability of departing from the usual convention, and that such a departure might indeed confuse communication of the Committee's intentions. It also noted that the average level of both M1 and M2

during the fourth quarter of 1984 was reasonably close to the mid-point of the previous year's range, an alternative base suggested by some. M3 and credit ran significantly above the 1984 ranges. Rebasing those aggregates at the mid-point of the 1984 ranges would thus have implied a wrenching adjustment in the levels of those aggregates, a result that would be contrary to the Committee's intentions. Essentially, such a change would have implied a substantial tightening to bring the growth of those aggregates into the new ranges, or, alternatively, a specification of ranges of growth for 1985 that would have been extraordinarily high and quite out of keeping with longer range intentions.

More broadly, a decision to regularly target growth from the mid-point of a previous year's range would seem to imply the continuing validity of a judgment made a year earlier that the mid-point of a previous range is in some sense a uniquely "correct" level of a monetary aggregate. The Committee does not share such a conviction. Instead, it believes that the appropriate trend of each aggregate needs to be judged in the light of evidence as to velocity changes and other factors as they emerge over time.

In setting targets for any year, the Committee is, of course, aware of the base level of the aggregate. Adjustments in the new target ranges themselves, or in the conduct of policy within those ranges, can take account of any modest distortions

in the base. Such considerations are reflected in the discussion of policy in the testimony.

Growth Ranges for the Aggregates for 1984
in Comparison with Actual Growth
(QIV to QIV)

| | Percent Increases | |
|---|---|---|
| | Ranges | Actual Growth |
| M1 | 4 to 8 | 5.2 |
| M2 | 6 to 9 | 7.7 |
| M3 | 6 to 9 | 10.5 |
| Domestic Nonfinancial Debt | 8 to 11 | 13.4 |

Growth Ranges for the Aggregates Adopted for 1985
in Comparison with Tentative Ranges and Those for 1984
(QIV to QIV)

| | Percent Increases | | |
|---|---|---|---|
| | Adopted Ranges for 1985 | Tentative Ranges for 1985 Set in Mid-1984 | Ranges for 1984 |
| M1 | 4 to 7 | 4 to 7 | 4 to 8 |
| M2 | 6 to 9 | 6 to 8-1/2 | 6 to 9 |
| M3 | 6 to 9-1/2 | 6 to 9 | 6 to 9 |
| Domestic Non-financial Debt | 9 to 12 | 8 to 11 | 8 to 11 |

For release on delivery
10:00 A.M., E.S.T.
February 27, 1985

CH/EXCHEQUER
REC. 11 MAR 1985
TO MR LITTLER
MR UNWIN
MR TURNBULL (NO.10)

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Senate Foreign Relations Committee

United States Senate

February 27, 1985

I am pleased to discuss with you this morning the role of the United States in the global economy. That role, of course, has many dimensions, and I can only touch upon a few of them this morning -- specifically on the relationships between our expansion and growth in the world generally, certain aspects of trade and exchange rate policy, and the problem of developing country debt.

As you know, we have enjoyed a strong recovery for more than two years, with the real Gross National Product rising by some 12-1/2 percent from the fourth quarter of 1982 to the fourth quarter of 1984.

GNP is a measure of production. Throughout this period, domestic demand has increased faster than the GNP. In essence, a significant fraction of demand currently generated here -- more than 2-1/2 percent -- is now flowing abroad, providing stimulus to production overseas. Put another way, U.S. purchases of goods and services have increased by about 15 percent over the past two years, as compared to the 12-1/2 percent increase in production.

With strong stimulus absent in the rest of the world, the growth of demand in the United States represented 70 percent of the total growth of demand in the OECD area from 1982 to 1984, even though we accounted for only 40 percent of OECD GNP in 1982. Moreover, countries outside the OECD area, including importantly many countries in Latin America, have similarly benefitted from the vigor of U.S. recovery.

The difference in economic performance over this period has been starkly evident in employment figures. In the United States, jobs increased by 7 million since the end of 1982. In contrast, there has been virtually no increase in employment in the rest of the OECD area as a whole, and in many of those countries unemployment rates have continued to fluctuate around their post-World War II highs.

