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THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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JULY 8, 9, AND 10, 1970

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THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

WEDNESDAY, JULY 8, 1970

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

The Joint Economic Committee met, pursuant to notice, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Widnall, Conable, and Brown; and Senators Proxmire, Fulbright, and Miller.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman, economist; and George D. Krumbhaar and Douglas C. Frechtling, economists for the minority.

Chairman PATMAN. The committee will please come to order.

Today the Joint Economic Committee is beginning an intensive review of the economic situation. In these hearings, which will carry through July 23, and possibly July 24, we shall hear from high Government officials responsible for economic policy and leaders in industry, labor, and the academic world who are intimately acquainted with our economic system. As I said in my statement announcing the hearings: "This midyear review is especially important this year because there is mounting evidence that, for the first time since the passage of the Employment Act, none—not one—of the major goals of the act is being achieved."

These goals are: high employment, steady economic growth, and stable prices. Unemployment reached 4.7 million in June, 1.3 million higher than a year ago. The seasonally adjusted unemployment rate for nonfarm blue-collar workers rose to 10.4 percent in June, compared with 6.1 percent 12 months earlier. For youngsters, the rate is even higher, 14.6 percent. The workweek in manufacturing is the lowest in almost 9 years.

We have had no growth in the economy in the past year when normal growth should be 4½ percent. We are now operating at a rate over $20 billion below our economic potential. The housing market has been devastated. State and local governments cannot find the money they need, even at usurious interest rates.

Nevertheless, inflation is still rampant. The most comprehensive price index—the GNP deflator—rose at an annual rate of 6.3 percent in the early part of this year, compared with a rate of 4.9 percent in the same period last year.

On top of all this, despite some loosening of the money supply, long-term interest rates have reached new peaks, while the Federal Government budget moves into the red again.

What has gone wrong? How can we make it right again? Can we depend solely on such monetary fiscal policies as we have seen last year and this. We hear that a liquidity crisis is about to engulf the Nation. This must be avoided. What steps can we—must we—make now and in the future to bring the economy back on track?

I hope that from these hearings we can develop a rounded, balanced program to halt inflation, reduce unemployment, and renew stable economic growth. The gentlemen here this morning are two of the most eminent authorities in the labor and business worlds. Mr. I. W. Abel is chairman of the AFL–CIO economic policy committee, as well as president of the United States Steel Workers of America. We shall also be hearing from Fred J. Borch, chairman of the board and chief executive of General Electric, one of the Nation's largest industrial firms. Both men have had long experience in examining the broad economic issues of the day.

Mr. Abel, if you will start first, your statement in full will be placed in the record; please summarize your remarks in about 20 minutes, to bring out the main points. We will want you to yield for questions by the committee. That will give us more time to ask you questions. Oftentimes we bring out things in questions that are not always brought out in the original statement. So we would appreciate your cooperation. If you have to have more time, of course, we will do that.

Representative WIDNALL. Mr. Chairman, before Mr. Abel's statement, would the gentleman yield to me for a short opening statement?

Chairman PATMAN. Certainly, yes, sir.

Representative WIDNALL. At the opening of these hearings on the state of the economy and prospects for the future, I believe it is essential we place them in the proper perspective. The administration has been attempting to bring 5 years of substantial inflation to a final conclusion by first cooling off an overheated economy and then maintaining the rate of production at a level calculated to discourage inflationary price and wage behavior.

To my mind, it is quite significant that the administration embarked upon this course with a definite, well-articulated plan in hand, and while many have criticized this program, no one as yet has provided a realistic and comprehensive alternative.

The most widespread criticism is that the administration has relied on general monetary and fiscal restraint to the exclusion of various forms of incomes policy to directly affect individual private wage and price decisions.

Most of the incomes policy proposals suggested include the resurrection of the wage-price guidelines created by the Kennedy administration and abandoned by the Johnson administration, and while learned men have argued strenuously over whether or not the guidelines did actually influence wages and prices in the middle 1960's, the record is embarrassingly clear on one major point. The wage-price guidelines did not prevent or terminate the inflation that began gathering momentum in 1965 nor did this incomes policy enable us to actually maintain an economy of high employment without inflation, as the Employment Act of 1946 indicates must be a primary objective of the Government.

At the other extreme on the incomes policy spectrum are direct controls on wages and prices, an alluring but deceptive proposal to fight inflation.

Aside from the fact that such controls will at best be ineffective and at worst produce substantial distortions in our economy, such controls are inimical to the freedom we allow and prize in our economic system.

The predominantly free enterprise economy which we enjoy has been the engine of this Nation's unmatched economic progress, and any measures to adjust its behavior must work within the institutional framework of that economy lest we severely inhibit its ability to continue to provide economic growth and employment.

I would be the first to agree that the present administration underestimated the strength of the 1970 inflation and the time it would take to return the economy to price stability. But it is only fair to recall that it was the top economic advisers of the previous administration who assured us that inflation would be stopped by the 1-year, 10-percent surcharge enacted in 1968. Furthermore, but for the disagreement on incomes policy, even economists of the previous administration have indicated that we are on the right path to a stable price environment.

I doubt that there is one among us who does not find the current period uncomfortable if not downright discouraging. We have gone through several months of that nightmare world of rising unemployment and rising prices at one and the same time. However, evidence is beginning to accumulate indicating that we have passed through the most difficult period and that relief is near at hand.

For one thing, the wholesale price index has risen less than 1 percent since January compared with over 2 percent in the previous 6 months. For another, consumer prices have ceased to grow at an accelerated rate giving indications they will slow down in the near future.

Finally, the drop in the unemployment rate last month, while probably not signaling an immediate trend, does indicate that the adverse effects of the slowing economy on employment may well be largely behind us.

Having described the general economic context of these hearings, I look forward to these hearings as set forth the alternatives to insure that relief from accelerating price growth will become more pronounced and prove permanent over the months ahead. once having solved the problem of inflation. how to best get us back to the road to healthy economic growth, high employment, and price stability. Thank you, Mr. Chairman.

Chairman PATMAN. I must reply briefly to the distinguished gentleman from New Jersey, Mr. Widnall, on the points that he brought out which, of course, were rather partisan in nature, which is all right with me, if he wants to bring them out. But he mentioned that inflation must be stopped, and I certainly and thoroughly agree with him that inflation should never have been started.

High interest rates started inflation. They had the false assumption that if you raised interest rates that that would deter borrowing, and that would have a tendency to stop inflation. But the truth is, and everyone knows it, that if you raise interest rates you immediately unbalance every budget in America from the housewife to the Federal Government, and you raise all prices. even the prices of the goods on the shelves, and the used cars on the carlots; you raise the price of everything immediately. That has been going on too long. It has

been ruinous to our country, and I think practically all of our economic evils can be traced directly to high, extortionate, excessive, usurious interest rates, and the way to stop inflation is to roll interest rates back. Last December our Committee on Banking and Currency in the House, of which Mr. Widnall is a member and I am a member, initiated legislation to give the President of the United States the same authority that a Wall Street banker has to go out on the front porch and raise the prime interest rate. When the present administration came into power, the prime interest rate was 6 percent. It wasn't long until it was 8½ percent, and considering the fact that every time you raise rates you affect all debts, public and private, aggregating at that time when it was raised on June 9, 1969, 1 percent, that automatically had a potential rise of $15 billion a year on all the people because our debts, public and private, aggregated $1 trillion 500 billion at that time.

So I join Mr. Widnall in the hope that we can stop inflation, and I offer as a remedy the same thing that caused inflation, just do the reverse, and the President has the power to lower interest rates now under that law that we passed, and I hope that he will soon go out on his front porch, like the Bankers Trust representative did on June 9, 1969, and announce that rates are lowered, the prime rate is not 8½ or 8 but is back to even 6 percent, where it should be, or even lower, if he feels like he should place it there.

And if the President doesn't have enough power, I feel like our committees on the Hill will join his efforts to give him the legislation that he needs to fully and fairly and properly stop the inflation that is going on in our country.

All right, Mr. Abel, will you start now, please, sir.

STATEMENT OF I. W. ABEL, CHAIRMAN, ECONOMIC POLICY COMMITTEE, AMERICAN FEDERATION OF LABOR-CONGRESS OF INDUSTRIAL ORGANIZATIONS; ACCOMPANIED BY NAT GOLDFINGER, DEPARTMENT OF RESEARCH, AFL-CIO

Mr. Abel. Thank you, Mr. Chairman and members of the committee.

My name, as the chairman has said, is I. W. Abel, and I do appear here as chairman of the Economic Policy Committee of the American Federation of Labor and Congress of Industrial Organizations.

I want, at the outset, to express my appreciation to the committee for the invitation to be here, and to express and convey to the committee, and through the committee to the Members of Congress, the mood that prevails among the men of the mines, mills, and factories today.

This is a mood of great uncertainly, a feeling of great frustration, coupled with anger, and a feeling of some helplessness in the face of what has been happening; there is a hesitancy about what lies in store for the future, a well-founded feeling that they have been the victims of inflation by shrinking buying power and now layoffs and cuts in working hours, and this mood is neither good for the workers of the country nor for the Nation itself.

One does not have to have a degree in economics or mathematics to know whether your paycheck is enough, whether you are making it or you are lagging behind, to read the stories in the press of record profits in the 1960's, and to conclude bitterly that you have been denied a fair share of such record affluence.

Our free enterprise system, as our democracy, is supposed to function for the benefit of all, not just a majority, silent or otherwise. The truth of the matter is that the economy has not been functioning for the benefit of all, and so today we find ourselves with the worst possible combination of developments. We have the most severe inflation in 20 years, the highest interest rates in 100 years, and the sharpest increase in unemployment in 10 years.

The longest economic recovery in our history has come to an end. The acceleration in the cost of living has been shocking. To the average worker it has been brutal. The cost of living increased 5.4 percent in 1969, and since last December it has been rising at a yearly rate of more than 6 percent. Recently, the Department of Labor reported that unemployment was 3.9 million in June, an increase of 1.1 million since last December. The rise in unemployment is concentrated among the unskilled, Negroes, teenagers, construction workers and the semiskilled. But, Mr. Chairman, the sharpest percentage increase has been among professional, technical, and skilled workers.

Also, weekly working hours are being cut. In June the average workweek in manufacturing was down to its lowest level since the recession year of 1961. And for all nonsupervisory employees in private, nonfarm employment, their average weekly working hours in June were nearly the lowest on record. As a result of these trends, average weekly earnings of many workers have been cut while inflation continues.

Recently, the Labor Department reported that the average worker in private, nonfarm employment earned $118.72 a week in May. For such a worker, with three dependents, after Federal tax take-home pay was only $104.02. In terms of buying power, his take-home pay was less than last year and less than in 1965.

As for the interest rates, in recent months they have remained at or close to their record peaks, after skyrocketing in 1969 as the chairman has just pointed out.

These interest rates are a major factor in the inflation of the past 2 years as these peak rates are passed on, through the economic system, to the consumer. In 1968, for example, the effective interest rate on FHA new-home mortgages was 7.13 percent. In the past several months this rate has been between 9.10 percent and 9.29 percent—an increase of approximately 30 percent. And the home buyer is being saddled for years in the future, as he pays off a mortgage for 20 or 30 years—a burden which is more than heavy enough in so-called normal times but is truly shocking at present rates.

An analysis of the accelerated rise of consumer prices in the first quarter of 1970, by the Labor Department in its Monthly Labor Review (June 1970), stated that—

> The rise in mortgage interest rates—at an annual rate of 14 percent in the first quarter of 1970—was in large part the result of policies to reduce inflationary pressures.

Now, all of this deterioration in the economy has been greater than the administration expected. The rise in unemployment has been sharper than expected. The administration anticipated that the sharp rise of the price level would start to ease before now. Now we are informed that administration economists expect a small pickup in sales, employment and production in the next several months. This

expectation is based upon the easing of monetary policy by the Federal Reserve Board, the social security increases of last April, the Federal pay increase legislation, the expiration of the surcharge tax and the recently effective small tax reduction—with some show of strength in consumer markets.They believe that the softness in the economy will depress prices and increase sales. They also expect a pickup in productivity and less pressure on unit costs.

These expectations, or hopes, of administration economists, even if realized, would not mean the end of the problems of our members. I say this because even if such expectations are realized, there will still be a continuing rise in unemployment. There will be this continuing rise because their expected improvement in economic activity would be rather slow—not enough to absorb the normal growth in the labor market and increasing numbers of discharged servicemen. So, even if their expectations pan out, there will still be substantial unemployment and trouble for our members. It also must be said that what they expect, may not happen. They have been off the mark in their other expectations. And of course, nothing can be assumed to be a certainty at the present time because if there is one word which describes the present economic situation, that word is uncertainty. Administration economists fail to recognize this, as they fail to recognize the seriousness of the present situation or to face the possibility that present conditions could snowball.

We must also take into account in assessing the present situation, that we have had 6 years of an investment boom in plant and equipment. And with all this being installed, and now with industrial production moving down, there is a buildup of idle productive capacity. Industry's operating rate the past several months has been approximately 79½ percent of capacity, down from 84¼ percent in 1968, and it is still declining. With this kind of a situation and the present deterioration in the economy, many businesses are postponing their investment plans. Now, in this regard, if two things happen, we can be in for more serious times. If consumer markets do not show the expected strength, and if business investment keeps moving down, there is a real danger that the present deterioration of the economy may begin to feed on itself. I say this because at some point, if these two things happen, we will experience widespread inventory cutbacks, further production cutbacks and still more layoffs.

However, despite the uncertainty and the possibility of real chaos, the administration is permitting the downward drift in the economy to continue and holding to what is called its "game plan"—a rather inept and calloused phrase for what it entails. But worse than this sideline position, the administration shows no sign that it is prepared to move the economy quickly back to a high employment even after the present recession runs its course. The Council of Economic Advisers' Report of February 1970, makes this statement, and I quote from it.

They said:

> Projected available output is assumed to be below potential from 1970 until 1972, as a result of policies to slow inflation * * *

In brief, the administration is allowing the present recession to continue, with a danger of a deepening of the recession and with the threat

of economic stagnation and widespread unemployment even after the recession has run its course.

We know what has happened, what is happening, and we have some ideas on what may happen. But let's take a moment to see how we got where we are today. The events and actions which caused the present economic situation were not unplanned; they just didn't happen. They were the result of deliberate, planned policies. In the name of fighting inflation, the Federal Reserve Board began its tight money policy in December 1968, and when the present administration assumed office, it reinforced this restrictive policy.

So, during 1969, the sequeeze on the economy became tighter. Between June 1969 and February 1970, there was hardly any increase in the Nation's money supply; and with that, interest rates skyrocketed. Also, Federal construction projects were cut. This kind of policy might have been justified if there had been widespread shortages—a case of too many dollars chasing too few goods. But there were no general shortages of goods and manpower, and there was no real reason to apply such a squeeze. But the squeeze was applied and its immediate and most devastating effect was on residential construction.

Housing starts were at a yearly rate of 1.9 million in January 1969. By May of this year the yearly rate was down to 1.2 million—a drastic drop of 37 percent. In the face of steep advances in interest rates, State and local governments have been forced to put off building hospitals, schools, roads, and public buildings, and again, adding to the burdens of those not responsible for the inflation in the first place—the workers, their families, and consumers in need of such facilities. Small and medium-sized businesses also were hit by an inability to obtain loans, or had to settle for loans at very high rates. These increases in interest rates alone have been a major factor in raising costs and prices all along the line—to the farmer, to the manufacturer, to the wholesaler, to the retailer, to the worker, to the consumer, and to government at all levels. Additionally, these record interest rates have built-in high costs and prices for years to come. And as this whole process continued, we got a recession with inflation.

Moreover, as the volume of sales and production levelled off and declined, productivity also lagged. As a result, unit costs rose, adding to inflationary pressures.

In the name of fighting inflation, the administration's "game plan," with its high interest rates and production cutbacks, has actually been a major source of the accelerating price pressures of the past 18 months.

But the squeeze on the economy had little effect on most of the big, blue chip corporations—with their huge profits, large depreciation allowances, and preferred lines of credit at the banks which gave them first call on loans. Moreover, when these companies borrow money, they pay the lowest available rates from the banks. Is this favored treatment of the wealthy corporations a fair rule for the players covered by the so-called "game plan"?

So, the banks took care of the rich and the blue chips. They also evaded the Government's economic squeeze that has been putting everyone else through the wringer, and they increased their lending. They did it by calling in dollars from their foreign branches and by heavy use of commercial paper, mainly by newly created one-bank holding companies. Therefore, while available funds dried up for

home construction, State and local governments and small business, bank loans were increased to the huge corporations and the rich to bankroll the capital goods boom, business mergers and the conglomerate takeovers, gambling casinos, and investments in foreign subsidiaries. Today, with the Federal Reserve having moderately relaxed its monetary squeeze, the banks are continuing to ration money, as they see fit, without regard for the needs of the American people and with any Government regulation.

It is also important, in examining the entire inflation picture, to see not only how we got where we are but also "why." Too many are too anxious to single out trade unions as the villain in the picture. They simply overlook the facts of what has happened and ignore completely the role of corporate greed.

When unions bargain, they try to offset previous increases in living costs and to gain some improvement in buying power and living standards. The theory is that this is not only good for the workers, but it is good and essential for the health of the economy and business.

In the 1960's, the record shows that the accelerated rise in living costs came first, long before the push for larger wage settlements. Between 1960 and 1965, increases in wages and fringe benefits in manufacturing industries were less than the rise of industrial productivity. Unit labor costs of industrial goods moved down 1.6 percent but wholesale industrial prices went up 1.7 percent. Profit margins on each item widened and, with the expansion of sales, total profits of industrial companies skyrocketed.

In the same period, unit labor costs in the total private economy increased only modestly but consumer prices jumped 6.6 percent—more than twice as fast as the small rise of unit labor costs. As a result, profit margins in the total economy widened, and with increasing sales, business profits soared.

It was not until 1966–67, after the increased rate of rising living costs got underway in 1965, that the size of collective bargaining settlements also began to move up. Unit labor costs began to increase and business raised prices at an accelerated rate in an attempt to maintain or even widen profit margins.

Until 1965, when living costs increased 1 to 1.5 percent a year, the median collective bargaining settlement was under 4 percent. This is according to the Department of Labor. Wage and fringe benefit increases of more than 5 percent did not become widespread until 1967 and 1968, long after the sharper increase in the cost of living began in 1965. In 1969, it was 7.4 percent per year over the life of the collective bargaining agreement, normally 3 years, and with an 8.2 percent in the first year.

The fact is that the inflation that developed in the 1960's has been largely a profit inflation—combined with a dangerous credit inflation in the past 18 months. From 1960 through the first half of 1969, corporate profits after taxes were up 93 percent: but the after-tax weekly earnings of the average nonsupervisory worker were up only 34 percent—three-fifths less than profits. And in terms or real buying power, the gain for this worker was only 10 percent.

It was in 1966 that Gardner Ackley, Chairman of the President's Council of Economic Advisers, told a meeting of the U.S. Chamber of Commerce, and I quote from Mr. Ackley's statement, he said:

Now that profits after taxes . . . are providing the highest sustained rate of return on owner's equity in our modern history, it is time to ask whether a further rise in the share of profits in the national income is in the interests of the health of the Nation's economy or in the interest of business itself.

The conclusions from a reading of these facts are these: Workers have not shared fairly in the record prosperity of the 1960's through equitable wage adjustments; consumers have not shared fairly in such prosperity because industry did not hold the price line when it could well have afforded to do so and still make substantial profits. Moreover, if the facts on the increased profits and take-home wages had been reversed, then only could the finger be pointed at unions.

Business profits have dipped since mid-1969, despite the continuing rise of prices as a result of the administration's squeeze on the economy and the decline in the volume of sales and production. However, the price structure, as a whole, is now set so that when sales do start to go back up, profits again will shoot through the roof.

Last February the AFL-CIO Economic Policy Committee made this comment, and I quote from the committee, we said:

Confronted by these developments in recent years, the AFL-CIO has urged the Government to combat inflation through selective measures, specifically aimed at the profit inflation, the business investment boom and other trouble spots, rather than a severe squeeze on the economy as a whole—with its discriminatory impacts on homebuilding and other sectors of the economy.

The AFL-CIO also has made other specific recommendations to take America out of recession and end inflation before the bankrupt policies of the administration aggravate the already grave damage to American living standards . . . and before present conditions snowball.

We have said that selective, pinpointed credit controls should have been imposed a year and a half ago, rather than putting the whole economy through the wringer. If the President and the Federal Reserve had followed such a policy, the Government would have curbed the amount of credit going to the blue chips for mergers, conglomerate takeovers, et cetera, and we would not have had the tight money, high-interest rate squeeze on the economy. But they did not choose to do so. And we know the results.

Last December, Congress granted the President broad authority to curb the specific causes of credit inflation, to impose interest-rate ceilings and to expand credit for needed housing, public facilities and regular business operations.

Six months have passed and the President has failed to use this specific grant of authority by the Congress.

So prices continue to rise rapidly; layoffs and production cutbacks are spreading; and urgent social needs are unmet. Therefore, the AFL-CIO executive council, at its meeting on May 12–13 of this year, in the face of what has happened, recommended the following steps to end the recession and inflation:

1. Confronted by the President's failure to use his authority, we urge Congress to direct the Federal Reserve System to establish selective credit controls, to establish maximum interest rates on specific types of loans and the allocation of credit to where it will do the most good for America. We believe this is a matter of great urgency—top priority—and is needed now. Congress should step in and direct the Federal Reserve to do what the President has failed to do.

2. The council recommended that the Government should require that a portion of such tax-exempt funds as pension, college endowment and foundation funds—as well as bank reserves—be invested in Government-guaranteed mortgages to meet the goal of 26 million new and rehabilitated housing units in 10 years.

3. To curb the price-raising ability of the dominant corporations. Government action is needed to curtail the continuing high rate of business mergers, which has been greatly increasing the concentration of economic power in a narrowing group of corporations and banks.

4. The specific causes of soaring pressures on living costs, such as physicians' fees, hospital charges, housing cost and auto insurance rates, should be examined for the development of practical, sensible measures to dampen these pressures.

We have also said that the Government should examine the whole area of administered prices and adopt legislation to curb the price-raising ability of major corporations in major industries.

As far as selective, pinpoint actions by the Federal Reserve Board are concerned, we call to your attention the fact that the Board recently has taken two selective actions of the kind that are far from priority needs. The Board has reduced margin requirements for purchases of stock to encourage speculation in the stock market, and it has removed the interest rate ceiling on a 30- to 90-day bank deposits of $100,000 and more—this latter action to aid the banks, the blue chips and the rich.

Now for some very brief comments about controls and guidelines before I conclude my remarks with some general observations. The AFL–CIO has taken the position that if the President, after the establishment of selective credit controls, determines that he needs more authority to stabilize the economy, the AFL–CIO will cooperate. But we have stipulated that such controls must be equitably placed on all costs and incomes—including all prices, profits, dividends, rents, and executive compensation, as well as employees' wages and salaries. And plus the additional condition that where inequities do exist, they will be corrected. Certainly, there are many such instances at the present time.

Talk of a wage guideline policy as an incomes policy is economic fakery. One-sided curbs on workers' wages—with no effective restraint on prices or incomes of other groups—would be inequitable and unacceptable. Moreover, the guidelines approach has a record of futility and failure.

What is needed, what has been needed for some time, is an effective and equitable policy to stabilize the economy, to strengthen the fabric of American society and sustain full employment. I know we are all aware that full employment is stated national policy as expressed in the Employment Act of 1946. But we all also know that it has not been implemented and there certainly are no indications that its implementation is under consideration. But it should be, because America needs expansionary economic policies to revive the economy, to bring us what we have promised ourselves—full employment. Moreover, the needed rise in output will, in itself, reduce inflationary pressures by boosting productivity and slowing the rise of unit costs.

We need an expanding supply of money at reasonable rates. We need the full funding of Federal appropriations for such socially vital needs as housing, education and health care, community facilities, hospi-

tals—and the Federal Government must act as the employer of last resort.

The way to balance the Federal budget is to balance the American economy. The welfare of the American people and the desired expansion of the national economy need a fiscal stimulus, not continued fiscal restraint.

We have urged the Congress, and we reiterate our plea, to adopt appropriate expansionary policies that can quickly get the economy back on its feet, get us on the road to full employment with jobs at decent wages for all those willing and able to work.

President Nixon also subscribes to this philosophy—or at least he did as a presidential candidate on October 21, 1968, when he said, and I quote him:

> In the next four years, we must help create 15 million new jobs. . . . Economic growth is the answer to job security. Economic growth is the best assurance for a workingman that his job will be secure, his real earnings on the rise, his route to advancement open.

End of the quote of the President.

Later, after assuming office, the President sent a message to AFL-CIO President George Meany– this was in February 1969—in which he said:

> We must find ways to curb inflation . . . without asking the wage earners to pay for the cost of stability with their jobs.

In the absence of presidential deeds to support such presidential words, one must conclude that the administration is willing to tolerate substantial unemployment to slow down inflation. But let us make the charge that only the administration regards the worker as expendable in the fight against inflation. It alone does not believe in the trade-off theory—jobs and full paychecks for less inflation. It is shared by many. When the Business Council met during the October before the present administration took office, it agreed that the Nixon administration should take swift steps to halt inflation even if such steps meant an increase in unemployment to as much as 5½ percent. They may very well realize their figure without any fear that they will be among the 5½ percent.

And this is what deeply disturbs me, and my colleagues in the labor movement—his detached, unconcerned, coldly analytical assumption that the American worker is expendable in the fight against inflation; that the unemployment is the price that has to be paid.

The American worker is not expendable. He is not a cold statistic on a computer print-out. It is time he is recognized as not expendable. It is time he is recognized as indispensable. It is economic nonsense and unjustifiable to ask the worker, who has not shared fairly in the profit boom and whose real earnings have lagged, to make the further sacrifice of joblessness in order to cool the inflation he did not cause.

After all the statistics have been recited, after all the charts have been drawn and analyzed, one gets down to the basic fact that inflation and unemployment concern human beings. Unemployment means hardship, privation and perhaps some suffering. The state of joblessness is not something that a worker can look at with detachment. So he has a right to expect, and I would say, Mr. Chairman, to demand, that another way be found to harness inflation.

He has the right to ask the question: Is there any real suffering if General Motors or Ford or AT&T or U.S. Steel make a few million dollars less a year? Is there any real denial of the necessities of life if corporations hold the price line when they enjoy fat profits? He has the right to ask: Why shouldn't industry share its affluence with consumers through steady prices and with their workers through wage adjustments instead of charging what the market will bear? To him this is the correct, painless answer to a sound economy.

Much time could be spent in reciting the litany of problems confronting our Nation. I will mention only one: The crisis of confidence in our institutions; a fear that they are not responding to the needs of people. In making our economy truly work for the good of all, there must come from those who hold economic, political and legislative power and authority, a general resolve to bring equity and stability to the economy without making the worker the fall guy. Not until this is done, not until the economy works for those who need it the most—the old, the aged, the jobless, the untrained—can it be said that our economic system is meeting the needs of all Americans. We think it can be done. We will continue to insist that it be done. And we will continue to take the position that the only correct policy regarding unemployment is one of full employment.

Mr. Chairman, I again, on behalf of the AFL–CIO Economic Policy Committee, appreciate the opportunity to appear before this committee this morning with a presentation of some of the views representative of organized labor.

Thank you.

Chairman PATMAN. Thank you very much, Mr. Abel.

After hearing from the next witness, each member will be allowed to question the witnesses, on the first go around, 10 minutes each.

Now we shall hear from Mr. Fred J. Borch, chairman of the board and chief executive of General Electric.

Mr. Borch, you are recognized, sir.

I will ask you to remain, Mr. Abel, and we will interrogate you at the same time we interrogate Mr. Borch.

Mr. ABEL. Thank you, Mr. Chairman.

STATEMENT OF FRED J. BORCH, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE, GENERAL ELECTRIC CO.

Mr. BORCH. Mr. Chairman, distinguished members of the Joint Economic Committee, my name is Fred J. Borch, and I am chairman of the board of the General Electric Co.

It is a privilege to appear here at your invitation today to participate in the Joint Economic Committee hearings on the 1970 midyear review of the economy.

Now, as so often happens in a nation's history, we are tugged in opposite directions. Both economists, and our economic indicators, disagree as to what our course should be.

I have been asked to discuss what role productivity, prices, wages, and profits play on public policy. Since most of the action in this area for the last couple of years has had its origin in the need to bring inflation under control, I will begin there. But, with the indulgence of this committee, I would like then to go on to a subject of considerable

concern to me—the need to bring our productivity up to the sternest and best requirements of the 1970's—just ahead.

The administration has been trying to bring back under control an inflation that had its origins in the guns and butter philosophy that accompanied the Vietnam buildup, through fiscal and monetary measures designed to dampen demand and cool the economy. The distortions resulting from the inflation have become deeply rooted and the measures required to correct them will, understandably, take time to become effective. For the year 1970, having been committed to such a program, the Government's proper course, in our opinion, is to follow through with its existing program.[1]

By this, we mean Government fiscal and monetary programs that avoid deficit financing, and provide modest monetary expansion.

For the longer term beyond 1970, however, we believe that the character of the economy and the attitudes of the American public are changing in such a way that public policies should be used to better meet the accelerating needs of people, to enlarge the pool of skills, to raise productivity, and to increase our real national output.

I would like to examine with you, very briefly, this morning three reasons for this:

I. The Nation's commitment to higher levels of employment,

II. The higher expectations of people; and

III. A fundamental shift in our economy from the industry-agricultural sectors, to the services-producing and Government sectors.

I.

First, the Nation is committed to ever higher levels of employment but we still have not learned how to achieve this goal without excessive inflation.[2]

I assume that your committee will be examining the relationship between monetary and fiscal policies and current levels of employment. But from where I sit I should point out that some rise in the unemployment index is an inevitable consequence of past rises in unit labor costs, as employers struggle to keep costs under control.

Another part of the rise in the index has been sparked by the desired reentry into the labor force of women looking for jobs to supplement the family income which has been hit by inflation.

Another very significant factor is the result of the cutbacks in spending for space and defense as we face the problem of those leaving the Armed Forces, or laid off in defense production.[3]

In General Electric, for example, our total employment in defense-related products (aerospace and aircraft engines) predominantly,

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[1] Beginning in 1966, until enactment in 1968, I endorsed the idea of a tax increase as being needed to stem inflation—even though, short-term, it would have an adverse effect on our consumer businesses. This was consistent with the views taken at that time by the Council of Economic Advisers in their annual reports of 1966–68.

[2] Even the definition of what we mean by "high levels of employment" has become a moving target. Back in the expansionary days of the early 1960's, a 5-percent unemployment rate would have been regarded as reasonable progress toward the 4-percent "interim target" set by the Kennedy administration. Now a 5-percent unemployment rate is regarded by some as an excessive price to pay for dealing with inflation.

[3] Defense Secretary Laird, in a recent speech, said that defense spending in the next fiscal year would be cut back to 7 percent of GNP—the smallest percentage in 20 years. Employment in the Defense Department (military-civilian) would be reduced by 680,000 from fiscal year 1969 to 1971; with a reduction in the work force required for defense production of another 600,000—down to 6 percent of the labor force from 8 percent in 1969. Even without counting the cutbacks in our space programs, this will involve more than 2 million men and women in the next 2 years.

peaked in June 1969, and the same period in which total employment for the company peaked. Between then and last March the decline in our total defense employment has accounted for 10,000 of the 12,000 reduction in jobs across the whole company.

As we get back hopefully toward the end of this year to a resumption of real growth in the economy, with a lesser rate of inflation, we should see the employment index respond.

II.

In addition to the commitment to keep employment at high levels—a second major reason for the changing character of the U.S. economy involves the higher expectations of our people. These tend to change and expand with the ability to serve them. In our American society, attainable goals have a way of becoming imperatives.

As we look to the 1970's, there is an urgent need for more output than we have learned how to produce. Needs presented by our international obligations, the problems of our cities, the problems of our physical environment—all will press heavily on and substantialy influence the nature of the output of the 1970's.

Hence, it is essential that we get that additional output without excessive inflation.

But there are disturbing trends working against this objective.

III.

One consequence of the shift in social expectations and consumer demands leads me to my third point—that is the growth in the service-Government sector of our economy; which by 1967, had increased to 56 percent of the working population, versus industry at 39 percent, and agriculture at 5 percent.[4]

The significance of this change in our economy is that it represents a shift of consumer demand and employment from work areas which have had a record of relatively high increases in productivity per-person per-year to others where the increases in productivity per person have been very much lower—as in the very fast growing State and local government sector.

An example of the growing differential in productivity between the manufacturing sector and the services sector, and its effect on cost of living, is shown by the fact that in the last 2 years durable goods prices have increased about 7.2 percent while medical care has gone up about 13 percent—an average of about 3.6 percent per year in durable goods prices versus 6.5 percent for medical. At the same time, construction labor costs increased 9.1 percent on an average annual basis; while State and local taxes increased 15.2 percent per year.

Such sharp increases in price levels in the services sector have a double barreled effect. The manufacturing sector, under the whiplash of both foreign and domestic competition, is forced to, and does, improve productivity. But increases in the cost of living generated by the services-Government sector create pressures for continually

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[4] I haven't seen a more recent projection, but all indicators would lead to the assumption that the services-Government sector has increased its share of total employment still further.

higher salaries and wages in the manufacturing sector. The lack of productivity improvements in services is thus, in a sense, folded back into manufacturing costs, contributing further to the overall problem of inflation.

Economists refer to the type of inflation we are currently experiencing as "cost-push." However, it might be more accurate to describe what is currently taking place as—"cost-push" inflation in the aggregate, with "demand-pull" from those areas in which needs are not really postponable—medicine, education, garbage collection, utilities, and so forth—being folded into manufacturing costs at the bargaining table.[5]

A particularly troublesome effect of this fundamental shift in our economy from agriculture and manufacting to services is the unfavorable leverage it exerts upon our world trade and investment and our overall balance of payments. As we have already observed the cost of services and Government functions is the most rapidly rising element in our cost of living, and as such powerfully enlarges the already unfavorable wage and tax differentials which exist between American and offshore producers competing in both international and domestic markets.[6]

It should be noted that the growth in the services-Government sector will not compensate because we can't export the output of this sector to pay for an ever-increasing stream of manufacturing imports as reflected in our international balance of payments.

American manufacturers have endeavored to counter these forces with substantial investments in automation and product development programs. With their resources thus committed, they have two major choices:

(1) To respond to cost-push inflation by making still additional capital investments domestically, directed toward further cost reductions and improved manufacturing yields; or (2) to build or buy manufacturing facilities offshore. Hence we have the anomaly in the United States of a sustained high level of capital investment in the face of both mounting idle manufacturing capacity and unprecedented money costs.

With the manufacturing sector accounting for a rapidly diminishing fraction of our total employment and output, it becomes increasingly difficult to "compensate" in this way for the rapidly spiraling costs in services and Government, with further investments in manufacturing automation.

Once the problem is stated in this form, you can perhaps understand why businessmen—particularly those of us who are engaged in the increasingly difficult task of developing, manufacturing, and selling products around the world—have less faith in the efficacy of the many proposals for so-called "incomes policy" or wage price controls than do many others. If effective at all, they would be least effective where they are needed most—and vice versa.

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[5] A special case is the construction industry—which has been experiencing a "super-inflation"—with ripple effects throughout the economy

[6] Most other industrialized countries provide substantial incentives for capital investment, including tax policies that encourage it and support their exports. Furthermore, in many other countries the effective rate of corporate taxes is lower than in the United States, resulting in a relative disincentive.

Capital investment is the major source of productivity gains. American industry spends about 6 to 8 percent of GNP for new plant and equipment. Japan, the most rapidly growing economy, spends over 30 percent.

In the first place, and as a purely practical matter, the extraordinary number of small establishments and institutions responsible for pricing and wage decisions in the services and Government sectors make these areas highly resistent to any type of price and wage control or even policy influence.

In the second place, mounting idle capacity and eroding profit margins in the manufacturing sector demonstrate that the forces of competition are already restraining prices there relative to the services sector.

Thus we are confronted with the fundamental question: How to get the economic growth we need—without inflation—to meet our national goals. The answer, I think, certainly long-term, must lie in improved productivity—across the board—including all sectors of our economy and particularly the services Government sectors.

Let's look at one specific example involving construction labor. Our company contracted to provide comparable, complete nuclear powerplants to, respectively, a United States and a Japanese utility. The plant construction phases went forward under our overall responsibility with these results: The U.S. plant using U.S. construction labor required over 5.4 million skilled craft man-hours; the Japanese plant using Japanese labor required less than 4.25 million skilled man-hours. My associates tell me this reflects primarily the relative productivity of the work forces rather than any unique requirements of the site, the specifications, the materials or the regulatory authorities.

This kind of result means much more to businessmen than any amount of theorizing about productivity. When you have more than 1 million arguably avoidable man-hours on a construction contract you have a cost overrun of painful proportions. To the businessman this means corporate working capital is consumed not generated, it means that cash flow is negative not positive; this means your bank loans go up instead of your earnings. It puts a severe strain on the business involved and in the aggregate on the economy itself.

If this problem were in the manufacturing sector it would be attacked by investment of capital in labor saving facilities. However, this example, dealing with what is essentially construction labor, where in our experience the productivity crisis has peaked, is part of the greater challenge of improving the productivity in the services sector as we know it today in this country.

Long range, I feel we are going to have to reexamine many of our Government policies of the last half century in an effort to find an answer to the problems of lagging productivity in services, and the as yet inadequately demonstrated capability of the business community under present policies to contribute the new technology and modes of organization that are needed.

Moreover, I think we have to ask ourselves whether a body of labor law, born at the beginning of the middle third of this century, during a period of mass unemployment, may not have tended to create an unbalanced concentration of power in the hands of organized labor, whose focus seems to be on status quo rather than adaptability to new national needs. The result has all too frequently been to frustrate the development of needed new skills, and the introduction of new technology in a manner that is quite inappropriate in an economy desiring such growth, but at the same time struggling with the dilemma that

full employment without improved productivity translates all too readily into slow growth and fast inflation.

Another opportunity for increasing U.S. productivity lies in the need to enhance the efficiency of Government operations—particularly in State and local governments, which have the most rapidly growing employment and costs.

I think we have to ask ourselves whether the current need for improved Government services directed toward urban decay, pollution and deterioration in the very fabric of our society does not demand a far more rigorous analysis of our alternatives, and an improved discipline of planning in all levels of government.

A particular opportunity, an example, for government industry cooperation lies in using today's unemployment to improve the quality of tomorrow's work force.

This challenge has been a matter of particular concern to us in General Electric. Our operating people have emphasized their concern with this problem. They want these so-called hard-core individuals, who have made good, to continue with the company, and they hope that this will be possible. To meet this problem, we have developed some specific ideas which we have been discussing with key individuals in the administration.

This proposal would require substantial revisions of the current Government sponsored training programs for disadvantaged people. These programs would be expanded and restructured to encourage the training of all employees on layoff, whether or not they are classified as "disadvantaged."

Such an approach to training during layoff has the particular value, in this time of restrained economic growth, of providing continuity of work activity. It can be a vital asset in honoring the joint business-Government commitment to the disadvantaged of the Nation.

This might, hopefully, be accompanied by revisions in national labor policy to achieve a more balanced approach to the problems of a full employment economy by creating an atmosphere in which unions and management alike accept the responsibility of continually opening up work opportunities, upgrading employee skills and improving the productivity of employees—in part by encouraging employees to learn new skills and providing encouragement for employees to move into new areas of responsibility and opportunity.

I have talked here, as I said at the outset, primarily to the subject of productivity, and from the standpoint of manufacturing productivity. In trying to be constructive on the very complex problems confronting this committee, I have necesarily stressed the rigidities that have been built in, and prevent or hinder us in achieving steady growth through the optimum utilization of our resources.

Now, to close on a more upbeat note, let me count our blessings. As someone has suggested, the uneasiness about the American economy is at least twice as bad as the economy itself. Personally, I am highly optimistic. I think the opportunities for the U.S. economy, and incidentally, General Electric, in the next 5 years, are very great.

We are blessed with:

1. A growing and good labor force,
2. An abundant technology, and
3. Great depths of managerial and professional talent in this country.

Accordingly, I put forward this simple proposition that our society is a productive society; that its prime mission, as well as its great genius, is its productivity; and that improving productivity in the services-government sector of the economy, as we continue to improve productivity in the manufacturing sector, will be the keystone of our national progress.

And I, too, thank you gentlemen for the privilege of appearing.

Chairman PATMAN. Thank you, Mr. Borch. I shall not ask questions to be answered now, but I want to pose some questions for you gentlemen to answer when you look over your transcript, please, and I expect to ask other questions in subsequent hearings before this committee on the same thing.

First, I want to know if you believe that we have reached such a crisis in tight money and high interest—as demonstrated by the recent bankruptcy of a $7 billion railroad concern that couldn't pay its electric bills and had to go into bankruptcy—that we have to develop a way of financing worthy and deserving projects like the Penn Central, one of the biggest, and down to the lowest. It would be similar to, or patterned after, the old Reconstruction Finance Corporation, but not necessarily exactly like it, something that would, if credit is not available locally through financial institutions, receive applications and give consideration to them for loans at reasonable rates of interest, for worthy purposes.

The next question is whether or not you believe that interest rates are too high and, if so, what are your recommendations to lower the interest rates?

And three, Mr. Abel brought out that pension funds should be used for housing. I was very glad that he mentioned that because today under present interest rates a person who buys a $20,000 home having only a traditional term of 30 years, with the present rate of interest would be compelled to obligate himself to pay not only the $20,000 for the home but $38,000 for the interest. In other words, he would have to pay $58,000 to get a $20,000 home. I would like you to comment on that.