At the same time, the growth and relative dynamism of the American economy have helped attract a flow of funds from abroad, strengthening the dollar even as our external trade and current accounts have moved into deep deficit. The growing net capital inflow -- now supplementing net domestic savings of individuals, businesses and state and local governments by nearly a third -- has been a critically important factor in enabling us to finance both rising investment and the enormous Federal deficit. The strength of the dollar and the ready availability of goods from abroad have also been potent factors restraining price increases for manufactured goods in the United States.

c1) From one perspective, those results are gratifying for us, and our trading partners have benefitted as well. But there are, of course, serious flaws -- flaws that unless dealt with constructively, will undermine all the progress. Strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of heavy capital equipment. There have been exceptionally high levels of unemployment in many

other industrialized countries, and, looking ahead, too few signs of significant improvement in that respect. Moreover, the financial position of the heavily indebted developing countries remains vulnerable. Those difficulties feed back on prospects for our exports and our financial system. Interest rates remain high relative both to historical experience and to recent rates of inflation.

Those strains have specific causes and potential remedies. But it is also true they are all aggravated by underlying imbalances in our trade and budgetary accounts. U.S. trade and overall current account deficits reached levels of almost $110 billion and $100 billion, respectively, during 1984. Such deficits seemed almost unimaginable a few years ago, yet the present prospect is that those external deficits could rise still further. And it is not a coincidence that those external deficits are accompanied by internal budget deficits of unprecedented size during a period of prosperity, deficits that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy U.S. economic growth.

Economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running are not sustainable indefinitely in a framework of growth and prosperity. They imply a dependence on foreign borrowing by the United States that, left unchecked, will sooner or later undermine the confidence in our economy

essential to a strong currency and to prospects for lower interest rates. But the hard fact is that we have come to rely on that foreign borrowing to finance the combination of a budget deficit and the private investment demands generated by a growing economy. The largest and richest economy in the world has perforce been required for the time being to draw on savings that might otherwise have been invested abroad. Indeed, the inflow of savings from abroad is equal to something on the order of 15 percent of net savings (or about 8 percent of gross savings) in all other OECD countries combined. And, the related exchange rate pressures, trade imbalances and financial strains generate political as well as economic pressures toward economic nationalism and protectionism.

(iv)

It seems to me essential that those pressures be resisted. There are powerful reasons why such an approach is not in our economic interest whatever the response abroad.

For instance, we have encouraged developing countries to adopt policies that will enable them to service their debts, to enhance over time their productive capacity, and to grow. Success is dependent upon their ability to increase exports -- and as their exports grow they will also import, from the United States and other industrialized countries. But that success will be denied if the United States and other industrial countries protect their own markets from fair competition by developing countries.

Even if we could somehow shield developing countries from broad protectionist measures -- and it is not clear that

in practice we could do so -- there are other high economic costs from widespread protectionism. Quotas, new tariffs, or import surcharges all act directly to raise prices, and the problem would not be temporary if the effect would be to refuel inflationary expectations -- just at a time when so much progress has been made in changing that psychology. Other things equal, protectionist measures that actually had the effect of appreciably reducing some imports would presumably be reflected in still further upward pressures on the dollar, hurting exporters and industries not protected.

Beyond those specifics there are potentially much more damaging risks of a breakdown in a world trading order built up so laboriously after the chaos of the 1930s.

Consider, for example, the proposals now being discussed for a temporary import surcharge. Those proposals are sometimes coupled with other measures to reduce our budget deficit. Such proposals are offered as a relatively painless means of raising government revenue while simultaneously addresing the trade deficit.

One attraction is that an import surcharge effectively taxes foreign exporters as well as domestic residents. But it is also clear that any benefits, either for trade or for the budget, would be temporary. More lasting favorable consequences of the proposals would be derived not from the temporary surcharge but from the accompanying budget measures.

I would question whether the imposition of a surcharge makes those accompanying measures easier, or more difficult,

to enact. In any event, so attractive a tax to the United States would certainly be attractive to others as well. Most countries have budget deficits larger than they would like, and with high unemployment would not be averse to reducing imports. If the surcharge approach is, in effect, legitimized by the United States, wouldn't others find almost irresistible temptations to emulate our example? Would not that eliminate any net benefits and also have destructive implications for world trade -- upon which our hard-pressed farmers, among others, are so dependent?

At a more fundamental level, we cannot logically take actions to reduce our trade deficit and at the same time welcome the associated capital inflows from abroad. The trade deficit and our capital inflow are two sides of the same coin. Unless we reduce our budget deficit, success in improving our trade balance, and thus reducing the capital inflow, will only threaten stronger pressures on our domestic financial markets, jeopardizing housing and investment.

(v) In essence, a lasting solution to the problem of our external imbalance rests on simultaneously restoring internal financial equilibrium. I know of no approach to that problem that promises success other than straightforward measures to reduce our budget deficit over time. Approaches that obscure that basic need will, in the end, be counterproductive.