Next we would like your comments on whether or not the Congress should permit Delaware corporations to have so much power and influence over State laws in regard to mergers and conglomerates, and be allowed to override State laws on such things as branch banking and similar matters. Should Congress take some action on the Delaware corporation question, especially where it involves mergers and conglomerates?

Next is unemployment. What should be done if unemployment should continue as it is, or what should be done about the present unemployment situation? Millions of people are unemployed and something should be done to relieve their distress.

And the next is whether or not the Congress should do something about the trend of the one-bank holding companies, and whether or not banks should be required to stay in the banking business and not be permitted to engage in other peoples' businesses, particularly going into competition with their own depositors.

And next is what should be done about inflation, how it should be fought?

Everyone is against inflation. Of course, my remedy is to roll back the interest rates because that is what caused the inflation; but other people have different remedies and different ideals.

I would like to have the comments of you gentlemen on those questions, so will you comment on them when you look over your transcript for approval of this testimony.

(The following answers were subsequently supplied for the record by Mr. Abel and Mr. Borch:)

I. W. Abel's Replies to the Questions Posed by Chairman Patman

Answer 1. I believe that such National Development Bank should definitely be explored by the Congress. Organized labor will certainly examine this issue carefully and sympathetically. There surely is a need for a federal agency to provide credit, on long-term and low-interest rate terms, under specified conditions and for specific purposes.

However, I do not believe that American taxpayers' money should simply be handed out, as long-term and low-interest loans, to the managements of corporations in financial trouble. There is no rational reason for the U.S. government simply to bail out huge conglomerates (and their banker creditors) that have gotten themselves into dire debt problems through over-extension of take-overs, financed by high-interest loans from the banks and their holding companies.

There must be some quid pro quo for the American people and the U.S. government in such deals, if there are to be any at all. If the federal government establishes such an agency, it should also set forth the utter necessity for specifying the specific purposes, priorities and conditions, under which the loan is granted.

Answer 2. Yes, interest rates are much too high. They are extortionate. They must be brought down. At present we need a considerable expansion of the supply of money and credit. We also need selective credit controls, the allocation of available credit for high-priority purposes and interest-rate ceilings, along the lines of the statute adopted by Congress in December 1969.

Answer 3. My prepared statement to the Committee recommended:

"The government should require that a portion of such tax-exempt funds as pensions, college endowment and foundation funds—as well as bank reserves—be invested in government-guaranteed mortgages to help meet the goal of 26 million new and rehabilitated housing units in 10 years."

Answer 4. Yes, the Congress should take some action in this area of corporate law.

Answer 5. Unemployment is the key problem, at present. My prepared statement to the Committee presented organized labor's views on how to reduce unemployment quickly. The major requirement is expansionary monetary and fiscal policies to encourage the needed growth of sales, production and employment.

Answer 6. Bank holding companies definitely should be restrained. Moreover, government action is needed to curb the extremely disturbing trend toward the increasing concentration of economic power in a narrowing group of huge corporations and banks.

In addition, a comprehensive Congressional examination of the structure of the American economy is very much needed and long overdue.

Answer 7. My prepared statement spelled out the AFL–CIO's views in detail, on how we believe the current inflation can best and most rapidly be curbed.

Fred J. Borch's Replies to the Questions Posed by Chairman Patman

Answer. It has been a practice of long standing for the Government to provide needed financial assistance in support of industries and services which are considered essential to the national welfare. The situation at Penn-Central appears to be too complex to permit any judgment at this time as to the desirability of long-term Government assistance, although it appears obvious that some way must be found to provide short-term help if complete collapse of rail service is to be avoided. Without attempting to pass judgment on the Penn-Central situation, I think we must agree that 1) good railroad transportation is

essential to the country's welfare, 2) the railroads have been subjected to a high degree of Federal regulation, and 3) the railroads are required to compete with other forms of transportation which enjoy substantial Government aid, both direct and indirect.

As to the mechanics of providing Government financial assistance, there is a substantial amount of precedent available, such as the Reconstruction Finance Corporation and the V-loan program under the Defense Production Act. We feel that whatever vehicle may be established at this time to provide needed assistance should utilize, to the fullest extent, facilities already available in the private sector, rather than duplicating such facilities in Government bureaus. For example, a program which provides for a sharing of risks by Government and private lending institutions, as in the V-loan program, would permit the Government to leave the management of such loans in the hands of the established lending institutions, and retain their interest in developing solutions to the problems, in addition to reducing the amount of funds which the Government would be required to provide. It would seem appropriate to charge a fee for such guarantees, thus reducing, if not eliminating, the cost to the Government.

As mentioned previously in connection with the Penn-Central, there will undoubtedly be some situations where nothing short of a 100% Government guarantee will solve the problem, and the program should be sufficiently flexible to permit such treatment of newly-created, as distinguished from existing indebtedness. As solutions are developed to underlying problems, however, the need for 100% guarantees should disappear.

Answer 2. Interest rates remain high although there has been some easing lately. Undoubtedly, the high cost of funds which has prevailed during the past year has deprived many important economic sectors of the capital required for continued growth. Certainly. housing has been adversely affected.

However, the high interest rates resulted from the efforts of the Federal Reserve to stem inflation by reducing the flow of bank credit. With price increases accelerating, monetary policy had to be used to dampen economic activity in order to prevent runaway inflation. Happily the worst of the restrictive credit seems to be over; price gains have lessened and the Federal Reserve seems to be easing up on the credit brake.

Answer 3. In a free market economy, lenders have to be rewarded for surrendering control over their savings. Savers place some of their hard earned incomes in savings institutions and expect some return on their funds. The mortgage lender must charge an interest rate to pay off the original saver.

Answer 4. General Electric Company has been a New York corporation since its inception in 1892, and we do not have special knowledge or experience with the Delaware statute.

With respect to corporation laws in general, it should be noted that they are basically enabling and not regulatory laws. Corporations being the creatures of the state of incorporation can only exercise the powers conferred upon them by the state.

Provisions in state corporation laws with respect to mergers and consolidations are likewise basically of the enabling rather than regulatory type, that is, they would provide for the procedure for effecting the merger, including such things as obtaining necessary tax waivers, board of director and share owner approval, and the filing of the necessary papers in the Secretary of State's office.

The economic effects of a merger and questions with respect to its fairness to the share owners of each of the corporations involved do not turn on the particular state of incorporation of the merging companies. For example, the Federal Antitrust Laws are the principal yardsticks in judging the competitive effects of a proposed merger. With respect to fair disclosure of the terms and conditions of the merger. the Federal Securities Laws would govern (particularly the proxy rules) whenever securities are being issued to effectuate the merger, as is invariably the case. Attacks upon the fairness of mergers have been made in both Federal and State courts, and the outcome of this type of litigation in no way depends on where the corporation happens to be incorporated.

Consequently, state corporation codes including that of Delaware probably have had little or no effect on the merger movement, although the Delaware Law provides a more expeditious way of consummating a merger. Mergers involving Delaware corporations, like others, would be subject to review and possible attack by the Department of Justice, FTC, SEC, possible other regulatory agencies, share owners, and possibly other interested parties (e.g., creditors). Cor-

porations generally would not seek to expedite a merger unless they were reasonably certain that it would withstand such reviews and possible attacks.

Answer 5. As pointed out in my submitted testimony, the rise in the unemployment index is composed of a number of factors, and employment, of course, is closely related to the state of the economy.

As we get back hopefully toward the end of this year to a resumption of real growth in the economy, with a lesser rate of inflation, we should see the employment index respond.

Nevertheless, there is an opportunity to use such periods, constructively, to improve the quality of our labor force. We are discussing with government agencies a program for joint industry/government support for voluntary training and upgrading of the skills of the unemployed.

Answer 6. This is a question that we would prefer to leave to others, because it is wholly outside of our field of operations, and we have no special knowledge or competence to answer. Our interest in banks is to obtain the best possible banking service and adequate credit accommodations. Presumably, you will receive much expert testimony on this during the course of the hearings.

Answer 7. Fighting inflation is complex because the problem is extremely involved. The principal concern last year was to stop price escalation as abruptly as possible. Consumer, business and government demands exceeded the economy's ability to produce. Fiscal restraint and tight credit dampened economic activity and helped to stem inflationary pressures.

These measures though beneficial in the short run, do not tackle the fundamental problem of low productivity in the rapidly growing services and government sectors. I have suggested in my testimony that we should seek to enlarge the pool of skills in our workforce, to raise productivity across the board, and thus increase our real national output. The inflation which we have endured is heavily concentrated in the services sector, as the following table highlights.

CONSUMER PRICE INDEX

	Percent change, April 1969-70	Share of percent change, total index
Meat	11.9	9.0
Home maintenance repairs	10.6	8.8
Mortgage interest rates	11.7	7.8
Auto insurance rates	13.6	4.9
Doctor, dentist fees	7.2	4.1
Cigarettes	11.4	4.1
Local transportation	15.2	3.2
Property taxes	7.9	2.5
Hospital services	12.3	2.2
Airline fares	6.4	1.1
Women's dresses	6.8	.8
Coffee	17.7	.8
Cracker meal	13.9	.5
Parking fees	11.5	.3
All other	4.1	49.6
Total Consumer Price Index	6.0	100.0

Suggestions for improving productivity in the services sector, in my testimony, and by others, includes: the encouragement of private investment in the services sector; immigration of badly needed skilled professionals; re-examination of procedures in the professions to determine those functions which could be performed by skilled technicians; and elimination of over-restrictiveness on entry into the workforce, and changing work rules.

Likewise, it has been suggested that Government programs should be vigorously studied in order to determine the cost effectiveness of various proposals to improve the planning discipline at all levels of government.

Chairman PATMAN. I yield to Mr. Widnall for 10 minutes. Each member will be allowed 10 minutes to interrogate on the first go-around.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Abel, Mr. Borch, I think you both made excellent statements

which have been very helpful to the committee in trying to whip up some final statement in connection with the findings of our hearings.

Mr. Abel, I would first like to ask you, you said in your statement, "the guideline approach has a record of futility and failure."

In your opinion would there be any point in resurrecting the wage-price guidelines at this time?

Mr. ABEL. No; I don't believe, sir, that there would be.

Representative WIDNALL. At any time in the foreseeable future?

Mr. ABEL. No; we are very much opposed but, as I said in the statement, if the President feels that we have reached the place where we have to have such drastic action we will, with certain understandings of fairness of application, cooperate to the best of our ability with mandatory efforts to curb the inflationary trend.

But we do not believe that we should have guidelines of the nature you mention.

Representative WIDNALL. Why do you believe they have failed?

Mr. ABEL. Well, our experience during past periods certainly proves that. They failed particularly with respect to control or regulation of prices. It seems to be much easier to enforce them insofar as their application to workers and wages are concerned than to the price structure.

In addition, I will remind you that they were applied primarily to workers' wages. They were not an incomes policy by any stretch of the imagination. This, according to our point of view, is very unfair.

Representative WIDNALL. Yes; I know that.

Do you think a freeze on wages and prices might be a good idea at the present time?

Mr. ABEL. No; I don't. If there is some kind of mandatory regulation, not a freeze, we feel by all means there has to be consideration to those sectors that are lagging way behind at the present time. To impose a strick freeze; you just impose inequities and injustices on people who are the least able to bear them.

Representative WIDNALL. Thank you.

Mr. Borch, I believe your company has had considerable experience in trying to aid workers improve their skills and also to provide the opportunities for learning that would enable minority groups and others to enter the work force. Have you had enough of it so that you can give a report on your own experience as a company?

Mr. BORCH. It has been very satisfactory, Mr. Widnall. We have experimented with a variety of programs, and I think, over time, have learned that this is a great resource that the country has that has not been fully tapped. We are finding, for example, after a rather difficult beginning period, perhaps 6 weeks to 2 months, that these folks have become very productive members of the work force, with less turnover than normal hires, and excellent productivity, and I think Mr. Abel might concur with this from his experience, too. This is the reason why we are suggesting the expanding of this type of program with Government help during this period, when our greatest need, as we see it, is to upgrade the skills of people.

Representative WIDNALL. Has your own company been able to absorb a lot of graduates of your schools?

Mr. BORCH. We have absorbed everyone we could get.

Representative WIDNALL. So that the demand is there if you can get the qualified workers?

Mr. BORCH. At the moment we are having difficulties, as you know. I described to you the fact that we have had a reduction in work force of something like 12,000 people recently, the great bulk of which results from the cutback in space and defense spending. But interestingly enough we have been able, for example, in our aircraft jet engine business, as the military orders have fallen off, by converting our productive capabilities here to the Douglas, DC-10 trijet commercial engine, to have experienced an increase rather than a layoff in these areas of employment.

So this particular case has been a transition that was relatively easy and quite natural as a result of some planning that we did some years ago.

But it is not so easy generally to take people who have been involved in the defense and space area and immediately find employment for them in other areas of the economy. This is a time-consuming thing and in many cases involves changing their homes and locations and things of this kind.

Representative WIDNALL. Mr. Abel, you say, you will continue to take the position that the only correct policy regarding unemployment is one of full employment. How do you define full employment?

Mr. ABEL. Job opportunities for all those who are willing and want to work on a job.

Representative WIDNALL. Do you have any figures that you could apply as to what unemployment rate would be acceptable or would be expected?

Mr. ABEL. Well, we certainly feel that we should reach the lowest level. Now what that might be, I don't assume we can ever reach a zero level, as some people like to use the term, but certainly it can be substantially lower than what it is today. There is always a changeover, as you well know, with respect to job changes, opportunity openings, and so on, that creates momentarily a measure of unemployment. But our position is that we can get it down to perhaps one, one and a half percent, not five or five and a half or 6 percent.

Representative WIDNALL. Mr. Abel, there are a number of millions counted in the unemployment force, but of those millions a substantial amount in numbers will be those who are in the period of transition. Either they voluntarily left the job, they are taking a short vacation before going over to a new job, or they are changing location. Related to the figures of unemployment, what percentage or what numbers would you say would be the hard-core unemployed: those who have been unemployed for some time and are having difficulty in getting jobs and getting help and assistance?

Mr. ABEL. That is difficult to come up with. Even at the beginning, using the Labor Department's figures, because as we all know after a certain period of time a lot of these so-called hard-core people just discontinue their efforts to find employment, they are not on the unemployment compensation rolls, et cetera, and so they are not even figured in the statistics we have with respect to unemployment.

It is our feeling that particularly in the ghetto areas of our major cities there are many thousands of unemployed, hard core, that aren't even included in the statistics that we now have that we think are way too high.

For me to give you a figure as to what we might consider acceptable, I don't know how you would arrive at that.

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Representative WIDNALL. I don't think there is any figure that is truly acceptable to anybody. I mean, I am sure of that.

Mr. ABEL. Especially the fellow who is unemployed.

Representative WIDNALL. But we do know there are a number that are physically handicapped. There are a number who don't try too hard to become employed, and some who don't even want to undergo the job training which would be necessary to improve their skills so that they could get a better job or get a job at all. Do you have any indication as to the number of union members whose wives are also employed?

Mr. ABEL. No, I don't have; and I don't think we have any source of that kind of information.

Representative WIDNALL. I ask that thinking of many, many instances where a husband will be a schoolteacher, his wife is also a schoolteacher, and their combined employment produces a pretty good amount in wages and salaries, and when you just take one individual in the family and say he can't support the family and then don't relate it to who else is employed in the family, you are not getting the true impact on the economy or a true answer to it.

I certainly think that everybody should be provided a living wage and the opportunity to get a good salary, according to their skills, but sometimes I have seen those who have been marching with the people who say that they have to have a living wage, they are able to have a little summer home down at the beach, and they have got two cars in the family because the wife works and they are doing pretty well, as a matter of fact, and it would be very interesting if we could gather together some of the figures on that.

My time is up.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Mr. Abel, you put great deal of stress on unemployment as one of our principal economic problems. Now I think you seem to imply that it is our No. 1 problem; is that correct?

Mr. ABEL. Right, sir; right.

Senator PROXMIRE. I must say, on the basis of the statistics, it is hard to disagree with you. I think you cited several that many of us have neglected. The fact that hours of work are very low, 37.2, I think, is the latest figure on a seasonally adjusted basis.

Mr. ABEL. Roughly 37 a week.

Senator PROXMIRE. Which means as the demand picks up instead of hiring more people employers are likely to put the people who are already on the payroll to work a little longer; longer hours.

Mr. ABEL. Right.

Senator PROXMIRE. In addition, we are operating, as you point out, far below capacity; it is below 80 percent of capacity, 79 percent; and this means that the capital goods boom, that has acted as an accelerator in our economy, is unlikely to give us that kind of buoyancy or dynamism in the next few years, and I expect that would tail off and that would mean more unemployment.

In addition, all of us hope and expect we can cut back our military expenditures. The Secretary of Defense has announced the next few years there will be a million fewer people in the Armed Forces. We hope, in addition, there will be space cutbacks, and there have been some space cutbacks, in the Apollo program.

Now the only counterbalancing factor that I have heard, either from Mr. Borch or others, is there are elements in the economy such as the expiration of the surtax, and so forth; the feeling that the Federal Government is likely to run into a deficit that might counteract this to some extent but the critical factor that the economists look at is the full-employment surplus and, as I understand it, no matter what we are likely to do in the next several months, in fact in the next year or so, we are likely to have a full employment surplus.

In other words, the effect of the Federal Government is likely to be a restraining effect on the economy.

Now your solution to this is, you say is, to fund, full funding of a series of programs.

Let me ask you first about housing. We have set as a housing goal 2.6 million housing starts a year. We are now operating at about 1.2 million housing starts; far short of it.

Do you, when you say "full funding," mean that the Federal Government should take whatever steps we have to take in terms of monetary policy and in terms of subsidy to see that we are building those 2.6 million housing starts a year?

Mr. ABEL. Correct, sir.

Senator PROXMIRE. And you would take the same position with respect to funding education programs that we should provide appropriations for the full authorization amount?

Mr. ABEL. Correct.

Senator PROXMIRE. And I presume that much of this would be in the private sector area; that, for example, you would not expect that the Federal Government would provide much of the funds for the 2.6 million housing starts. That would be because the private sector would be brought in through lower interest rates, and so forth.

Mr. ABEL. That is right; and we are suggesting, Senator, that the Government come up with a program of securing these kinds of investments like other investments are secured by the Government.

Senator PROXMIRE. Now, I suspect——

Mr. ABEL. It would be an inducement.

Senator PROXMIRE. What is holding us back, especially in this latter area with regard to a monetary policy to stimulate housing, is the haunting fear of inflation. We have not licked it. We have cut and run under these circumstances, as some have put it, that we are likely to create a further inflation, and what you would propose, as I understant it, to cope with this is, No. 1, the use of credit controls that are now on the books to hold back business investments, for instance, in plant and equipment, and channel that into housing to the greatest extent that you can; and then you have other more long range proposals like curtailing mergers and so forth.

Mr. ABEL. Right.

Senator PROXMIRE. What concerns, I think, many citizens and economists, Mr. Abel, is that if you follow your prescription, you might be moving into a situation where you would have to have price controls, wage controls, profit controls, rent controls, and freeze the economy if you are going to move into a policy position of having, say, 3-percent unemplyment or less. How do you meet that argument?

Mr. ABEL. You are saying now that with such a program you freeze the whole economy.

Senator PROXMIRE. Such an expansive program may be highly inflationary; some economists argue it would be highly inflationary, if you go that far to have all these housing starts and move ahead in education and move ahead in all these other areas because prices would begin to rise and we may have to have, as you say, necessary price and wage controls right across the board.

Mr. ABEL. Certainly, there has to be, in our judgment, first, better control of our monetary operations and, as the chairman has pointed out here this morning, as long as we have the kind of interest rates that are applied to home loans there is just no possibility, no hope, of individuals obligating themselves to that extent. They just can't. And our suggestion is that with reasonable interest rates and controls, as we have had in the past, and a guarantee on the part of the Government, we can induce the flow of funds that presently exist in pension funds across the country as well as in endowment funds and other sources of capital into the housing field to provide the opportunities for people to own their homes.

Senator PROXMIRE. I agree wholeheartedly with that purpose, and I think it is a very good one. But what concerns me is if we do get into a situation where money is easier and easier to borrow and more available people do start building homes and buying automobiles and doing things they can't do now because money is hard to get, won't you have a situation once again where we have very serious inflationary pressures?

Mr. ABEL. Well, this is a possibility, but I think you have got to keep in mind that even with the high and usurious interest rates that are being charged, a certain level of this is going on regardless and people, the ones who are really suffering, are the small people who need the homes. This is the sector that is really suffering.

Senator PROXMIRE. Certainly I would agree that we could do much better than we are doing, and where we have a situation where we have so much slack in our economy and so much idle resource without approaching the point where we have universal controls.

Mr. Borch, I would like to ask you, you said that one of the most constructive things we could do would be to aim at increased national output, real output.

Mr. BORCH. Real output.