I do not want in any way to suggest that, important as action with respect to the budget deficit is, that approach

will somehow deal with all the problems of the global economy. In particular, other industrial countries have clear responsibility and opportunity to take actions themselves to enhance their economic prospects. The importance of policies to deal with structural rigidities in their economies has often been noted. Moreover, in some important countries where inflationary pressures have been successfully contained, and where credible long-term anti-inflationary monetary policies are firmly in place, there may be scope for action to stimulate their growth by constructive measures to speed tax reductions or otherwise.

Certainly, much remains to be done to restore sustainable growth patterns in much of the developing world. Over the past two years or more, a number of the more advanced and largest developing countries, particularly in Latin America, have made serious efforts to implement appropriate adjustment programs in conjunction with IMF and private financing arrangements. Clear progress -- in some cases, spectacular progress -- has been made in eliminating or narrowing external imbalances. Mexico and Venezuela in Latin America, and Yugoslavia and Hungary in Eastern Europe, have produced current account surpluses. Brazil's current account deficit was essentially eliminated last year. Happily, most of those countries have also managed to restore a measure of domestic growth. All of that progress was facilitated by access to foreign markets, most importantly in the United States.

In some instances, the progress in adjustment has encouraged and justified longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico, Venezuela and Ecuador, and serious negotiations are underway with Brazil and Yugoslavia.

However, these signs of progress do not mean that the "debt problem" is behind us -- or that, more broadly, the borrowing countries are firmly on a path of sustained strong growth in a context of political and economic stability. Indeed, some of the more fundamental adjustments necessary to that end are still absent, or only partially in place. Inflation, for instance, remains disturbingly high in many of the countries, and in some is still rising to new peaks. Spontaneous new investment by either domestic firms or from abroad has often been slow to develop, reflecting in considerable part concern in some countries about the role for private investment and the degree of controls and market distortions. Moreover, on the more purely financial side, cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required despite the protracted and tedious nature of the process. Rather than impatience, the need remains for energetic and constructive approaches to the longer-term problems faced by individual countries.

I will conclude with a few words about the dollar. Few if any anticipated the degree of strength that the dollar has displayed persistently for some time, nor can it fully be explained by such factors as relative interest rates or differences in inflation rates. No doubt, relative confidence in our economic prospects, in our political stability, and in our business climate have played a part, as has a sharp diminution in our bank lending abroad. At the same time, the widening gap in our trade position suggests that our basic competitive position cannot support so high a dollar indefinitely.

The policy question is what measures can be taken to encourage a reasonably competitive equilibrium over time. I suggest that the general approach I have alluded to today would work in that direction.

Credible measures to reduce the U.S. budget deficit would alleviate one source of inflationary concern and encourage lower real interest rates than would otherwise be the case. In that environment, some other important industrial countries might find it easier to undertake more stimulative policies at home. If they managed at the same time to deal more effectively with some structural rigidities, the perceived contrast between the opportunities in the U.S. economy and the relative sluggishness of European economies could constructively be diminished. If developing countries could reduce inflation and restore more confidence in their own business climate, their own citizens would then employ more of their savings

in their own countries, and funds could again be attracted in greater volume from the United States or elsewhere.

(vii) At times, forceful official intervention in exchange markets could have a useful role to play. But that role has to be complementary and subsidiary to more basic measures to have lasting impact. That is why measures to deal with the fundamental imbalances in our own financial requirements are so important.

Over the near term, prospects for the economic performance of the United States, and to a lesser extent the rest of the world, appear to be favorable. We want to build sensibly on those strengths and to deal in a lasting way with the imbalances. Purely symptomatic treatment is not adequate -- and, in the form of protectionism, will be counterproductive. The more basic approaches necessarily take time, and we have let too much time pass already. But fortunately we can still proceed from a position of strength. I trust we will make the most of the opportunity before us.

*******

11 MAR 1985
11 12 1 2 3 4 5 6 7 8 9 10

Prime Minister (4)
Confirmation that Volcker for one does not regard the trade deficit / high dollar as sustainable and that a lower budget deficit is part of the solution. AT 13/3

RECENT TESTIMONY BY MR. PAUL VOLCKER, HOUSE BANKING COMMITTEE, 26 FEBRUARY, 1985

(i) Our trade deficit increased to about $110 billion in 1984, far higher than ever before, and the entire external current account deficit - counting both goods and services - has deteriorated by about $100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

(ii) It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits - deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

(iii) The net capital inflow approached $100 billion last year, and it will probably need to be still larger this year. Domestic net savings - by individuals, businesses, and state and local governments - are running at about $325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

/ (iv) But we

E.R.



(iv) But we are in a real sense living on borrowed money and time.

E.R.

SENATE FOREIGN RELATIONS COMMITTEE: 27 FEBRUARY, 1985

(i) But there are, of course, serious flaws - flaws that unless dealt with constructively, will undermine all the progress. Strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of heavy capital equipment.

(ii) US trade and overall current account deficits reached levels of almost $110 billion and $100 billion, respectively, during 1984. Such deficits seemed almost unimaginable a few years ago, yet the present prospect is that those external deficits could rise still further. And it is not a coincidence that those external deficits are accompanied by internal budget deficits of unprecedented size during a period of prosperity, deficits that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy US economic growth.

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/on

E.R.



on foreign borrowing by the United States that, left unchecked, will sooner or later undermine the confidence in our economy essential to a strong currency and to prospects for lower interest rates.

(iv) The largest and richest economy in the world has perforce been required for the time being to draw on savings that might otherwise have been invested abroad. Indeed, the inflow of savings from abroad is equal to something on the order of 15 per cent of net savings (or about 8 per cent of gross savings) in all other OECD countries combined. And, the related exchange rate pressures, trade imbalances and financial strains generate political as well as economic pressures toward economic nationalism and protectionism.

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(vii) At times, forceful official intervention in exchange markets could have a useful role to play. But that role has to be complementary and subsidiary to more basic measures to have lasting impact.

NBPM
US [struck through] file

House of Lords · Westminster

Dear David —

For your boss!

They're absolutely right ...

James

Reply to: The Lord Hanson, 180 Brompton Road, London SW3 1HF

THE WALL STREET JOURNAL, TUESDAY, FEBRUARY 26, 1985

# REVIEW & OUTLOOK

## How Not to Save the Pound

It is always possible to debate what messages the market is sending when it pushes the pound down toward parity with the dollar. But it's not plausible to interpret the current market as suggesting that British taxes are too low. Yet–incredibly–that seems to be the interpretation gaining currency in Britain.

Our man Peter Truell delivered news of this in a dispatch from London earlier this month. And over the weekend London's Telegraph newspaper reported Mrs. Thatcher had returned from her talks in Washington more convinced that caution was needed in the budget to be introduced in three weeks. The paper said "it was acknowledged in Whitehall" that the chancellor would have to shelve plans for a bold tax reform in favor of a strategy to save the pound. At Whitehall they probably make their soup out of water and phosphorous.

The thinking behind this idea seems to be that a tax cut could ignite inflation and further undercut an already battered pound. Somebody seems not to have told the British that the U.S. has managed to cut both taxes and inflation without denting the dollar. The idea also seems to be that a tax cut would boost the government's borrowing requirement–British lingo for its deficit–at a time when the government is determined to hew as close as possible to a balanced budget. Here too someone seems to be overlooking the American record, which suggests that carefully constructed tax cuts in high marginal rates lead to revenue increases.

More important than this is the fact that it was the enormous tax cut President Reagan pushed through in his first term that kicked off the American boom and sent the dollar on its way. The boom is being propelled by the mandate, delivered in the 1984 election, for more of the same. Mr. Reagan clearly was trying to do Mrs. Thatcher a favor when, in his press conference Friday, he brushed off her complaints about the deficit and the dollar and declared that the problem is that America's trading partners haven't caught up with the U.S. recovery.

Britain–and the rest of Europe, for that matter–seems to resist this notion. In recent weeks, for example, the British have been trying to halt the pound's plunge by jacking up interest rates. Rates have been boosted more than *four points* since Jan. 1. Yet this hasn't pulled the pound out of its dive. The currency may lose its tail-section altogether and head for the ocean unless someone gets more power to the engines.

Tax cuts would be precisely the thing to supply that power. Mrs. Thatcher and her chancellor, Nigel Lawson, seemed to be thinking along the right lines a few months ago, when their aides started talking about a new round of tax cuts. Government spokesmen were hinting at the time that personal taxes might be cut by between $1.5 billion and $3.25 billion in the coming fiscal year. Our sources suggest these cuts would bite at the margins and provide some of the increased incentives to work that Britain needs to start catching up with America. So now is a time not to abort the tax cuts but to be bold.