Senator PROXMIRE. I would agree wholehartedly. But it would seem to me that the principal problem here is one that Mr. Abel put his finger on, that we have idle resources now, idle plants and equipment, idle manpower, that we are not putting those to work. I don't see how we can increase our real national output when we have more than 4 million Americans who want to work not working, when we have 20 percent of our entire factory capacity not operating, and the very constructive notion you had of having hard core people trained and working, it seems to me is a fine ideal but you are not going to do that with 5-, 6-, and 7-percent unemployment because a manufacturer simply cannot afford that. You cannot afford that.

If your demand for General Electric products dried up, you couldn't afford to keep those people at work very long. As long as the demand is high, then you are out looking for people and you are willing to train them and you are willing to do whatever is necessary to see that they become skilled and able to do a job.

Mr. BORCH. I have a very basic faith and confidence in the soundness of our economy, and when I note that consumers are putting something like 7 percent into savings, and not spending their money as they normally do for goods and services, I am convinced that the buying power is there.

Now, the main concern here, as Mr. Abel pointed out, is a lack of confidence on the part of the consumer. That confidence stems largely from the problem of inflation and what they may fear lies ahead, and I think for that reason they are playing it close to their vests, as you and I would under the same conditions.

Now, I think when inflation is brought under control visibly, and the cost of living index is reduced, as it will be in the last 6 months of this year in comparison with the first 6 months, I think you will see a regeneration of consumer confidence. And when this happens, the real growth of the economy, Senator, in my judgment, will be inevitable.

Senator PROXMIRE. Well, may be the real growth will be inevitable but we are a long, long way from cracking this tough unemployment situation. One of the most optimistic predictions was the one that appeared in July in Fortune. They foresee interest rates moderating, inflation losing, but they had to say that unemployment would continue to worsen for the very reason you say: That productivity will improve, and the same number of workers will be able to produce more, and further, as hours lengthen you are going to have more hours for the same workers to produce more. So, with increased productivity and longer hours you can get more production—much more—before there is any incentive for employers to hire many more workers. Also, our labor force will be growing.

Mr. BORCH. It may not grow, Senator, as rapidly as we would like to see it, but I think our history of past slowdowns in the economy would indicate that as long as the fundamental strength of the economy is there, and it is on a sound basis, this will be self-correcting.

It may take a little longer than any of us in this room would like to see it, but I think once consumer demand restates itself, then you are going to have manufacturers like General Electric resuming a rather rapid growth of capital expenditures for new and more productive facilities. And I think your risk at this point becomes the question that was directed to Mr. Abel, namely, if you do this too rapidly, I share your concern that you will run a very good risk of going on an inflationary binge once again. So it is a matter of balance.

Senator PROXMIRE. My time is up.

Chairman PATMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Abel, what would you regard as a fair interest rate? Would you say 4 percent would be a fair interest rate?

Mr. ABEL. No, I wouldn't. I have often needled our own economists every time they present me a paper on some corporation's profits, they note that 6 percent is considered a fair return, and I asked them how it is that an industry or a company might survive on 6 percent while they are paying 9 or 10 percent interest on their bonds. So I don't know whether 6 percent is considered today a fair and equitable return or not, but it is more than you and I get for our money if we should have a dollar to put in a bank or in Government savings bonds.

Senator MILLER. Well, if you had to borrow some money you would be delighted if you could borrow it at 4 percent, wouldn't you.

Mr. ABEL. Certainly I would. Yes.

Senator MILLER. All right.

Now, if you are borrowing it from me, and I see an inflation rate in the cost of living of 5½ percent and I know that if things continue that way until the end of the year when you repay me, if you pay me back in a year, my dollars are going to be worth 5½ percent less, you couldn't blame me for charging 9½ percent interest, could you.

Mr. ABEL. No, no, apparently not.

Senator MILLER. All right.

Mr. ABEL. Especially under our economic system. It is charge all the traffic will bear apparently.

Senator MILLER. All right.

And I think you have made a very good presentation of the fact that the increases in the cost of living preceded many of these wage increases. You can't blame a wage earner if he is, let's say, getting $100 a week, and he knows that 5½ percent of that is going to be taken out by inflation, for coming around and asking for at least $105.50 just to stay even with the board. And I suggest to you that the same thing is true with the people who have money to lend. You can't blame them for charging 9½ percent interest based upon, let's say, 4 percent for the use of the money and 5½ percent inflation factor. So, I think that what we get down to is not so much to blame the heads of the unions or the wage earners or the people who lend money as to blame those who caused the inflation in the first place, and I regret very much that you have highlighted this point.

Now it might be a little unfriendly for you to come before a congressional committee and do so, but I, for one, am certainly ready to place the blame where the blame ought to be, and that is on those in control of the Congress who ran your Federal Government $60 billion deeper into debt in a period of 5 years and topped it off with a $25 billion deficit in 1968. That is where inflation started, and I am not about to blame wage earners or money lenders for what those in control of the Congress caused.

While I appreciated the excellent job you did in pointing up the relationship between the increases in the cost of living and increases in wages, I must tell you that you kill off the effectiveness of your statement when you refer to the "bankrupt policies of the administration."

Now, Mr. Abel, 2 months ago I was out in Los Angeles, and James Tobin, a Democrat and former member of President Kennedy's Council of Economic Advisers, praised the Nixon administration's anti-inflationary policy. He is an economist, an experienced economist, and you are not, and he, if anything was speaking against interest because of his political affiliation. What you failed to point out is that it isn't the bankrupt policies of the administration, because the policies of the administration are on paper, and they are not worth any more than the price of that paper unless those in control of the Congress carry them out.

So I think if you are going to refer to bankrupt policies, you might well refer to the bankrupt policies of those in control of the Congress, and preceding Congresses, who are responsible for laying the foundation for the inflation that we are suffering under.

Mr. ABEL. Certainly, Senator, the administration is responsible for its policies, primarily the so-called hard money policies, and those policies, in our judgment, are the root causes of our difficulty and, as I pointed out, it has been talked of for the last several years, you know, that the only way to cure the inflationary spiral that we are confronted with is the implication of the hard money policies and the inducement of unemployment.

You recall, as I do, and all the rest of us, the dialogs of the trade-off of employment for price stability, and certainly these are the administration policies. We can't accept them as anybody else's policies.

Senator MILLER. I would have to ask you to give me a direct quotation from the President or somebody speaking for the administration which indicates that we are going to have a trade-off in the form of unemployment for stability. I know there has been talk about it but I would like to ask you to provide, for the record, quotations——

Mr. ABEL. There not only has been talk about it but it is actuality. Unemployment has risen but prices have risen too, and the inflation has continued.

Senator MILLER. Well, Mr. Abel, if you are going to say that the policy of the administration to move away from a wartime economy, which certainly gave up full employment, all right, 3½-percent unemployment rates which the former President bragged about, if you are going to say that a policy to move out of that wartime economy into a peacetime economy is the clause of increased unemployment, I think everybody in the administration would be delighted to accept that, because we want peace first. But I must tell you that the policies that you are talking about are on a piece of paper, they have been delivered to the Congress by the President in his messages and they are not worth any more than that piece of paper unless the Congress, those in control of the Congress, carry them out, and I think it ill behooves you to talk about bankrupt policies of the administration, which are on a piece of paper when they haven't been implemented by those in control of the Congress, and those in control of the Congress are the ones who laid the foundation for the inflation we suffer under.

Mr. ABEL. Well, I am not, Senator, by any stretch of the imagination saying that Congress doesn't have some responsibilities, but certainly Congress, as I know Congress, and our Government, receives leadership from the administration, whether it be this one or the preceding administrations, and we look to the administration to give guidance and programs, and we of labor, of course, expect Congress to enact policies and programs to improve our status and our society and we are quick to point out shortcomings of Congress just as much as the administration is.

Senator MILLER. I would have felt much better about it if you had balanced your statement by doing that very thing this morning. I appreciate what you just said because I do feel that you want to be fair about it, but it would have been a lot better if you had pointed your finger——

Mr. ABEL. Well, Congress, as I recall, Senator, has given the administration some powers and some authority that they could use that they haven't used in helping at least making a start in correcting the economic condition we find ourselves in.

Senator MILLER. Let me ask you one further question on this point. You recommend full funding of appropriations. You didn't couple with that a recommendation that Congress pass the necessary taxes to insure that they be funded without going further into debt. Would you couple that with your recommendation?

Mr. ABEL. I think you first want to see the programs that you are funding, and I think you have got to consider, too, the programs that have already been funded that haven't been implemented. That was another part of the administrations actions of stopping a lot of programs that Congress had already enacted and funded.

Senator MILLER. Well, do you think that those programs should be backed by enough taxes to cover them without having your Federal Government go further into debt?

Mr. ABEL. Well, we, of course, have to give consideration to the conditions and the times. We all want a balanced budget, we all want a balanced economy. If anything, we want less taxes and less spending, but when necessity calls for it, certainly the labor movement is in favor of the Government sponsoring programs and assuming an indebtedness for the good of all of the society.

Senator MILLER. And the taxes.

Mr. ABEL. Taxes as well.

Senator MILLER. Thank you.

Mr. ABEL. We have advocated taxes at times, you know.

Chairman PATMAN. The gentleman from Wisconsin, Mr. Reuss, Representative Reuss?

Representative REUSS. Thank you, Mr. Chairman.

These are excellent statements from both you gentlemen. I would expect industry to speak for industry and labor to speak for labor. If they don't who will. It doesn't bother me in the least.

Mr. Borch, in your statement you say that you have endorsed the idea of a tax increase as being needed to stem inflation, and I commend you for it. I have a bill before the Congress which would retain the surtax on the income tax on corporations, which expired just a few days ago, until such time as the President shall certify that U.S. military operations in Southeast Asia have ceased, the idea being to confront the very alarming deficit that looms for the current 1971 fiscal year, and get additional funds into the Treasury so that the Treasury does not have to make the money market even worse by frequent incursions into it, in other words reduce the deficit. Would you favor such a bill?

Mr. BORCH. I think, Mr. Reuss, it is a question of degree. If the deficit, and we have seen all kinds of numbers in this forthcoming deficit, is a modest deficit, I would not recommend you impose a surtax at this time.

If, on the other hand, there is any danger whatsoever of the deficit going up to the order of magnitude that it did a few years ago I would impose a surtax, reimpose it very quickly.

Representative REUSS. We will, of course, hear more about this as the hearings unfold, but the present projection is that even the administration has changed its estimate and foresees a deficit under current accounting methods approaching $2 billion, and that under the old accounting would be the kind of hair-curling deficits that used to scare former Secretaries of the Treasury, so we shall see, and I am very grateful for your answer.

Mr. Borch. I agree with Mr. Abel that to the degree it is possible for the administration and the Congress to do so the Federal budget should be as close to balance as reasonable but it should not be the ultimate objective at all times. I think leeway both ways is perfectly sound, and at this time I must repeat what I said to Senator Proxmire, that the time is coming shortly, I think within a matter of months, when consumer confidence is going to be regenerated again. When that time comes you are going to see increases in your tax collections, as corporate profits improve, as more people get on the payrolls and your revenues increase—I think the problem today is largely a revenue deficit; isn't it Mr. Reuss?

Representative Reuss. Yes; and that is why I suggest we could use some more revenue.

Mr. Borch. It is a revenue problem.

Representative Reuss. Anyway thank you for your answer.

Mr. Abel, yours was an interesting statement, too, particularly in its human element, what is happening to people generally and your blue collar workers in particular.

The present economics of our country are to, as you pointed out, increase unemployment by considerably more than a million men and women over what it otherwise might be and to have the highest interest rates in a hundred years.

In terms of a steelworker in Gary, for example, that means that he is upset, his job security is threatened even if he continues to hold a job, interest payments on his home and his refrigerator are way out of sight, his schools at the local level continue to deteriorate, his taxes on his income, and particularly on his home, are grinding, to say the least, and perhaps worst of all he has seen his real income deteriorate in recent years by reason of inflation, increases in the cost of living.

Now, the main spokesman for the administration, Mr. Agnew, doesn't talk much about unemployment or high interest rates. Instead his thrust is to blame the troubles of our country on those who oppose the war, or university students, or the television, newspaper people, and I gather your testimony is to the effect that what we need to do in this country is to get back toward full employment and expanded growth which you think can be done if we cease fighting a nonexistent demand through inflation and instead by the use of credit allocation controls and perhaps by the use of price controls on administered prices, you think we could then get back in a forward economic motion and that there would be a greater chance of having social unity in this country and not the terrible cleavages between fellow Americans that we all regret to see now.

Would that be a fair statement of your position?

Mr. Abel. Correct, Congressman. I don't think there can be any question in anyone's mind of the great potential we have in our society if we are going to get our society back to the semblance of unity as you suggest. Certainly the demand is there to keep our industries going at full blast and provide full employment, just to rebuild our cities, just to provide the needed transportation facilities, the hospitals, the schools, and all of the institutions that all of us need so badly, to make ours the kind of a society that we promise ourselves that it will be, and we are not going to get it if we are going to let our moneys be used in the form of usurious payments and our people to remain idle when

they should be engaged in productive pursuits, and our industries, while modernized, to be put in production rather than to lay idle after they have been modernized and improved.

Representative REUSS. Thank you.

Mr. Borch, you had an interesting little case study of what it cost you here and in Japan to build substantially equal facilities, and how it took many more man-hours in this country than in Japan, with the implication that there is some featherbedding, some restrictive practices going on, and I deplore them, if true.

In fact, labor aren't the only people who go in for featherbedding, are they? Isn't it a fact that in medical care, where you correctly pointed out a horrendous 13 percent cost increase in 2 years, isn't one of the reasons for the high cost of medical care that our medical schools aren't producing sufficient physicians so that we have got them here from Pakistan and the Philippines and India and every place else and there aren't enough of them; and isn't it further a fact that the physicians, the doctors, own trade organization, the AMA, has rather consistently opposed the provision of an adequate number of physicians in this country?

So isn't there, what I am saying, isn't featherbedding an endemic disease in this country and not one in which our friends from labor are the only specialists?

Mr. BORCH. I am afraid I would have to go a little bit further than that, Mr. Reuss, and say I know of a number of instances where there is considerable featherbedding among management which we are trying to dig out a little bit.

But I think on the question of the medical schools which you pointed out, I think we have a problem of not enough facilities. I am not especially familiar with the AMA, but there is a problem with medical facilities in this country, and something should be done about that. I certainly agree with you there is a shortage of doctors.

Representative REUSS. Thank you very much.

Chairman PATMAN. Yes.

Representative Brown?

Representative BROWN. First, I must say that I was fascinated by my colleague from Wisconsin, Congressman Reuss' interpretation of administration economic policy through Mr. Agnew's statement about the newspapers. As a newspaperman, I have difficulty figuring that out, but I will work on it for the rest of the day and see what I can come up with.

I was very interested, Mr. Borch, in your statement concerning retraining the unemployed. Are you suggesting this be an industry program to take advantage, of unemployment, and train workers for greater productivity or are you suggesting it should be a governmental undertaking?

Mr. BORCH. I am suggesting this as a joint undertaking similar to a number of the programs that the Government has had in effect through the Department of Labor, contracts with major companies where—they are nonprofit contracts obviously, but they do help alleviate the costs to the companies of training people who are in this hard core group. I am not in agreement with Mr. Abel's statement that the hard core per se, as I got the inference, are unemployable. The experience has been quite the reverse. People in the ghettos and so forth, if they make the efforts, are employable.

No, my concern—did I misquote you, Mr. Abel?

Mr. Abel. Yes.

Mr. Borch. I am sorry, I apologize. My point was that as a result of hiring so many, as we have in the last few years, who have been very productive, when business falls down the seniority system requires that the last on is the first off. This has been particularly distressing to us, and what we are urging here is that with respect to people on layoff—and not just the disadvantaged or the more recent hires—anybody on layoff be given the opportunity through a joint government-industry program to learn higher skills. For when business resumes, I think this is going to be our greatest shortage.

Our unemployment statistics mask the fact that when there were 3½ percent unemployed, the lowest, let us say, in our history, there was a tremendous shortage, I mean a real shortage, of skilled people.

Representative Brown. Now let's get to one of those——

Mr. Borch. I would like to see them upgraded to get more people into the skilled classification.

Representative Brown. And certain industries, I believe, have only recently emerged from a period in which they experienced substantial shortages of skilled people.

Mr. Borch. Yes, sir.

Representative Brown. As a matter of fact, some industries have not yet recovered.

Mr. Borch. Yes.

Representative Brown. This problem exists even though we have an increase in the total rate of unemployment?

Mr. Borch. Yes.

Representative Brown. The SST is a subject of some controversy. We have increasing unemployment in the aeronautics industry today. In light of that fact it seems somewhat illogical that some of my colleagues in the Congress argue that the Government should be an employer of last resort, presumably by sponsoring public works projects, and yet oppose any Federal interest in the development of the SST, a project which not only provides gainful employment but also one which improves the productivity of the aircraft industry.

If we defer action on the SST and then retrain everyone that is unemployed in the aeronautics industry at Government expense, what if we decide to continue with something like the SST? What happens to these people who have been retrained for some other kind of work?

Does that present any economic advantages or disadvantages?

Mr. Borch. I may surprise you by saying that I don't believe that the decision as to whether to go forward or not to go forward with the SST should be based on the current employment situation.

Representative Brown. It is a factor of input in that decision, it it not?

Mr. Borch. It is a factor of input, but I don't think it will be a factor of input over the length of time involved in this project. I think it should be discussed on its merits which are quite different, I think, from the matter of facilitating an unemployment situation at this time, important as that is to the regions and the localities that are affected.

I think basic decisions of this kind have to be made on the basis of priority decisions made with respect to the allocation of Government

resources—our tax dollars. I think these require the very firmest kind of scrutiny, and my decision on the SST would be based on looking out a few years and taking a very hard look at the impact on this country—considerations of the stability of the dollar, and of our international balance of payment. This is a very, very critical element that we have not discussed here at all.

Representative BROWN. It is my understanding that under the suggestion you have made, if somebody became unemployed they would get, in addition to their pink slip, the directions to the employment office, also some kind of ticket to the local employment training center and receive training in an industry which is currently short of labor.

Mr. BORCH. Not quite, I think, Mr. Brown. What we are talking about here is providing a training program, in the same facilities that the jobs program and the others have already been conducted in most of the major companies of the country, and a great many of the smaller ones, and I would get those facilities tuned up to the higher levels of skill, education, and training.

Representative BROWN. Of course, the inevitable result of sagging production is idle labor and idle plant capacity. Do you have any similar recommendation as to what might be done to upgrade idle plant capacity so that our productivity could be increased?

Mr. ABEL. Well, I think, by and large, you will find in this country our industries have been upgrading their plant and facilities. The steel industry, as an example, that I am most familiar with, has invested many billions of dollars over the last 5 or 6 years in technological improvements and new systems of producing steel. We have, without question, the most modern facilities for making steel that man has devised, and when the full impact of this modernization program gets into full stream, I think we are going to be amazed at the amount of steel capacity we do have.

Representative BROWN. You would consider that desirable then?

Mr. ABEL. Yes, very much so.

Representative BROWN. Given today's credit restrictions, how would you suggest the industries which wish to upgrade their facilities obtain the credit to do so?

Mr. ABEL. How what credit, sir?

Representative BROWN. The credit necessary to upgrade plant capacity.

Mr. ABEL. Well, our industry has done a pretty good job of developing the funds for that out of their earnings. It is only recently that they, most of the industries have resorted to raising outside capital again. There has been a tradition more and more and one that has concerned us——

Representative BROWN. I am a little confused. I understood that you were critical of the high profit levels of some of the recent years. Now you are telling me that it had an advantageous effect on the economy.

Mr. ABEL. No, I am saying in the past we have always expected investment capital to be equity or borrowed capital, not taken out of earnings of a given institution.

Representative BROWN. Perhaps I also misunderstood you then because I got the impression from your testimony that you were criti-

cal of the present allocation of credit in this country, and that borrowed capital——

Mr. ABEL. I am critical of the high usurious rates that are being charged for credit, yes, and critical of the way the banks are allocating scarce credit.

Representative BROWN. Perhaps if I have another 10 minutes as we progress today I will be able to explore that further. I believe what happened in the 1960's was left out of your testimony.

Chairman PATMAN. I assume it would be all right for you gentlemen to answer any questions tendered by any member in writing when you look over your transcript?

Mr. ABEL. Yes, we would be happy to.

Chairman PATMAN. Senator Fulbright?

Senator FULBRIGHT. Thank you, Mr. Chairman.

Well, Mr. Abel and Mr. Borch, I was impressed by the fact that neither of you mentioned the effect of the war upon our economy. Do you feel, Mr. Abel, that it has no substantial effect upon our economy?

Mr. ABEL. Oh, there is no question, Senator, when you have a war budget, whatever you want to call it, of some $20 to $30 billion, it has an impact on the economy. There is no question about it.

Senator FULBRIGHT. Do you know how much we have spent on the military establishment since World War II?

Mr. ABEL. No, I don't. You certainly are in a better position to have those figures.

Senator FULBRIGHT. We have spent directly about $1,000 billion, and including the indirect costs of veterans and others about $1,200 billion; a very substantial sum, isn't it?

Mr. ABEL. It certainly is.

Senator FULBRIGHT. Do you think you can take that out of an economy as large as ours without having a very adverse affect upon it?

Mr. ABEL. No, you can't.

Senator FULBRIGHT. It has always been a great puzzle to me, as interested as you are, and I know you are, and you gave a very good statement about it, in our economy that your organization has been so enthusiastic about the support of the war. It has been a contrast that I have never understood.

Mr. ABEL. I don't think, Senator, it would be an enthusiastic support. I don't think anybody supports war enthusiastically. I think it is merely a case where the labor movement supports our Government's effort in Southeast Asia. We are in trying times, and certainly we do support the Government in this kind of an effort. At the same time, we do try to direct our efforts in a constructive fashion to find solutions for this problem, and bring about peace and deescalation of the war.

Senator FULBRIGHT. Well, your organization, of course, it is no news to you, has great influence in the Congress. You have many people devoted to your interests, and I believe that the attitude of your leaders, particularly Mr. Meany, with regard to the war, not just recently, but going back to 1965, their support of President Johnson, was very significant and still is.

I may say that Mr. Borch says the same thing. His optimism about the return of confidence in the near future is utterly inexplicable to me, if I read the newspapers correctly. What do you base your opti-

mism on—this returning confidence—when you look at the markets and what is going on in our international balance of payments?

I can't understand why you are so optimistic.

Mr. BORCH. Senator, at the risk of sounding Pollyannish——

Senator FULBRIGHT. You do sound very Pollyannish to me.

Mr. BORCH. At the risk of sounding Pollyannish——

Senator FULBRIGHT. You sound almost like the administration.

Mr. BORCH. It is always the darkest just before the dawn.

Senator FULBRIGHT. I see.

Mr. BORCH. And from every indication that we can see I firmly believe that we are at the bottom now, the low point. This assumes, however, to your point let me remind you, Senator Fulbright, that I did state that the inflation today was caused by the guns and butter philosophy that accompanied the Vietnam buildup.

I made that clear, I thought, in my statement.

Let me also say that the Vietnam war has been, and remains, central to our economic problem.

Senator FULBRIGHT. You certainly didn't make that clear in your statement. The only reference was this guns and butter, which is a very equivocal statement. I am not sure, do you think the war is good or bad for this country?

Mr. BORCH. The sooner it can be soundly and honorably terminated, the better off we all would be. In my opinion there is no higher priority.

Senator FULBRIGHT. What do you consider an honorable basis?

Mr. BORCH. I would prefer not to argue with you on that score, Senator.

Senator FULBRIGHT. I just wondered, you put the qualification in. I thought you meant something, if you don't mean anything it is all right?

Mr. BORCH. Senator, I don't think we should cut and run.

Senator FULBRIGHT. I see. Then we should continue to victory?

Mr. BORCH. We should not continue to victory.

Senator FULBRIGHT. Let's get on to another thing. Do you now consider you are competitive with the Japanese and the Germans in international trade?

Mr. BORCH. We are now. Let me make a statement, on that.

Senator FULBRIGHT. You brought it up, you said one thing hasn't been discussed is our balance of payments.

Mr. BORCH. All right.

Senator FULBRIGHT. A very serious matter, and it is very serious, isn't it?

Mr. BORCH. Right.

Senator FULBRIGHT. Are we competitive today with the Japanese?

Mr. BORCH. If we are looking at it from a straight economic basis and forgetting government interposition, the Japanese Government, the German Government, the tax rates, the effective tax rates in Germany, we are competitive.

But one can't ignore that whole blanket of items that I just dismissed so quickly.

Senator FULBRIGHT. Well, but, of course, you can't ignore it and they are an element in being competitive, and inflation, you could add inflation, and wage rates, you could add all of that.

Mr. BORCH. Other countries are having inflation, too.

Senator FULBRIGHT. But the point is are you competitive today? Can they undersell you, are they underselling you?

Mr. BORCH. They can and they do.

Senator FULBRIGHT. They do?

Mr. BORCH. Except on high technology products.

Senator FULBRIGHT. I thought, Mr. Abel, you said we are very efficient in our steel production. Do you consider that our production of steel is more efficient than the Japanese today?

Mr. ABEL. It is equally efficient, I would say.

Senator FULBRIGHT. Why is our balance of payments so, and our balance of trade especially has gone down from, it used to be traditionally $5 or $6 billion, it is now down to less than a billion and, of course, with the other deficits we have a serious deficit in our balance of payments, and just a very minor margin in balance of trade.

Why do you think that is true if we are competitive?

Mr. ABEL. Well, it is true for many reasons. As Mr. Borch has said, Government subsidies have a role in it and, of course, restrictions by some governments, such as the Japanese Government.

As an example, the American steel industry wouldn't be permitted to give steel away in Japan, even if they gave green stamps with it. The Japanese Government wouldn't let them bring it in, so there is no competitive problem there. That's why we are talking about quotas.

Everybody gets excited in this country, you know, but they think we can let our markets just be thrown open to any kind of competition or that we should reduce our standards as workers to the level of standards of workers in some other countries. We just don't believe in that.

Senator FULBRIGHT. Then you are advocating a quota system, a return to protectionism; is that what you mean?

Mr. ABEL. If you want to term it protectionism.

Senator FULBRIGHT. What do you term it?

Mr. ABEL. We think it is our responsibility and it is our Government's responsibility to do what is necessary to protect the standards of American workers in our industry.

Senator FULBRIGHT. Does any country ever do that when it is competitive, can undersell the other one?

Mr. ABEL. Pardon.

Senator FULBRIGHT. Does a country ever do that when it is competitive?

Mr. ABEL. I think so.

Senator FULBRIGHT. Does it?

Mr. ABEL. There is a lot of reasoning behind this when you look into the actual record, the Japanese do. Other governments do. Also, after all, we did rebuild the industries of both countries you make mention of, Germany and Japan, following the destruction of World War II.

Senator FULBRIGHT. You are quite right, and I think this is why they are so effective. I don't deny that at all, but what I do raise, raise this question, is here you two of the greatest leaders in our country, you don't mention at all or just in passing that the war, which is the principal reason for the distortion in our economy, and it isn't just the direct cost of military establishments, but the related effects. It is very far reaching.

When we have a debate in the Senate, and we have lost some very close votes—yesterday we lost one by two votes, the papers, as sometimes happens were erroneous. A vote we lost on $300 million for space was 35 to 37, it was two votes, three of our people gave a pair, and the vote was determined, and I just want to correct the media. I wish they would be a little more accurate in that because it actually was only two votes difference, and yet we lost a vote to cut $300 million.

One of the big arguments is always made, you see, that space, atomic energy, SST's, all of these things, are supposed to have fallouts that might benefit the military. When you have a military establishment that dominates the whole economy, plus these other matters that are related, and in which the argument is made that we are in some indefinite, and I think very vague way, helping the military establishment also, if we spend money on such things as space and atomic energy, there is really nothing left for the sewer systems, the housing, and so on.

You also noted that the Government is proposing $100 million to build houses in Saigon; did you see that in the paper?

Mr. ABEL. No, I didn't.

Senator FULBRIGHT. Well, it was on the front page yesterday, a hundred million dollars being proposed to build houses, among other things, in Saigon. I don't quite see how that is going to help our economy. But these are all fallouts and part of the war picture. I don't see how you can possibly ignore this, and leave a balanced impression of what our economic situation is. I really think it ought to be taken more seriously.

There really isn't any reason for optimism about this war being over, Mr. Borch. How in the world you can think after expanding it into Cambodia it is about to be concluded is beyond my comprehension.

Do you think it is about to be concluded?

Mr. BORCH. I certainly do.

Senator FULBRIGHT. You do. How?

Mr. BORCH. Senator, you asked me for my opinion, and I think that the withdrawals that are going on will continue to go on, will crank this thing down and wind it down, and I sincerely hope that what the President has in mind doing works.

Senator FULBRIGHT. Well, your hope is very fine.

My 10 minutes are up but I just call your attention to the fact that even if we withdraw people, the plans are clearly developing that we hire mercenaries to do our fighting for which we pay.

It isn't going to be any decrease in the money that it costs you or the taxes that you pay.

This is quite clear even from the administration's statement.

Mr. BORCH. I hope you are wrong, Senator.

Senator FULBRIGHT. Well, it isn't wrong. This is what they have just been saying if you have looked at the debates in the Senate.

Chairman PATMAN. This discussion is very interesting. At this time, each House is meeting, right now. I wonder if we could afford another 5-minute round. Would you like to try that?

Since I didn't ask any questions a while ago, may I say that it can be documented that—I hope Senator Fulbright listens to this—the excess cost of interest in this country is greater than the cost of the Vietnam war. The excess cost of money and credit in this country

including exorbitant and usurious interest, is more than the cost of the war in Vietnam.

Senator FULBRIGHT. I wasn't talking about the war, Mr. Chairman. I was talking about the overall Military Establishment.

Chairman PATMAN. I am not trying to get into a controversy with you, Senator Fulbright, but just telling you what the facts are. The fact is, as I said, that when the interest rate is raised 1 percent, the debts, all public and private debts then, increase by $15 billion a year. When it was raised one-half percent, the total cost to the American people is $37,500 million a year. Today the American people are paying on the basis of $120 billion a year for interest alone. So it can be documented that the excess costs of interest, including exorbitant and usurious interest, is more than the cost of the Vietnam war.

Now, there is another question raised by one of the members. I think it was a member who is not present, but he will read the record. You know people who are acquainted with the old-fashioned country church, are aware that the parishioners took great pride in paying their bond issues if they had any, and when they paid off the bonds they had a bond burning, and they were very happy over it.

It was quite a celebration, quite an event. But unfortunately our Government has not pursued that policy, and today in the New York Federal Reserve Bank there are $57,500 million in Government bonds, U.S. Government bonds, that have been paid for once, fully paid for. If you do not want to accept my statement of that, if you do not, read the testimony of Mr. William McChesney Martin or other members of the Federal Reserve Board. No one has denied it, and all of them have said, yes they have been paid for once, and that is it.

We are paying our debt twice sometimes, and if you credit that $57,500 million, our country is in pretty good shape and will be for a good while to come. But if you keep on paying interest on that as we are doing today, it is burdensome to the people, especially, in view of the excessively high, exorbitant, and usurious interest rates which we are paying today.

Now, I appreciate the testimony of you gentlemen. I don't know of any two witnesses who could have done more for the enlightenment of our members, and presented more knowledge and information than yourselves, and I am going to take advantage of the opportunity to ask you some questions in writing and, of course, ask you to answer them.

I will yield to Mr. Widnall 5 minutes.

Representative WIDNALL. Thank you, Mr. Chairman.

I will take advantage of the opportunity of submitting questions for the record, which I trust you will answer.

(The following answers were subsequently supplied for the record by Mr. Abel and Mr. Borch:)

I. W. ABEL'S REPLIES TO THE QUESTIONS POSED BY REPRESENTATIVE WIDNALL

Question 1. You maintain that, "the inflation that developed in the 1960's has been largely a profit inflation," and cite a "capital goods boom" as a major contributing cause. But isn't it the prospect of a profit that induces a business firm to hire employees? And doesn't capital investment equip the worker with the tools and materials necessary to increase his productivity and thus his value to the firm? In other words don't profits and capital investment help create jobs and improve worker productivity? And isn't there a real danger that if prospects for profits continue to prove grim and the desire to expand and modernize plant and equipment slackens, unemployment will become even greater?

Answer. Business investment in new plant and equipment is an essential activity in a modern economy—for replacement of wornout plants and machines, for modernization and for expansion. Obviously, workers are involved in building the plants and producing the equipment; rising business investment in fixed capital, therefore, results in increasing employment.

However, American economic history teaches us the essential lesson that when such investment shoots up in a capital goods boom, it is followed by a decline. Such capital goods boom is not only unsustainable, it is also usually inflationary, as it presses on available resources. Moreover, the decline in capital goods outlays, that follows such a boom, is usually related to recessions and increasing unemployment.

Therefore, it is best for the national economy and the American people for business investment in plant and equipment to increase steadily, in relation to the expansion of total national product. The unsustainable capital goods boom that got under way in 1964 was moving the American economy into troubles by 1965, when military expenditures began to accelerate.

By July 1970, we have had six years of an unsustainable capital goods boom—with merely a moderate pause in 1967 and the first-half of 1968. Industry is now operating at only about 79% of its productive capacity and new plants and machines are being installed at a rapid rate. There is now danger of a decline in capital goods outlays, and perhaps a period of years of sluggish investment expenditures, as a result of the prolonged and unsustainable boom in new plants and machines, which was encouraged and partly subsidized by U.S. government policy.

Question 2. You quote former CEA Chairman Gardner Ackley as indicating in 1966 that a further rise in the share of profits in national income would not be in the best interests of either the economy or the business sector. And it is true that profits as a share of income originating in nonfinancial corporations reached a peak of over 21 percent in the fourth quarter of 1965. However, since that time the profit share has been declining and employee compensation has been increasing as a portion of income. At present, profits are at their lowest share of income originating in nonfinancial corporations in the entire postwar period, and employee compensation took nearly 82 percent of income during the fist quarter of this year.

Don't you think this may be unhealthy for long term economic growth? Isn't there a limit to how long low profits can be pushed before adversely affecting future growth and employment? Don't profits have a useful role to play in a healthy and growing economy?

Answer. The present level of corporate profits, as a percent of coroprate income, is the result of the current recession. The price level, as a whole, is now set so that when sales and production begin to rise again—with rising productivity—profits will start to shoot through the roof, as they did from 1961 into 1969.

Question 3. In your statement you compare the 93 percent increase in corporate profits between 1960 and 1961 with a 34 percent increase in after-tax weekly earnings of workers. Do you think it is fair to compare the growth of total corporate profits with average worker weekly earnings? Wouldn't it be much more reasonable to compare the growth in total profits and total corporate labor compensation, or the increase in weekly earnings per worker with profits per firm? Can you compare for us the growth in total corporate employee compensation over the 1960–1969 period with total profits?

Answer. From 1960 to mid-1969:

Coroprate profits after taxes shot up 93%.

But the after-tax personal income of all Americans increased only 76%—about one-fifth less than profits. And that includes the effects of a large increase in employment, as well as the income gains of individuals.

The after-tax weekly earnings of the average non-supervisory employee in private non-farm employment increased only 34%—about three-fifths less than profits. In terms of buying power, the gain was only 10%.

Since the middle of 1969, profits have declined, as production and sales have declined under the impact of the Adminstration's squeeze on the economy. Prices have continued to climb. The price level is now set for profits to shoot up, again, as soon as sales and production begin to move up from the present recession.

FRED J. BORCH'S REPLIES TO THE QUESTIONS POSED BY REPRESENTATIVE WIDNALL

Question 1. You say in your statement, "In our American society, attainable goals have a way of becoming imperatives." Isn't this also true of some unattain-

able goals as well? What effect does viewing unattainable goals as imperatives have on the nation's determination to solve pressing social problems? Isn't it likely that setting unattainable goals would adversely affect our will to strive for improvements? And doesn't this have an unfortunate effect on the national temperament?

Answer. Obviously, if unattainable goals come to be held as "imperatives," a great deal of time, effort, and resources may be wasted, and the effects on a society may be frustrating and demoralizing, to say the least. But the reference here was in the context of the steadily enlarging area of "attainable" goals, the technical-social economic problems that can be solved if we establish our priorities wisely, use our resources well, and all work together towards common goals.

Question 2. You indicate there appears to be a wide disparity between productivity increases in the manufacturing sector, which have tended to be high, and those in the "services-government" sector, where productivity grows much slower. Isn't it true that our measures of productivity in the service and government sectors are as yet quite crude? How much of this apparent disparity is the result of our inability to accurately measure output in service industries?

Answer. Up-to-date measurement of productivity in the services and government segments is, indeed, crude. Precise measurement is difficult. We have but to look around us to see signs of low productivity in these sectors. Such casual conclusions are confirmed by skillful statistical analysis. Dr. Victor R. Fuchs in his definitive study, "The Service Economy", published by the National Bureau of Economic Research, Inc. in 1968, confirms the evidence of our observations. Dr. Fuchs, after allowing for the imperfections in the data available, concluded that real output per man in the service sector grew at 0.6 percent per year from 1948 to 1968. On the other hand, manufacturing productivity advanced 2.9 percent per year. So, while one cannot precisely measure the productivity of each specific service branch of government, the available evidence supports the conclusion that productivity in these areas is quite low. Certainly, before embarking on programs to improve a particular subsector's efficiency, we would want to verify its actual productivity. I am convinced, however, that low productivity in the service and government sectors is general and presents the nation with a serious economic problem; one that we have only belatedly come to recognize.

Question 3. Mr. Abel indicated in his statement that it was his belief that the inflation in the latter part of the 1960's has been largely a profit inflation. Isn't it true, however, that profits play an important role in economic growth and employment? Could you describe the role that you believe profits play in growing production and employment and what might be expected to occur if somehow profits were maintained at their current level or that of the early 1960's?

Answer. We do not agree with Mr. Abel's statement. Inflation in the late 1960's was not a profit inflation. Profits after taxes were virtually flat for several years after 1966 and have been declining since mid-1969 while price gains accelerated. Retained earnings—the income available to corporate business after paying taxes and dividends—have dropped almost 50 percent since 1966.

Mr. Abel's evidence for his claim that we have had a profit inflation is erroneous. He has mixed apples with oranges. Mr. Abel states *total* corporate profits after taxes gained 93 percent from 1960 through the first half of 1969, while *weekly* earnings increased only 34 percent. The comparison is invalid; *total* profits cannot be compared with *weekly* earnings of individual workers. Mr. Abel should have looked at the growth in total compensation of employees which was up nearly 88 percent in the period.

Selecting 1960, a recession year, as a base period gives a false impression since profits slumped during the business decline. A more valid comparison should be changes since 1959. On this basis total profits rose 56 percent through the first quarter of 1970; at the same time total compensation of employees jumped 112 percent. Factory workers' earnings per week jumped 45 percent in this period, while manufacturing profits per sales dollar dropped 17 percent.

The impairment of the profits picture could have serious implications for the nation's growth. Retained earnings are a key source of venture capital. It is these funds which are plowed back into corporate investment, into new plant and equipment which provide the increases in productivity that enable us all to look forward to increasing standards of living. If profits continue to be weak, business will find it more and more difficult to maintain investment programs to modernize and expand plant capacity. Productivity growth will slow and the nation's standard of living will fall below its potential.

Representative WIDNALL. I would like to make this comment. I just wanted to say this while he was here, and I don't think it makes much difference whether I say it after or not, but I think the function of the Congress is being taken over completely now by the staff members, and it seems to me that when we have reached a point where a committee of the Congress goes overseas, both parties represented, and what comes out of that trip is a newspaper conference held by a staff member, I don't know why the Senator should have all his interest in South Vietnam or anything like that, because they are going to run the country, it is quite obvious, and not the Members of the Congress.

Representative BROWN. You are blaming the staff for the war in Vietnam?

[Laughter.]

Chairman PATMAN. You are specifying, Mr. Widnall, one particular committee; you are not charging other committees.

Representative WIDNALL. I am not, but this could be extended. We have got the precedent.

I am just very pleased that we have the two witnesses we have had today. You have been very forthright and have given us some good information, and I know that when we submit questions to be answered for the record it will always be very helpful.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. I want to congratulate Mr. Borch for your answer to Congressman Brown on the SST which is very statesmanlike, especially considering the fact that your company makes the engines for the SST.

I would like to call your attention, I am sure you are familiar with it, to the findings of the Treasury Department that the construction of and the use of the SST would not be advantageous in our balance-of-payments deficit.

Mr. BORCH. We do not agree with it.

Senator PROXMIRE. I would hardly expect you to agree. One of the most constructvie points in your statement was your emphasis on increasing productivity in the government services sector. Unfortunately there is no credit given government for improving productivity if we indeed improve productivity. There was a study a few years ago made by Kermit Gordon, budget director, measuring government productivity which showed a large increase in some Government agencies, for instance a gain in 1 year of 15 percent in Internal Revenue by using computers.

Mr. BORCH. The Federal Government has had an excellent record but this is relative to States and local governments.

Senator PROXMIRE. There is a great deal we can do in Congress, we have a transportation policy to which we apply no economic analysis at all; go ahead and build roads where maybe mass transit would be better. We have no system here in the Congress for making our judgments based on careful economic analysis of what the alternatives are and what is the most efficient way to do it.

I bring this up because this afternoon the Appropriations Committee is marking up our legislative appropriations, including funds for this committee and we probably are not going to get the funds we need to provide economic analysis by the Joint Economic Committee because they think it is unwise to give this committee another $125,000.

That $125,000, in my view, can save literally billions of dollars a year if properly used and I am convinced it could be.

Let me ask you, Mr. Borch, you stated that between June 1969 and March of 1970 General Electric laid off 10,000 employees in defense-related jobs. What was the total GE employment in defense-related production in June of 1969?