Wall Street
JOURNAL.
25/2/85
RIVERSIDE, CALIFORNIA

# The Outlook

## *High Unemployment Is Likely to Linger On*

*NEW YORK*

Does the rise in unemployment to 7.4% of the civilian labor force last month indicate that we have already seen the lows in joblessness for the current business expansion? Do we face a rerun of the 1970s and early 1980s, when the low achieved in each succeeding business cycle was consistently higher than in the previous one?

Most economists don't expect much improvement in unemployment figures anytime soon. The latest consensus forecast by the four dozen analysts surveyed monthly by Blue Chip Economic Indicators, a Sedona, Ariz., newsletter, envisioned unemployment averaging 7.1% this year and 7.0% next year.

However, Audrey Freedman, a senior research associate at the Conference Board, notes that her own prediction that unemployment "will sit around 7.2% this year" isn't a prediction that nothing will be going on. Far from it. Just to keep unemployment from rising, she says, "you will have to create 1.5 million jobs" to match the growth in the labor force. She expects those jobs to be created, but not many more—not enough to reduce unemployment further—because "the recovery is aging and flattening out."

So far in this cycle, the unemployment rate hit its low, 7.1%, last June and again last November. That may well be as far down as it gets; unemployment tends to be a leading indicator at cyclical peaks. Moreover, that low substantially exceeds the highest monthly rate, 6.1%, during the 1969-70 recession.

Here is how the unemployment-rate lows have been trending higher during the four previous business expansions:

| *Cycle Peak* | *Lowest Rate* | *Month* |
|---|---|---|
| Dec. '69 | 3.4% | Jan.-May '69 |
| Nov. '73 | 4.6 | Oct. '73 |
| Jan. '80 | 5.6 | May '79 |
| July '81 | 7.2 | Apr. '81 |

Analyzing such trends, economists try to filter out cyclical joblessness from the unemployment lingering on even during booms—often called the natural rate of unemployment. That unemployment, which can't be reduced without unleashing steep inflation, is divided into frictional unemployment—the 3% or so of workers voluntarily between jobs—and structural unemployment—workers with inadequate skills.

During the 1970s, most economists believe, the natural rate of unemployment rose. Michael Wachter of the University of Pennsylvania cites three reasons:

—**Unfavorable demographics.** Baby-boomers and women flooded into the labor force, and jobs couldn't be created fast enough. Moreover, youths and women tend to be less attached to the labor force, and as they float in and out of jobs, frictional unemployment rises.

—**Rising government transfer payments.** As unemployment compensation, welfare and Social Security benefits increased, the unemployed could be choosier about jobs.

—**Inflationary shocks.** Surges in oil and food prices hit when many labor and commodity markets were already tight, and the government felt forced to clamp down and fight inflation more quickly—at the cost of jobs—than it would in a slack economy.

Now, Prof. Wachter estimates, the natural rate of unemployment probably has dropped to about 5¾% from perhaps 6¼% in the late 1970s. He notes that the surge of new job-seekers has slowed, and in the future "the demographics will continue to be favorable." So they will. According to the Bureau of Labor Statistics, the labor force aged 16 and over, which grew 1.3% a year in 1950-60, 1.7% in 1960-70 and 2.6% in 1970-80, is rising only 1.6% in 1980-90 and will increase just 1% annually in 1990-95.

Furthermore, President Reagan has halted the increase in inflation-adjusted transfer payments. And inflation is down, although Prof. Wachter notes the danger posed by steep federal budget deficits.

Other factors also may be paring the natural rate of unemployment. Prof. Wachter observes that the minimum wage, often said to inhibit hiring of low-skilled workers, has been eroded by inflation since its last increase, to $3.35 an hour, in January 1981. If the minimum had kept up with the 16.5% gain in nonsupervisory production workers' average pay since then, it "would now be $3.90," he adds.

**Meanwhile, the youths and women who earlier swamped the labor market have acquired wider job skills and now presumably could, if laid off, find new jobs more quickly. And as actual unemployment drops, their increasing skills may reduce the natural rate.**

Moreover, as Mrs. Freedman noted in a recent paper, "Union power to set industrywide wage rates has clearly decreased during the past four years." Unions thus have lost some of their ability to keep real wages from falling enough to enable employers to hire most of the jobless.

But tending to raise the natural rate of unemployment has been rapid technological change, which forces more job switching. In fact, a study by Michael Podgursky of the University of Massachusetts found that by the late 1970s, the primary source of structural unemployment had shifted from youths to prime-age males; unions couldn't halt surging imports, factory automation or the decline of smokestack industries. High-tech industry can't replace lost basic-industry jobs and, by lifting productivity, it enables output to rise faster than employment.