Mr. BORCH. Senator, this would be a very rough guess but I would say approximately 60,000.

Senator PROXMIRE. What was the total in March of 1970?

Mr. BORCH. My 60,000 was March of 1969. So it would be 10,000 to 12,000 less.

Senator PROXMIRE. 12,000 less?

Mr. BORCH. Yes.

Senator PROXMIRE. What is the total today?

Mr. BORCH. Approximately the same.

Senator PROXMIRE. About the same. What was GE's total company-wide employment in June 1969 and March of 1970?

Mr. BORCH. Worldwide 400,000 and domestic 300,000.

Senator PROXMIRE. What is it today?

Mr. BORCH. Down just about the amount of the defense and military cutbacks. But I wish to remind you that we faced a special situation coming out of a long strike and I don't think we might be representative of the industry as a whole because we are filling pipelines.

Senator PROXMIRE. I take it defense is 20 percent of your employment.

Mr. BORCH. Of volume and employment.

Senator PROXMIRE. What is your rate of return on sales or is it computed on return of investment?

Mr. BORCH. As to return on sales I don't have those figures, those numbers, in front of me, Senator.

Senator PROXMIRE. What is it on defense work?

Mr. BORCH. Historically, they have been about half what we get on commercial products.

Senator PROXMIRE. What does that mean? What is your return on investment?

Mr. BORCH. It will vary widely.

On defense business it historically has varied very widely and it depends, Senator, and you understand that this very clearly depends upon the stage in which the business is going through. On the R. & D. stage, of course, return is very minimum.

Senator PROXMIRE. Overall, say take 1969, was your return on investment for defense work higher or lower than on commercial work?

Mr. BORCH. I would gather approximately the same. But I would like to get that for the record for you, Senator.

Senator PROXMIRE. I would appreciate that very much. In fact if you could for the record I would appreciate it if you would give me those figures from 1965 to 1969.

(The information requested by Senator Proxmire of Mr. Borch was not available at the time of printing the hearings.)

Mr. BORCH. I would like to call your attention to the fact that our real measure of profitability is not either of the ratios you use. What we look for is return on contributed value.

Senator PROXMIRE. But you have an obligation to the stockholders, of course.

Mr. BORCH. If we get that ratio on contributed value that is what we look for. This is the effort we put in, General Electric puts in. Our return on contributed value in defense and space is about two-fifths of what it is on regular commercial business.

Senator PROXMIRE. Do you have now and could you supply for the record what General Electric companywide profits were from 1965 to 1969?

Mr. BORCH. Yes.

Senator PROXMIRE. What were they in 1969?

Mr. BORCH. We had a strike in there, it is a deflated number. It is not a good number.

Senator PROXMIRE. At any rate you will give us that for the record. My time is up.

Chairman PATMAN. All right, Representative Brown.

Representative BROWN. Mr. Abel, can we return to your assessment of Government economic policy during the 1960's. What effect do you think an increased Federal debt had on interest rates and other aspects of the economy?

Mr. ABEL. Well, I think there is no question that during the 1960's we did have an expanding economy, and a developing inflationary economy, with moderation to begin with, but in the last few years, of course, it went out of bounds. I think the record will show that perhaps for the first 5 years there was an average yearly rise of about one and a half percent or less.

Representative BROWN. Could you normally expect interest rates to go quite high during that period of uncontrolled Federal deficits?

Mr. ABEL. I don't think you need expect it. It did happen. I personally see no reason why the bankers and the money lenders should be privileged to have the excess capital drained off for loans at ever-higher interest rates.

Representative BROWN. Do you see supply and demand as a factor where there is only so much available capital, and the Government is in the market borrowing a good deal of that available capital in competition with industry, and the individual homeowner and others, and, thereby, creating a competition for that capital and higher interest rates?

Mr. ABEL. No; I think, if my memory is correct, we will find that we didn't increase the supply of money and that was the big contributing factor. The Federal Reserve could have increased the amount of available money and credit, but instead they chose to permit the banks to increase the prime interest rates and to permit the banks to allocate the credit in our economy, rather than Congress or the President. If there was an excess of moneys, in my judgment, Congress should have used its taxing powers to drain it off, rather than give carte blanche to the banks to milk it off.

Representative BROWN. But as you note Congress didn't do that and, of course, the Federal Reserve System——

Mr. ABEL. That is right.

Representative BROWN (continuing). By raising its prime interest rates and not increasing the supply of money is in effect undertaking a function of rationing. The Federal Government can pay the high interest rates, as opposed to the homeowner and industry. Government got the money and other kinds of operations did not.

I would like to talk just a minute about the cost of government, to pursue the point that Senator Fulbright raised with reference to our competitive situation abroad. The figures I have suggest that in 1960 the total cost of Federal, State, and local governments was $136 billion out of a gross national product of $503 billion, or approximately 26 percent in this country. The latest figures available show the total cost of Federal, State, and local governments to be $293 billion out of a total gross national product of $932.3 billion or 31 percent.

Can either of you relate that to what happens to the cost of American products abroad, the cost to our productivity or our competitive position in selling products in the world market?

Mr. ABEL. You might. I certainly am in no position.

Mr. BORCH. I am in no position to know what the relative take of foreign governments is. I do know their tax rates are quite differently based, as you know. They are more heavily on value added and things of this kind and less on corporate taxes, but what that ratio would be I don't know.

Representative BROWN. Would you comment on the increasing cost of government in this country, from 26 to 31 percent?

Mr. BORCH. Yes.

Representative BROWN. What does that do to our competitive position?

Mr. BORCH. It folds itself, of course, into manufacturing costs and ultimately prices.

Representative BROWN. And so this makes us less competitive abroad.

Mr. BORCH. Definitely; providing the others aren't moving as rapidly.

Representative BROWN. Whose responsibility is that?

Mr. BORCH. I beg your pardon?

Representative BROWN. Who do you feel is responsible for not exercising more restraint in the area of governmental cost?

Is that——

Mr. BORCH. I will let Mr. Abel answer that one.

Mr. ABEL. I would assume you, as Members of Congress, have a great responsibility in this area. Certainly it is true, by and large, by actions of Congress that we incur these indebtednesses and certainly Congress has the taxing powers that could be exercised. So a major responsibility is yours, although I think all citizens have, and all segments of our society have, a responsibility and should have a concern with our indebtedness, and the operation of our economy.

Representative BROWN. And the cost of government in competitive market places. I would agree with you, sir, and I think it is a perceptive statement. Still we are responsive to our constituency and the American people are largely unaware, I think, of the economic costs that result from the activities of the Federal Government.

Mr. BORCH. We can't export government.

Representative BROWN. Precisely.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. I will be very brief, Mr. Chairman. I had tactfully, Mr. Borch, decided not to bring up the SST and, as you know, on Senator Proxmire and me Boeing and GE should not rely for that program.

I have suggested and others have suggested that on balance the national priorities currently would be better served if, with whatever

Federal subsidy is needed, Boeing were put to work making a good mass-transit vehicle and GE were put to work making a pollution-free engine for it. Wouldn't that really be a happier outcome than the one we are on now in this?

Mr. BORCH. I think here, Mr. Reuss, this is a matter of priorities that we all face. But one, unfortunately, isn't in the lovely position of making priorities based on exactly what happens today, and one has therefore got the added problem, and yours is worse than ours in General Electric, of balancing the short term versus the long term.

Representative REUSS. Isn't there a long-term need for an improved mass-transit system in this country?

Mr. BORCH. Yes, very definitely, and we are working very hard on that. We have an interest in this, too, but I would like to say——

Representative REUSS. But I haven't heard about the same kind of breakthroughs we have been told you are about to make in the SST. So we obviously can't, we are not doing both. You don't think you could go along with me in feeling that if you could make the same profits, and if your employees could keep on working for GE, and the same were true of Boeing, wouldn't it be better that they be making a breakthrough in mass transit rather than in jet set air travel?

Mr. BORCH. Well, I noticed your comments on profits because you know there are no profits in the SST, there haven't been for several years and there won't be presumably for a long, long time. But, on the other hand, I think when you look at what is happening to air travel, and the growth of that 5 years out, and you ask yourself how the current generation of planes and technology is going to handle that load, I fear for the situation unless we go supersonic, I really do.

That is a major concern. I don't believe the present generation of jet planes can handle with the airport facilities, the load that is coming up here—60, 70 percent greater 5 years out. And I think this is going to present a real problem to the United States.

Besides I don't like to be noncompetitive with the French and British and the Russians, that is another thing.

Representative REUSS. To conclude then, because I do want your view——

Mr. BORCH. I don't expect you to agree on this.

Representative REUSS. As a citizen you feel that we ought to be putting those resources into the SST today rather than into developing a pollution-free mass-transit vehicle?

Mr. BORCH. I think we must do both. The most immediate problem is mass transit. The longer range problem is the supersonic transport.

Now we have got the neat little problem of how do we do this.

Representative REUSS. Well, thank you very much.

Chairman PATMAN. May I announce the program for tomorrow, July 9, credit and money markets, Donald Regan, president, Merrill, Lynch, Pierce, Fenner & Smith, Inc., A. W. Clausen, president and chief executive officer, Bank of America, and Henry Kaufman, partner, Salomon Brothers & Hutzler.

Please accept the thanks of the committee for your very fine testimony each of you.

The committee is adjourned. I will be unable to be here tomorrow so Senator Proxmire has agreed to serve as chairman.

(Whereupon, at 12:35 p.m., the committee was adjourned, to reconvene, at 10 a.m., Thursday, July 9, 1970.)

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

THURSDAY, JULY 9, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:02 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman and Widnall; and Senators Proxmire and Jordan.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman, economist; and George D. Krumbhaar and Douglas C. Frechtling, economists for the minority.

Senator PROXMIRE (presiding). The committee will come to order.

Gentlemen, I have to explain that Chairman Patman wanted very much to be here as he thinks this is perhaps the most important of all of our meetings in this series of meetings on the state of the economy at midyear. But he was detained. He is at another meeting. He will be here later and he asked me to go ahead and open the meeting in his absence.

Other committee members will be here, too. We have all kinds of conflicts and we also have a habit, unfortunately, of not coming precisely on time. I am delighted you are all here.

We continue our hearings on the state of the economy, hearing testimony from three distinguished practitioners from the world of finance. Financial and money markets have been battered for more than a year and a half by unprecedented demands for credit under extremely unsettled supply conditions. Nineteen hundred and sixty-nine witnessed one of the tightest money policies on record, sending interest rates to 100-year highs. And then in 1970 as policymakers attempted to ease conditions, long-term interest rates remained high and, in recent months, are still rising. A "credibility gap" was built up as the price inflation continued unabated, and fears developed that the easing of the money supply would make it more difficult to bring prices and costs under control. Even the threat of a major liquidity crisis appeared on the horizon.

This is where we are today. We have asked our witnesses at today's hearing to address themselves to the analysis of the basic economic problems and their solution as seen from the center of the financial world. Are financial markets resilient enough to cope with the battering they have taken and to respond to the investment needs of the economy?

This administration has depended almost entirely on fiscal and monetary policies—with what appears to me to be a singular lack of success. Am I right? If so, what else can we do? If this evaluation is wrong, where is the fault?

This committee is most fortunate in having here today Mr. Donald Regan, president of Merrill Lynch, the largest brokerage house in the Nation; Mr. A. W. Clausen, president and chief executive officer of the Bank of America, the largest bank in the country; and Mr. Henry Kaufman, partner and economist for Salomon Bros. & Hutzler. I am sorry, Mr. Kaufman, but we were not able to ascertain the numerical rank of your firm. However, I do know it is one of the largest—maybe the largest—institutional broker-dealer and bond house in the Nation.

So, we have three firms which have a great record of success in this country and the top men who are among the principal reasons for their successes.

Mr. Regan, please proceed. We would like to keep your oral comments to 15 or 20 minutes with the understanding that your full statement will be put in the record.

Did I pronounce your name right "Regan" or "Reagan."

Mr. Regan. It is Regan. No relationship.

STATEMENT OF DONALD T. REGAN, PRESIDENT, MERRILL LYNCH, PIERCE, FENNER & SMITH

Mr. Regan. This seems to me to be a particularly appropriate moment for you to be holding this general review of the economy and the condition of the securities markets. We stand now at a crucially important time in our economic history. This moment, and the 6 months to come, constitute a testing time of our determination.

As always at such times, the loudest voices are those of the doomsayers. Dire forecasts of a prolonged slowdown, and worse, now abound. The year we hear most about is not 1971, but 1929. We are told that the consumer is full of pessimism. Projections are being made that show an extensive and prolonged decline in business spending for plant and equipment. Despite the current slowdown, credit availability remains extremely limited. Interest rates continue to sit on a very high perch.

The current word in vogue in this context is "liquidity," or, in another of those violences that economists commit on the body of our language, "illiquidity." "Illiquidity" means a shortage of cash—and certainly we are all familiar with that problem. We saw its serious consequences in the recent bankruptcy of the Penn Central Railroad, a matter rightly of great concern to the Congress.

Our statistical analysis does indicate that general corporate liquidity is low. The ratio of current assets to current liabilities of corporations has declined in recent years. It now stands considerably below the traditional 2-to-1 ratio. Cash assets for U.S. corporations as a whole have declined from 1965 to the present. Working capital increased only $1.8 billion in 1969, compared with a $13.5 billion gain in 1968 and $10.7 billion in 1967. There is no doubt that some corporations are vulnerable.

Yet, there is not any need to push the panic button. The decline in cash assets, for example, is explained in part by the fact that corporate

treasurers have gotten a lot more sophisticated in the past 5 years. They put their cash out to work, instead of letting it lie idle. Record borrowings are redressing the slowdown in increase of working capital. And, in the aftermath of the Penn Central affair, the Fed took some significant steps, including the lifting of the ceiling on certain kinds of certificates of deposit, that succesfully calmed the short-term money markets.

Let me add a note about those record borrowings. Last year, new corporate bond issues reached a total of $18.3 billion, including both public and private issues. Our estimates at Merrill Lynch indicate that this year public issues alone have already come to $11.5 billion. We believe that total issues for this year will come to somewhere between $24 and $25 billion. That means that the country is now in the midst of the largest bond-issue financing in its history.

And individuals are playing their greatest role in capital raising in history. The direct investment that they are making in fixed income securities has never been so large. Last year individuals invested $10.2 billion in marketable Treasury securities, $4.5 billion in the various agencies of the U.S. Government, another $4.5 billion in municipal bonds, and around $5 billion in corporate bonds. That total of over $24 billion last year was more than twice the amount that individuals invested in fixed income securities in 1968.

Of course, corporate liquidity must be rebuilt. But I believe that process may already be underway, and will surely take place naturally as the economy revives. We are not about to see a liquidity crisis that will drag us all down.

Meanwhile, though, the threat of "illiquidity" is regarded as still another grim omen for the future. Confronted by all this unmitigated pessimism, those of you who bear such important responsibilities in the financial and economic field are faced with some extremely hard choices.

But in my judgment it would be a very serious mistake to yield to the impulse to cut and run. Monetary and fiscal ease at too rapid a pace could throw away the benefits that should be coming from 18 months of restraint. The restraint has brought with it no small degree of hardship. The securities industry, for one, has been hard hit. I am afraid, however, that we shall have to sustain that hardship for a while longer.

The economy may go nowhere through the autumn period. Output may barely grow at all. Unemployment may creep higher. But, if monetary and fiscal policies continue to follow a moderate course—by which I mean if they are only gradually and carefully eased—the outlook beyond is quite favorable. Probably sometime during the winter, a slowing of the rates of price and then wage inflation should begin to show itself. The leveling in capital investment will limit the growth of demand for credit. Funds will then be freed for municipal borrowing and the financing of residential construction—both socially important objectives. But, of course, fiscal responsibility on the part of the Congress and the administration is an essential ingredient.

Once it becomes clear that the economy will be less inflationary, and continuously subject to responsible monetary and fiscal control, corporate profits should turn up once more. Interest rates should

decline significantly. Predictions are always dangerous. Some new peaks of demand may be yet to come. But assuming that the policy of only moderate expansion is followed, we think that, by the end of 1970, the yield on long-term, high-quality corporate bonds will have declined by about one full percentage point from the recent highs.

We must, of course, assume some degree of stability in the international situation, including the continuation of our gradual withdrawal from Vietnam. Granted that premise, the groundwork should be laid for slow, sound business expansion in 1971. Consumer spending should turn up. At annual rates, private housing starts were running at 1,700,000 in January of 1969. In January of this year, they were down by 600,000 from that figure. But housing should undergo a powerful surge as a consequence of the natural forces that will be at work.

Gradually, in short, most of the enormous power of the inflation that we have been fighting will spend itself.

The resumption of sound growth and consequent higher profits should bring a higher index of confidence, especially on the part of institutions, in the securities markets. That should make the prospect of investment in the U.S. market more attractive to foreign investors as well.

In 1968, foreign investors were net buyers in U.S. markets of $2.27 billion worth of securities, thus making a positive contribution to our balance of payments. In 1969, they were still net buyers, in an amount of $1.48 billion. In the first 3 months of this year, they were net sellers in an amount of around $100 million.

Interestingly, though, our judgment is that these net sales were caused largely by foreign mutual fund redemptions. The direct investor has continued to buy. Merrill Lynch's foreign customers for the first 3 months of 1970 were net buyers at a rate even higher than the rate at which they were buying in 1969.

If we want to continue to attract foreign funds into this country, we must keep the channels open. The movement of capital across international frontiers must not be hampered. The Foreign Investors Tax Act, passed by the Congress in 1966, was a great encouragement to foreign investors. I hope we shall not lose the spirit that motivated that act.

As we see it now, that is the scenario, domestic and international, as far as the future of the economy goes. It is going to take considerable courage to see this drama through to the end.

But, if I may, I would like to suggest that there exists a source of encouragement here that has not been properly identified or understood. When we listen too long to too many experts—those people who inspect tea leaves and think they can read the future—we come to believe in them too much. We may start to believe that the only sentiment abroad in the land for the past year has been gloom, spiced somewhat with doom, seasoned by pessimism, and tasting of nothing but disaster.

I am sorry to say that many of these tea-leaf inspectors reside on Wall Street, at least from nine to five. On the other hand, though, I am happy to say that we have some pretty convincing evidence at Merrill Lynch that contravenes the gloom.

As legislators, you know the vital importance of keeping in touch with your home States and districts. With 168 offices all over the United

States, Merrill Lynch has a kind of constituency, too—a client constituency, if you will. We try hard not to lose contact with it.

Recently, Merrill Lynch sponsored a series of studies about our individual customers. Some were done by the well-known Survey Research Center of the Institute of Social Research at the University of Michigan. Others were carried out by our own staff.

The results shed a new light on recent financial history. They reveal a long, strong backbone of confidence in this country. That confidence on the part of investors has largely been overlooked. Yet, it is essential to a proper understanding of the experience that we are now going through, and so to our assessment of the future.

The confidence of which I am speaking, surprisingly enough, showed itself most strongly in the first few months of 1970. So—and this is the message from the client constituency—in the very period when the experts were most depressed, many investors in America were quite the opposite. They like the looks of the future. They act accordingly.

Let me start with an analysis of one critical indicator that we watch very closely—the number of new accounts we open. From January through June of this year, Merrill Lynch opened a surprising total of 215,000 new accounts. We are opening them at an annual rate of 434,000—the same rate at which we opened them during the bull market of 1968, and about the same rate as last year as well. In the face of a long bear market, and confronted with plenty of unpleasant news, lots of people in this country evidently still think that securities were a good investment.

The people who opened these new accounts share several important characteristics. To begin with, a high percentage of them—about half—had no close contact with Merrill Lynch before they opened an account with us. In other words, they simply called us up, or walked in. They know a little about stocks and bonds, but not very much. About 35 percent of them were making the first investment of their lives in the securities market.

Generally, these are people with incomes that we would judge to be modest. More than half of them have incomes of less than $15,000 a year. Over a third of them have a net worth of less than $25,000. Over half are under 40 years of age.

The amount of trading they do is commensurate with these means. A preponderant number of these accounts—I do not want to be too specific here, for competitive reasons, but let us say well over two-thirds of them—bring in to Merrill Lynch, over a 3-month period, less than $100 in commission revenue.

Their primary interest lies in the long-term future. They want to increase their net worth, although in ways that are essentially conservative. As an illustration of their conservatism, less than 10 percent open margin accounts. Ninety percent pay in full and in cash for what they buy. Overwhelmingly, they are bullish.

As witnesses to recent events, these people, even though until lately on the sidelines, appear to have learned a good deal. Significant differences emerge between their attitudes and the attitudes taken by those who were new customers a couple of years ago. Our new customer of 1970, having watched the market decline and having come to the vivid understanding that it is possible to lose money, is more interested than his predecessors in minimizing risk, and the safety of his capital.

He is also more concerned about income from dividends and interest than the new customer was in 1968.

His opinion about making a run for short-term profits is much more restrained now than 2 years ago. And the number of new customers who are interested in buying new issues and over-the-counter securities has declined rather sharply. As one would expect, people opening new accounts this year want to know more about municipal and government bonds. The appeal of high yields and security is pretty strong right now—strong enough to bring individuals into the bond markets in ever-increasing numbers, with consequent changes in the whole character of those markets.

At Merrill Lynch, we applaud these new attitudes. Speculative excesses were rampant in the bull markets of the sixties. The time for correction had come. At Merrill Lynch, we never really believed in the fable of Golconda.

Besides keeping a careful watch over these new accounts, we also study the characteristics of customers in general. I am speaking now not about Merrill Lynch customers, but about those of the entire securities industry. The benchmark study done for us by social scientists at the University of Michigan shows that over 60 percent of the people who own common stock or mutual funds can be classified as "conservative." Younger people, with income over $25,000 a year, are likely to be more speculative than other groups. You understand, Senator, when I say "conservative" here I am talking about financial, not politics. But more than balancing them off are larger numbers of unequivocal conservatives who would not take great speculative risk under any circumstances.

Even among the most speculative groups, there is interest in holding some stocks that are rated as conservative and safe. One significant group of investors—about 15 percent of the total—are frequent buyers but infrequent sellers. They are for the most part small investors. Half of them are blue-collar workers. Seven out of 10 of them own less than $10,000 in stocks. They have a low financial net worth, and are heavily concentrated in the $10,000–$15,000 income groups.

They include many young married couples. They view their purchases of stocks as building for the future with conservative investments. They believe in methodical investments along savings bank patterns, often on a monthly plan. Our studies show that they buy about 20 times over a 2-year period. They sell far, far less frequently. Some of them do not sell at all.

We regard these particular people as excellent prospects for the future. They will be valuable customers because of the purchases they will make, and because the nature of their investments will make their continued presence in the market likely. But also, they have an interest in getting guidance for a comprehensive investment program. They want more and more sophisticated advice about their financial affairs. As we shape our corporation for the future, we shall be developing the capacity to serve the totality of such needs.

We discovered with interest that all during 1970, during the sharpest drop in the bear market, the individual investor was on balance a net buyer. That was true in both round lot transactions and odd lot transactions.

The most depressing period of the long bear market came in May, when the Dow Jones industrial average dropped to 630. But this tendency on the part of the individual to buy and hold became more pronounced at just that time than at any other.

In that month, he individual investor trading in odd lots was a buyer 63 times out of a hundred. Trading in round lots, he was a buyer 55 times out of a hundred. We are not quite sure what the institutions were doing during this critical period. But know where the individual was.

Reports coming in from our offices across the United States also support the view that it was "heartland America" that was doing most of the buying. At Merrill Lynch, we keep records on the ranking of our offices in terms of the revenues that they generate. Many elements can affect these rankings, including changes in our local managers, and so on, so that a definite conclusion is hard to draw from them. Still, on balance, it looks fairly clear that people in middle America—in places like Little Rock and Houston and Albuquerque—were moving into the market at that crucial period. At the same time, the amount of brokerage done by our offices in the big seaboard cities was falling off.

So, in sum, I believe that we had a rather heartening demonstration of confidence from the heartland. Individuals, many of them very small investors, were very active as buyers at a critical moment. That explains in part the rise in the Dow Jones of 32 points on May 27—incidentally, the largest single rise for 1 day since the Dow was first charted.

I do not mean to go too far with this thesis. Investors are not happy right now. They never are when values decline.

And, despite the encouraging attitudes that they have shown toward the long term, investors have not been trading at the levels of past years. Thus far this year, volume on the New York Stock Exchange is down 9.3 percent as compared with the same period in 1968, and 4.1 percent as compared with the same period last year. On the American Exchange, the decline has been much sharper: On the same basis of comparison, volume is down 41 percent as against 1968, and 36 percent as against last year. The over-the-counter index shows volume at its lowest level since the index was started in 1967.

Let me explain, if I may, just what this means to our business. If a car manufacturer or a steel producer is caught with capacity inadequate to meet demand, he can say "delivery in 90 days." But in the securities business, each day's business has to be completed and locked up at the end of that same time. To meet that stringent requirement, securities firms had to increase costs tremendously.

But now volume has fallen. Many brokerage houses are caught between yesterday's high costs and today's low volume. Now, they face a dilemma. They can tear down their capacity to the level of current volume. But then they will not be ready when volume starts up again. They will experience the same cycle once more.

I do not say this problem is insoluble. With a strong capital position and good management much can be done. But to be too critical is too easy.

When volume picks up again, the profit pinch that has tightened on Wall Street over the course of the past couple of years will loosen.

The increase in commission rates, which is now before the Securities and Exchange Commission, will help, too. As you consider this matter of the profitability of Wall Street firms, you will appreciate, I am sure, the importance of the contribution that a healthy securities industry makes to the economy at large. That industry performs vital functions in the organization of our capital markets. That organization, in turn, provides the context in which the economy can flourish.

I am the last one to argue the cause of Wall Street as a blanket term. We are a heterogeneous bunch, scarcely warranting the term "industry" at all. The interests of Merrill Lynch are more likely to diverge from those of the other members of the street than they are to coincide. Many brokerage houses have been shortsighted and selfish. I have little patience with many of their practices.

But I think it is unfair not to grant this much: The nature of our business presents some very special and very difficult managerial problems. Volume fluctuation is important among them.

There are others. Merrill Lynch believes that insurance for the individual investor against the failure of his broker is imperative. We are somewhat shocked, though, at the thought that if certain current proposals are acted on, we shall have to pay some $2 million a year into an insurance fund that will help keep other firms—some good, some not so good, but all of them competitors—in business. I can't quite think of any parallel in our business history for that little oddity.

Further, to illustrate my point about divergence of views, we have never thought there was much merit in the idea that the taxpayer should be on the hook, perhaps for as much as a billion dollars, for such insurance. Indeed, we believe that the securities business, perhaps above all other businesses, should have the strength, the determination, and the willingness to pay its own way.

I do not like to live with philosophical contradictions or anomalies.

Behind the idea of insurance lies another, more important concept—it concerns what Justice Brandeis, in a celebrated phrase, called "other people's money." Those who hold "other people's money," and their securities as well, should be required to meet proper qualifications for entry into this business. Proper managerial practices, especially the conservative management of capital, should be imposed on those entrusted with other people's money. No firm with only a few thousand dollars in capital, with tendencies to speculate with that capital, and with inadequate managerial training and experience should be allowed in this business.

Never mind our own money in this context. It's other people's money I worry about. Both a need and an opportunity exist for some new creative regulation, very much in the public interest, in this connection.

Once we have the right controls in the right places, we'll still want sound and adequate insurance in effect for customers. But we won't have to use it very often. And we certainly won't need other people's money to fund it.

My mention of these matters, though, should not detract from my main point. The point is that during this testing time for the economy, we have seen evidence that the revolution known 10 years ago as "people's capitalism" is now an accomplished reality. Even through bad days like the ones we have been seeing, lots of Americans still believe

in owning a piece of American industry. The educational task about the reasons for owning stock is done. The lesson is learned.

I think this has significant implications for you as legislators. You are quite properly accustomed to dealing with identifiable groups who seek to press their views upon you—labor, business, youth, farmers, educators. I am suggesting that there is an emergent, rapidly growing, increasingly important group for you to consider. It has not yet found its voice and its identity. But it is a group that cuts across all the familiar lines and all the old, retreating special interests. Labor belongs to it, and farmers and all the rest.

These are the individual stockholders—a total of 30,850,000 of them. Too many of us have lost our confidence but they have not lost theirs. They are still buying in, not only to the markets but to the country as well. They read, they think, they make things happen. They intend to be heard, and to prosper. We should listen and take heart.

Thank you.

Senator PROXMIRE. Thank you very, very much, Mr. Regan.

Mr. Clausen, you may proceed. I would appreciate it, gentlemen, if you could confine your statement as much as you can. You have excellent statements, but we are under pressure of time.

Go ahead.

STATEMENT OF A. W. CLAUSEN, PRESIDENT, BANK OF AMERICA

Mr. CLAUSEN. Thank you, Mr. Chairman.

My name is A. W. Clausen. I am president and chief executive officer of the Bank of America National Trust & Savings Association, with headquarters in San Francisco. I am also president of BankAmerica Corp., a one-bank holding company organized in 1968 which became owner of all of the bank's stock (except for directors' qualifying shares) on April 1, 1969. My testimony this morning is given on behalf of both the Bank of America National Trust & Savings Association and BankAmerica Corp. Because I recognize the limits on the committee's time and the desire to question myself and other witnesses today, I will read a somewhat abbreviated version of my prepared statement and submit the full text for the record.

I realize it is customary for witnesses before this body to itemize current and topical issues relating to the general state of the economy. However, I would like to focus this morning on a broader spectrum of emerging trends as distinct from individual economic events. First, however, it may be useful to simply run through a few of the most immediate short-run problems and prospects:

> Without question, we have been skirting the brink of what in other days under somewhat different circumstances would be a test of financial confidence. And this has become a factor in the decisions made by businesses, financial institutions, and their customers. We cannot ignore this, and certainly we cannot allow it to gain any further momentum.
>
> A liquidity squeeze is evident in many quarters, and this is pushing hard on the demand for bank credit. It will be with us for the remainder of 1970.
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> The stability of financial markets has been exacerbated by changes in monetary policy, which rightly or wrongly has in a period of 24 months moved from the extreme of a virtually un-

fettered increase in credit flows to the opposite posture of almost total restraint. The monetary authorities may have had little choice, but the swings have had a disquieting impact on the market.

The Government's own role—through spending authorizations bred out of a wartime economy hand in hand with accelerated social programs—continues to throw too much of the burden of inflation restraint on the monetary authorities.

Cutbacks in defense programs will increase as our Armed Forces are withdrawn from Southeast Asia and other overseas bases, bringing some temporary dislocations in local employment.

The housing market is not responding promptly to the efforts, as extensive as they have been of late, to increase the availability of funds and to lower rates, chiefly because public expectations of capital gains in housing are at a low ebb and perhaps half the families are priced out of the market by extremely high costs—costs which, of course, are aggravated by inflationary forces.

Social unrest may mount during the fall election campaign, while work stoppages attendant to major contract negotiations could easily add confusion and cause normal economic indicators to fluctuate erratically. If this should come to pass, we should view it in its proper perspective and recognize it does not necessarily mean the whole country is going to pieces but that it is merely a peculiarity of an election year when sensitivities are running high.

I believe that most of these immediate problems have been identified and are being treated properly by the policy tools which exist. We are beginning to see positive results.

Now, we have made progress in our battle with inflation but we still cannot relax. As a business executive, I have no great fondness for Government intervention in private decisions revolving around wages and prices. But the upward pressures evident both in prices and in wage settlements so far this year clearly suggest that some form of more aggressive moral suasion by the Government is in order. We cannot afford to be passive. At the opposite extreme are direct controls (which some have been urging upon the Government). They are inefficient, inequitable, and at best only a temporary palliative. Therefore, I conclude we must support the President's proposals for a Commission on Productivity and a system of inflation alerts. But we need to move with alacrity—and vigorously.

The other ingredient to realistic anti-inflation action is a far more rigorous use of fiscal policy than has been in evidence. A fundamental lesson of the past few years is that deficit Government spending must be controlled if we are to achieve our national objectives of a higher quality of life in a noninflationary, full-employment economy. Spending priorities must be established and maintained.

This is more than a question of efficient Government—it is a matter of absolute necessity if we are ever to defuse the inflation time bomb that keeps ticking. Whenever there is prolonged and heavy borrowing from the private sector by the public sector—in excess of tax revenues—and whenever such funds are used to divert goods away from private consumption, inflationary pressures build up. The vigorous use of fiscal discipline is the only method of averting such pressures now

and of allocating increasingly scarce credit in the midst of proliferating social demands.

So much for the two areas requiring immediate action.

It is the conclusion of the Bank of America that many of them are symptomatic of real change—permanent, fundamental readjustment of our economic mechanism which it is imperative for us to recognize and understand if we are going to formulate public or private strategy to intelligently move forward to the goals we know we must set for ourselves.

Some of the objectives of strategy are already clear. And they are not exclusively economic. Indeed, their social and political coloration is part of why the formulation of economic policy seems so exasperatingly difficult these days.

Everyone in this room is familiar with the Nation's broad objectives.

Each of these national goals requires money. Our financial system forms a vital link in realizing political and social goals.

The increased pressures on financial markets we have seen in the last few years will not disappear with the reduction of our commitment in Southeast Asia. As it exists right now, the present financial system simply will be unable to provide enough credit and capital to carry out the tasks our society would like to undertake. Moreover, should we try to supply credit to meet all wants, inflation—already an ugly and stubborn antagonist—would reaccelerate and, amok, could very well destroy the financial and economic system we know today.

Let me say, in passing, that the strains on this mechanism already experienced in the past 12 months have been extraordinarily severe. We cannot, with any conscience, neglect to heed—and heed well—the lessons to be learned from the events of recent months. These lessons in the discipline of liquidity—a discipline ignored or forgotten only at peril—can redevelop the kind of risk-conscious leadership we need for the decade now starting, especially among new prosperity-nurtured generation of financial executives.

The long and pervasive deterioration of the securities markets may represent an unexpected positive development. With more than 30 million individual shareowners (more than four times the number counted in 1952), any malaise in the stock market is apt to have a substantial psychological impact on the general economy. But very possibly, the really important fact about what we have been witnessing may prove to be that the speculative fervor of the sixties is now gone. The markets have been wrung out. Unrealistic paper appreciation has been corrected, and today's equity price levels are much closer to what the asset underpinnings can support.

Meanwhile, the President, as you know, has appointed a Commission on Financial Structure and Regulation and that body has begun sifting the areas where it can make the most constructive recommendations. I believe there is clear and present need for such a reexamination and I am optimistic that the Commission will come forward with impartial suggestions to provide a new flexibility and a new dynamism in our financial structure. But there is justification for Congress, and this committee in particular, to begin its own consideration of the needs of our financial institutions as we enter the seventies. Specifically, I have in mind eight areas which deserve attention as we ready ourselves for the development of a long-term strategy.

First and foremost, the problems of liquidity. The problem of liquidity permeates all businesses, all governments, all banks, all financial institutions and, in fact, reaches out to individuals.

It is my judgment that the lack of liquidity linked to a worldwide shortage of money will be a chronic condition in the years ahead. This means that—whatever recommendations the Presidential commission may make—its recommendations should be designed to permit better management of the liquidity position of the financial mechanism.

Second, it seems to me that this committee should carefully evaluate the effect of fiscal policy on the ability of the financial mechanism to perform adequately. Obviously, the thrust and philosophy of taxing policy should be harmonious with the directions we seek for our financial mechanism. While it might be inappropriate for this committee to address itself to specific details of tax reform, it most certainly should have something to say on the broad aims of taxing policies to see that they are compatible with the objectives we set for our financial mechanism.

Third, I would hope that this committee would work towards a major simplification of the web of regulation currently spun around financial institutions. Narrow and restrictive legislation and regulations are throttling the ability of financial institutions to respond to the needs of the 1970's. We want our institutions to be creative, because to be responsive to the social torrents of our times demands creativity—the openmindness to experiment with new devices, new modes, and new forms of institutional arrangements.

Fourth, I would hope this committee would give serious consideration to the issue of equity, and here I have in mind specifically the problems of the commercial banking industry. Commercial banks historically have been forced to bear the lion's share of the burdens of Federal monetary policy. In the process, their ability to accomplish what is expected of them in serving the public and the needs of public policy has been seriously hampered.

On the simple basis of equity and effectiveness, I think it is time that the more onerous burdens of Federal financial control be spread more evenly among our financial institutions.

Fifth, there is little question that we have permitted the effectiveness of monetary policy to be undermined in recent years. Such financial institutions as credit unions, savings and loans, and the new wave of industrial-based credit mechanisms, operating in a nonregulated environment, have all eroded the Federal Reserve's traditional base for effectively controlling the credit supply. The simple fact is that in our present circumstances, the Federal Reserve has to squeeze harder and harder on a continually diminishing base of control. To bring more effectiveness to monetary policy, we must dismantle some of the current excessive controls on commercial banks to permit a more equitable and better balanced growth. For example, there is no economic or public policy reason why restraints of regulation Q should not be removed from all large denomination money market instruments. The recent suspension of ceilings on a limited segment of this market is a step in the right direction.

If banks were permitted to be fully competitive in the search for funds, the resulting inflow into the banking system would not only facilitate a more orderly intermediary accommodation of the essential

credit needs of the economy, but it would also increase the effectiveness of Federal control over the entire credit supply. And, obviously, such a course has the important plus benefit of diminishing rather than expanding discriminatory controls.

Sixth, it is to be earnestly desired that the committee will be mindful of the problem of the proliferation of Government agencies, and the overlaps and inefficiencies this creates. We have tended in the past to try to solve our problems by creating new special purpose agencies of a governmental or quasi-governmental nature. Some of these have been effective. Some have not. But the end result has been the mushrooming of special purpose agencies and we can hope that the committee will consider this problem in the context of its deliberations.

Seventh, we would hope that the committee would address itself to the issue of better coordination of monetary and fiscal efforts and their further removal, to the degree possible, from the political arena.

Finally, and perhaps most important of all, I hope members of this committee will keep uppermost in their minds the value of the market system in relation to our financial mechanism. Money, as long as it is free to respond to price, is one way, perhaps the only way, to bring the benefits of the market system and its allocation process into play on public sector problems.

I speak of money, but I also have in mind the market system per se. It is as important a contributor to our American concept of social accomplishment as it is a cornerstone of our economic institutions—for it is a system which is directed toward releasing rather than shackling the energies and abilities of the individual.

Now I wish to conclude by stating a proposition: If the American people fail to achieve the political and social goals they choose for themselves for the remainder of this century, it will be in large part because they have failed to strengthen and preserve the open market financial system which permits their implementation.

In summary, the policy tools which are currently available may succeed temporarily in containing short-run aspects of our major problems, but solving the short-run problems in my judgment, requires treatment of the basic changes and causes.

Admittedly, all this will take considerable time, but there is no better time than now to start.

Senator PROXMIRE. Thank you very much. You did a fine job abbreviating this. The entire prepared statement will be printed in the record in full.

Thank you very much.

(The prepared statement of Mr. Clausen follows:)

PREPARED STATEMENT OF A. W. CLAUSEN

Mr. Chairman and members of the Committee, thank you for this opportunity to testify at these hearings. My name is A. W. Clausen. I am President and Chief Executive Officer of the Bank of America National Trust and Savings Association, with headquarters in San Francisco. I am also President of BankAmerica Corporation, a one-bank holding company organized in 1968 which became owner of all of the bank's stock (except for directors' qualifying shares) on April 1, 1969. BankAmerica Corporataion and its subsidiaries had more than $27 billion in resources, as of March 31. The Bank of America has 987 domestic branches and offices plus another 96 offices overseas. Our permanent staff numbers approximately 33,500 persons. We have more than 180,000 shareowners. My testimony this morning is given on behalf of both the Bank of America National Trust and Savings Association and BankAmerica Corporation.

I realize it is customary for witnesses before this body to itemize current and topical issues relating to the general state of the economy. However, I'd like to focus this morning on a broader spectrum of emerging trends as distinct from individual economic events. First, however, it may be useful to simply run through a few of the most immediate short-run problems and prospects:

Without question, we've been skirting the brink of what in other days under somewhat different circumstances would be a test of financial confidence. And this has become a factor in the decisions made by businesses, financial institutions and their customers. We cannot ignore this, and certainly we cannot allow it to gain any further momentum. I say this for the benefit of the Congress, the President, the financial regulatory authorities—and the public, which is the ultimate arbiter of decisions in the marketplace.

A liquidity squeeze is evident in many quarters, and this is pushing hard on the demand for bank credit. It will be with us for the remainder of 1970.

The stability of financial markets has been exacerbated by changes in monetary policy, which rightly or wrongly has in a period of 24 months moved from the extreme of a virtually unfettered increase in credit flows to the opposite posture of almost total restraint. The monetary authorities may have had little choice, but the swings have had a disquieting impact on the market.

The government's own role—through spending authorizations bred out of a wartime economy hand in hand with accelerated social programs—continues to throw too much of the burden of inflation restraint on the monetary authorities.

Cutbacks in defense programs will increase as our armed forces are withdrawn from Southeast Asia and other overseas bases, bringing some temporary dislocations in local employment.

The housing market is not responding promptly to the efforts, as extensive as they have been of late, to increase the availability of funds and to lower rates, chiefly because public expectations of capital gains in housing are at a low ebb and perhaps half the families are priced out of the market by extremely high costs—costs which, of course, are aggravated by inflationary forces.

Social unrest may mount during the fall election campaigns, while work stoppages attendant to major contract negotiations could easily add confusion and cause normal economic indicators to fluctuate erratically. If this should come to pass, we should view it in its proper perspective and recognize it does not necessarily mean the whole country is going to pieces but that it is merely a peculiarity of an election year when sensitivities are running high.

I believe that most of these immediate problems have been identified and are being treated properly by the policy tools which exist. We are beginning to see positive results.