Economists figure that the economy must grow about 3% annually merely to provide jobs for new labor-force entrants, but the Blue Chip group, on the average, expects growth only slightly above that this year and below that next year. Without a new surge of growth, we may be stuck with 7%-plus unemployment for some time.

—HENRY F. MYERS

PREM 19/1654



# Senate Confirms Meese to Head Justice Agency

## Vote on Attorney General Was 63-31; He's Slated To Be Sworn In Today

By DAVID ROGERS and ANDY PASZTOR
*Staff Reporters of* THE WALL STREET JOURNAL

WASHINGTON – The Senate, after a year of controversy, voted 63-31 to confirm Edwin Meese as attorney general.

The number of votes against Mr. Meese was the largest against any cabinet nominee since Earl Butz was confirmed as Richard Nixon's agriculture secretary in 1971. Democrats accounted for all of the opposition, and final action was delayed by four days of partisan maneuvering over farm legislation.

"I think that politics played a very big part in what took place, but that's all behind us," said Mr. Meese, who will be sworn in today to succeed retiring Attorney General William French Smith. "I am committed to the fair, compassionate and forward-looking policies the department should have," Mr. Meese said.

Mr. Meese, a former county prosecutor from California and one of President Reagan's most outspoken conservative aides, is expected to advocate tougher sentences, including the death penalty, for some violent crimes. He also is likely to support expanded police authority to seize and use evidence in prosecuting criminals, and to call for increased compensation to victims of violent crime. Mr. Meese is expected to continue the Reagan administration's opposition to the use of racial quotas in school-desegregation plans and in affirmative-action hiring cases brought against companies and municipalities.

*Edwin Meese*

While serving in the White House, Mr. Meese has sought to ease antitrust constraints as a way to make U.S. industries more competitive with foreign concerns. He also has advocated legislation supporting prayer in public schools.

Although Mr. Meese hasn't said what his priorities will be in the new job, he will have an opportunity to place his stamp on the department by picking appointees for 11 of the top policy-making slots in the department. Some lawmakers and administration officials expect that Mr. Meese will be a more active administrator and a more vocal advocate of tougher anti-crime laws than was Mr. Smith, his predecessor.

Last month, Mr. Meese told the Senate Judiciary Committee he didn't see any reason for major increases in federal expenditures for anti-crime programs, but he urged states and cities to provide more financial and moral support for such programs. Officials familiar with Mr. Meese's plans for the department also expect that he will push for tougher anti-drug enforcement efforts by relying more heavily on the U.S. military to fight drug smuggling.

Mr. Meese was caught up in a swirl of controversy over ethical issues almost immediately after his nomination was announced 13 months ago. He was accused of using his White House position as counselor to the president to get federal jobs for individuals who helped him in personal financial matters.

A special prosecutor, Washington lawyer Jacob Stein, found last year that there was "no basis" for charges that Mr. Meese had violated federal law. He declined to comment, however, on "Mr. Meese's ethics and the propriety of his conduct for office."

The issue was revived last month when it was disclosed that a staff report by the Office of Government Ethics had concluded that Mr. Meese's financial transactions appeared in two instances to conflict with his official duties. After reviewing the matter and meeting with Mr. Meese's attorneys, the office's director, David Martin, decided against recommending any action. But disclosure of the staff analysis added to the bitterness that often marked the confirmation proceedings.

Within the Senate, Mr. Meese's confirmation was an important victory for the new majority leader, Robert Dole (R., Kan.), but it proved more of a struggle than expected. Democrats mounted a filibuster, delaying action until they were

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2 In Texas 800/392-4659
Hotels of the World

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US file

**US TRADE AND CURRENT ACCOUNTS ($bn)**

| | Trade (balance of payments)-basis | Current Account | |
|---|---|---|---|
| 1983 | -61 | -42 | |
| 1984 | -108 | -102 | |
| 1984 Q1 | -26 | -20 | |
| Q2 | -26 | -24 | |
| Q3 | -33 | -33 | |
| Q4 | -23 | -25 | (Bank estimate) |
| Forecasts | | | |
| 1985 Wharton | -130 | -115 | |
| OECD | -135 | -130 | |

Prime Minister (2)

This indicates that the improvement in the US current balance in Q4 1984 may be temporary. Outside forecasters expect the deficit in 1985 to be greater than in 1984.

AT
26/2