I can summarize this position quite briefly. We have made progress in our battle with inflation but we still can't relax. As a business executive, I have no great fondness for government intervention in private decisions revolving around wages and prices. But the upward pressures evident both in prices and in wage settlements so far this year clearly suggest that some form of more aggressive moral suasion by the government is in order. We cannot afford to be passive. At the opposite extreme are direct controls (which some have been urging upon the government). They are inefficient, inequitable, and at best only a temporary palliative. Therefore I conclude we must support the President's proposals for a Commission on Productivity and a system of "inflation alerts." But we need to move with alacrity—and vigorously.

The other ingredient to realistic anti-inflation action is a far more rigorous use of fiscal policy than has been in evidence. A fundamental lesson of the past few years is that deficit government spending must be controlled if we are to achieve our national objectives of a higher quality of life in a non-inflationary, full-employment economy. Spending priorities must be established and maintained.

This is more than a question of efficient government—it's a matter of absolute necessity if we are to ever defuse the inflation time-bomb that keeps ticking. Whenever there is prolonged and heavy borrowing from the private sector by the public sector in excess of tax revenues, and whenever those funds are used to divert goods away from private consumption, inflationary pressures build up. The vigorous use of fiscal discipline is the only method of averting such pres-

sures now and of allocating increasingly scarce credit in the midst of proliferating social demands.

So much for the two areas requiring immediate action.

On a longer term basis, I would like to pose a question, and then examine its implications for the Congress, the Executive and those of us in positions of responsibility in the private sector.

The question is this: are the changes now evident in the United States economy merely transitory? Or are they something more—symptoms of fundamental, basic change? Surely, changes are visible in almost any direction you choose to look. And it is the conclusion of the Bank of America that many of them are symptomatic of real change—permanent, fundamental readjustment of our economic mechanism which it is imperative for us to recognize and understand if we are going to formulate public or private strategy to intelligently move forward to the goals we know we must set for ourselves.

Some of the objectives of strategy are already clear. And they are not exclusively economic. Indeed, their social and political coloration is part of why the formulation of economic policy seems so exasperatingly difficult these days.

Everyone in this room is familiar with the broad objectives, but let me itemize the main ones briefly. This nation is dedicated to the eradication of poverty, to the re-building of our cities, to the rejuvenation of housing that is rapidly becoming obsolescent and inadequate, to the raising of educational opportunities and standards for all our people, to the elimination of environmental pollution and—I fervently hope, to the preservation and expansion of a private market economy that has provided this country's incredibly high level of material well-being.

These are the continuing aspirations of our nation. But each of these national goals requires money. It is not idle therefore to underscore the hard fact that failure of our financial mechanism to meet these needs would spell doom for some, or conceivably all, of these socio-political imperatives. Our financial system forms the vital link in realizing political and social goals.

I would take this reasoning one step further: the increased pressures on financial markets we have seen in the last few years will not disappear with the reduction of our commitment in Southeast Asia. As it exists right now, the present financial system simply will be unable to provide enough credit and capital to carry out the tasks our society would like to undertake. Moreover, should we try to supply credit to meet all wants, inflation—already an ugly, stubborn antagonist—would re-accelerate and, amuck, could very well destroy the financial and economic system we know today. Stated another way, the principal task facing our financial system—given all these factors—will be to find efficient and equitable ways to allocate limited credit.

Let me say, in passing, that the strains on this mechanism already experienced in the past twelve months have been extraordinarily severe. We cannot, with any conscience, neglect to heed—and heed well—the lessons to be learned from the events of recent months. These lessons in the discipline of liquidity—a discipline ignored or forgotten only at peril—can redevelop the kind of risk-conscious leadership we need for the decade now starting, especially among new prosperity-nutured generation of financial executives. To this extent, the stresses of last year and the opening months of this year may reveal some unsuspected benefits.

For the same reason, I submit, the long and pervasive deterioration of the securities markets may represent an unexpected positive development. With more than 30 million individual shareowners (more than four times the number counted in 1952), any malaise in the stock market is apt to have a substantial psychological impact on the general economy. But very possibly, the really important fact about what we've been witnessing may prove to be that the speculative fervor of the Sixties is now gone. The markets have been wrung out. Unrealistic paper appreciation has been corrected, and today's equity price levels are much closer to what the asset underpinnings can support. I remain confident about the fundamental strength of our economy and I personally welcome the fact that we are reacquiring a sense of basic values—of quality—in our security markets.

Meanwhile, the President, as you know, has appointed a Commission on Financial Structure and Regulation and that body has begun sifting the areas where it can make the most constructive recommendations. I believe there is clear and present need for such a re-examination and I am optimistic that the Commission will come forward with impartial suggestions or provide a new flexibility and a new dynamism in our financial structure. But there is justification for Congress,

and this Committee in particular, to begin its own consideration of the needs of our financial institutions as we enter the Seventies. Specifically, I have in mind eight areas which deserve attention as we ready ourselves for the development of a long-term strategy.

First and foremost, the problem of liquidity. The problem of liquidity permeates all business, all governments, all banks, all financial institutions and, in fact, reaches out to individuals. In many cases it is of sufficient severity that any interruption in cash flow can mean a difference between success and failure.

Over the past thirty years, there have been widespread and extensive changes in our financial system and the environment in which it operates. But all of these changes, important as they may be, are dwarfed by the relentless withdrawal of financial liquidity that has had its most dramatic impact on the banking system. It is my judgment that the lack of liquidity linked to a worldwide shortage of money will be a chronic condition in the years ahead. This means that—whatever recommendations the Presidential Commission may make—their recommendations should be designed to permit better management of the liquidity position of the financial mechanism. I do not say this lightly. The fact is that a greater measure of liquidity control is critical to the success or failure of our political aspirations, and it is also reasonable to say that many of my other considerations on the financial mechanism are influenced by the problem of liquidity.

Second, it seems to me that this Committee should carefully evaluate the effect of fiscal policy on the ability of the financial mechanism to perform adequately.

Obviously, the thrust and philosophy of taxing policy should be harmonious with the directions we seek for our financial mechanism. While it might be inappropriate for this Committee to address itself to specific details of tax reform, it most certainly should have something to say on the broad aims of taxing policies to see that they are compatible with the objectives we set for our financial mechanism.

Third, I would hope that this Committee would work towards a major simplification of the web of regulation currently spun around financial institutions. Narrow and restrictive legislation and regulations are throttling the ability of financial institutions to respond to the needs of the 1970's. We want our institutions to be creative, because to be responsive to the social torrents of our times demands creativity—the open-mindness to experiment with new devices, new modes, and new forms of institutional arrangements.

Fourth, I would hope this Committee would give serious consideration to the issue of equity, and here I have in mind specifically the problems of the commercial banking industry. Commercial banks historically have been forced to bear the lion's share of the burdens of federal monetary policy. In the process, their ability to accomplish what is expected of them in serving the public and the needs of public policy has been seriously hampered. The function of the banking system in the implementation of monetary policy has been vastly misunderstood by the American public and, indeed, by some of our lawmakers in Washington. The result has been that the banks—bearing the brunt of federal monetary policies—have received an undeserved and unfavorable public image, while their less-regulated brethren, unfettered and, in fact, in some cases, subsidized, have emerged from the difficult tight money conditions of the past few years with their public image untouched.

On the simple basis of equity and effectiveness, I think it is time that the more onerous burdens of Federal financial control be spread more evenly among our financial institutions.

Fifth, there is little question that we have permitted the effectiveness of monetary policy to be undermined in recent years. Such financial institutions as credit unions, savings and loans, and the new wave of industrial-based credit mechanisms, operating in a non-regulated environment, have all eroded the Federal Reserve's traditional base for effectively controlling the credit supply. The simple fact is that in our present circumstances, the Federal Reserve has to squeeze harder and harder on a continually diminishing base of control. To bring more effectiveness to monetary policy, we must dismantle some of the current excessive controls on commercial banks to permit a more equitable and better balanced growth. For example, there is no economic or public policy reason why restraints of Regulation Q should not be removed from all large denomination money market instruments. The recent suspension of ceilings on a limited segment of this market is a step in the right direction.

If banks were permitted to be fully competitive in the search for funds, the resulting inflow into the banking system would not only facilitate a more orderly intermediary accommodation on the essential credit needs of the economy, but it would also control over the entire credit supply. And, obviously, such a course has the important plus benefit of diminishing rather than expanding discriminatory controls.

Sixth, it is to be earnestly desired that the Committee will be mindful of the problem of the proliferation of government agencies, and the overlaps and inefficiencies this creates. We have tended in the past to try to solve our problems by creating new special purpose agencies of a governmental or quasi-governmental nature. Some of these have been effective. Some have not. But the end result has been the mushrooming of special purpose agencies and we can hope that the Committee will consider this problem in the context of its deliberations.

Seventh, we would hope that the Committee would address itself to the issue of better coordination of monetary and fiscal efforts and their further removal, to the degree possible, from the political arena.

Finally, and perhaps most important of all, I hope members of this Committee will keep uppermost in their minds the value of the market system in relation to our financial mechanism. As a banker, I am understandably concerned with the successful operation of our financial system. By the very nature of my daily duties, I am concerned about money and credit and how it relates to the rest of our affairs. In a democracy, these are the basic instruments of economic freedom, the tool through which individuals make their preferences known. Money, as long as it is free to respond to price, is one way, perhaps the only way, to bring the benefits of the market system and its allocation process into play on public sector problems.

I speak of money, but I also have in mind the market system. It is as important a contributor to our American concept of social accomplishment as it is a cornerstone of our economic institutions—for it is a system which is directed toward releasing rather than shackling the energies and abilities of the individual.

In addition to the advantages of effective marshalling of economic resources, it is of crucial importance in terms of personal liberty. Rather than being centralized in a few persons in authority, powers of decision are dispersed among millions of people. It is a system for the many rather than the few, and for this reason is inextricably bound to our political and social aspirations.

This market system has served us well. It has, in the very brief span of 200 years, permitted the United States to grow from a largely agrarian wilderness to a unique, highly-developed business civilization. It has provided greater equality in wordly possessions than any authoritarian society has done, or shown the slightest likelihood of doing.

Now I wish to conclude by stating a proposition: if the American people fail to achieve the political and social goals they choose for themselves for the remainder of this century, it will be in large part because they have failed to strengthen and preserve the open market financial system which permits their implementation.

In summary, I'd like to re-emphasize that uncertainty is the chief cause of our present economic drift, that no clear economic uptrend can emerge until confidence has been restored, and we must be prepared to face recurring economic problems such as now confront us until we take greater cognizance of the basic changes in progress and find agreement on our socio-economic priorities. The policy tools which are currently available may succeed temporarily in containing short-run aspects of our major problems, but solving the short-run problems in my judgment requires treatment of the basic changes and causes.

Admittedly, all this will take considerable time, but there is no better time than now to start.

I shall be glad to respond to any questions which the members of the Committee may have.

Senator PROXMIRE. Our last witness is Dr. Kaufman.

STATEMENT OF HENRY KAUFMAN, PARTNER AND ECONOMIST, SALOMON BROS. & HUTZLER, NEW YORK CITY

Mr. KAUFMAN. I want to thank you for inviting me to speak to you about the conditions in our money and capital markets. As noted by

the chairman in announcing these hearings, there are still some vexing and unresolved problems confronting us which deserve your attention.

In the financial markets alone, three unusual developments have accompanied the economic slowdown of the past 9 months. One is the persistence of an extraordinarily high level of interest rates. High-grade corporate bonds are currently yielding above 9 percent as compared with 8.35 percent in early October 1969, when economic activity started to slow down. Long-term Government and municipal bond yields are also higher now than they were 9 months ago. After several quarters of previous economic recessions, long-term interest rates were substantially below the levels which prevailed when the recession started. While it is true that short-term interest rates are below their 1969 peaks, they are nevertheless still very high and the net decline to date is far less than the drop which occurred in previous business cycle contractions.

A second unusual financial feature of the past 9 months of business slowdown is the unexpected trends in the volume of various credit demands financed by the marketplace. This is especially noticeable in our long-term credit markets. Let me illustrate this by referring you to table 1 in my prepared statement——

Senator PROXMIRE. At this point let me say that your tables will be printed in full in the record.

Mr. KAUFMAN. Fine.

These tables, of course, indicate the net volume of mortgage, corporate bond, and municipal financing during the last 3 quarters of economic expansion in 1969.

Mortgage financing recovered sharply during the subsequent economic slowdown, except during the latest business decline. Net new mortgage financing, however, has confounded cyclical expectations, thus far, by continuing to fall.

The net new volume of corporate bond flotations declined not during the business recession in 1957–58 and 1960–61. However, during the minirecession in 1967, corporate bond flotations rose sharply, and a spectacular increase has occurred in these demands since the peak in economic activity last year.

The net volume of municipal financing has increased significantly since the peak in economic activity in the third quarter of last year. However, a large part of the municipal financing thus far this year and in 1969 reflects a large volume of short-term tax-exempt notes, while long-term municipal bond financing continues to be moderate.

A third aspect accompanying the current business recession, unprecedented in the postwar period, is the increasing talk of a "liquidity crisis." This is a glibly used phrase and does not describe the essence of the problem. There is no evidence suggesting a malfunctioning of the most important elements of our credit structure; namely, the money market and the market for high-grade bonds. A large volume of transactions including new issues and secondary market transactions continues to be consummated daily in Treasury obligations and in high-grade corporates and municipals. Table 2 in my prepared statement also reveals that the net new volume of long-term market financing totaled an estimated $23.4 billion during the first half of 1970. This was just slightly below the first half record net long-term

financing in the first half of 1969 and was above earlier comparable first half-year periods.

Now, these total credit demands, however, were only partially financed in the traditional way; that is, through our financial institutions. Important nonbank financial institutions continued to experience disintermediation. The tight monetary policy earlier this year limited sharply the availability of bank funds. High market rates, however, encouraged individual investors to purchase directly a record $11.5 billion of fixed income securities.

The "crisis," if there is one, is with borowers who cannot redress their liquidity because of the deterioration of their credit standing and, to some extent, with a few institutions having marginal and nonmarketable assets. However, while this kind of illiquidity has its consequences, as I shall mention later, it has not and should not immobilize our national money and capital markets.

The causes of these financial stringencies are varied and date back to the decade just past. The virtually uninterrupted economic expansion of the past 10 years fostered immense euphoria and in turn economic and financial excess. The feeling of no real downside risk in business and investment decisions gradually gathered momentum in the 1960's. This sparked a boom in plant and equipment expenditures, and the bidding up of wages and prices. The expectation of continued substantial economic growth with no end to inflation encouraged many economic participants to act increasingly aggressive. At times national policies also abetted the euphoria in the economy. Economic participants began to conclude that our Government would accept an increasing rate of inflation and would not really discipline the emerging excesses. After all, the Vietnam conflict was not financed through taxation but through deficits financed for the most part not by savings but by monetary expansion. A growing number of new and prospective governmental social programs encouraged business to resist restrictive stabilization programs, which in earlier years had effectively checked excesses. To many, economic prospects seemed virtually guaranteed. In a free society, such prospects always trigger dangerous excesses unless they are quickly countermanded.

It should not be surprising, therefore, that the laxities in the economy and national stabilization policies also caused their financial counterparts. I shall name just a few of these financial distortions.

The demand for credit did not abate quickly as interest rates increased. To some, the cost of money was a small price to pay to secure tomorrow's comforts, profits or markets. Thus, the balance sheets of some borrowers, including those of individuals, business and local governments, became heavily encumbered.

Some lenders and borrowers have relied more on the acquisition of liabilities as a source of liquidity than on the holdings of liquid assets.

The quest for performance resulted in some relaxation of credit standards. Equity inducements became an added inducement to the extension of credit.

Nonbank financial institutions gradually allocated an increasing percentage of their net new funds for equity investments.

The seemingly assured future encouraged aggressive portfolio management in order to achieve high short-term performance. In this endeavor, the initial success of some portfolio managers encouraged others.

The demands on the credit markets were enlarged by the substantial needs of the Federal Government. While part of these requirements were designed to aid housing they have not increased the supply of savings, and it is, therefore, debatable that they aided housing to the full extent of the issues marketed by the agencies. Consequently, the competition for funds was additionally intensified, thereby raising the level of interest rates.

Unfortunately, the imbalances in our economy and financial markets have caused some hardships, penalties and losses. This is why it is important to prevent them from reoccurring. Fortunately, we will pass through this period with the important sectors of our credit markets remaining viable and intact. The events of recent months have set in motion a series of reactions in the financial markets which within time will improve their functioning and stability.

The "go-go" era in portfolio management is rapidly coming to a close. As a result, more funds should become available for traditional investments such as fixed income securities.

I suspect that many financial institutions are in the process of reviewing their lending and investing practices with the objective of improving credit quality. If so, this would be the first time in the post-World War II period that many financial institutions have not become significantly more willing lenders as credit policy has eased. Previously, the upgrading of credit quality has taken place as credit conditions have tightened and not when they are in the process of easing.

The widening yield spread between highly rated and lower rated bonds clearly reflects the new preference for high quality credits.

A most important development concerns the impact of declining stock prices and corporate profits as well as the new emphasis on marginal liquidity problems on business decisions. The financing of such transactions as mergers and stock market requirements is nearly at a standstill. In addition, the combination of tight money and the falloff in internal cash generation is most likely forcing many corporations to sharply curtail their capital outlays for the balance of the year and into 1971 beyond present survey estimates. This will gradually reduce the external financing needs of business and, therefore, free our credit markets to finance more of our housing and local government needs.

My detailed estimates of the net credit flows for the second half of this calendar year are shown to you in table 3 of my prepared statement. Briefly, I estimate that the net volume of private mortgage financing will total nearly $12 billion.

For reasons stated earlier, the net volume of corporate bond flotations should gradually moderate, totaling nearly $6.6 billion in the second half of the year, still moderately large but down substantially from $12 billion in the first half.

Municipal bond offerings will accelerate somewhat in the latter part of this year as a result of the expected improved availability of bank funds.

A dramatic slowdown now appears to be in process in commercial paper financing, which should continue for the remainder of the year. The limited liberalization of regulation Q will enable banks to issue CD's and to lessen their dependence on the issuance of paper through their holding companies. The funding of corporate liabilities and the

hesitance of some short-term investors in committing funds to this market should also limit commercial paper financing.

In contrast, the market financing demands of our Federal Government, including the requirements of the U.S. Treasury and the various Federal agencies, will be very large. As shown in table 3 of my prepared statement, I have estimated these combined demands at $14.8 billion net, $3.2 billion larger than in the comparable period last year. Therefore, these demands by the Treasury will thus preempt considerable money from other sectors of the credit market such as housing and State and local governments.

On the supply side, the flow of funds into financial institutions should improve over the very weak inflow of the first half. In particular, the easing in monetary policy will most likely expand the availability of new bank funds by an estimated $25 billion.

Nevertheless, in the second half of this year, individual investors will probably continue to make substantial direct purchases in fixed-income securities, although not as in the first half.

My credit flow analysis for the balance of this year is in no way meant to suggest that the credit markets will be entirely free from occasional additional credit insolvencies. There may well be additional stringencies for marginal credits. This kind of problem cannot be quantitatively isolated from aggregate credit flow statistics.

In conclusion, I should like to make a few modest proposals for your consideration which, if adopted, would help to enhance the well-being of our financial system.

First, there should be a broader recognition among policymakers that each year we generate a limited, although large, volume of genuine new savings, which finances the demands for credit and thereby economic activity of all sorts. Enlarging the demands for credit does not generate a corresponding increase in the supply of savings unless national stabilization policy measures are adopted to generate the additional funds.

Second, in this connection, it would be extremely helpful if official economic forecasts would be supported by detailed credit flow estimates showing the credit demands to be generated by the economic projections for the period ahead and how these demands will be financed. If this kind of discipline had been applied during the past 5 years, the financial counterpart to the economic projections would have frequently revealed that the economic projections were not financeable without escalating interest rates sharply, without an inflationary increase in money supply and without the emergence of other distortions in the credit markets. Legislators should be told in detail whether or not economic prospects will fall within the resource capability of our financial system.

Third, we should improve our knowledge of the impact of the Federal Government on the economy and the credit markets. The budget should encompass all of the federally sponsored programs which are now excluded, but still make demands on the economy and the credit markets. This is not to say that the programs outside the budget are not deserving but by including them, the priorities of the Federal Government will be well defined and ranked. Indeed, an all-encompassing budget procedure would not only clearly show the priorities of the Government but would be a start towards inter-

mediate and long-range budgeting, which is an important prerequisite for effective fiscal stabilization policies.

Fourth, budgetary surveillance should be improved. It should become much more of a joint effort between the executive and the legislative branch. The trends in receipts and expenditures should be monitored and analyzed more frequently than takes place presently through the official annual and midyear budget reviews. This year in particular the inadequacy of the current procedures contributed to additional stresses in the credit markets. In January, the annual budget review projected a budget surplus for both fiscal 1970 and 1971. These projections were steadfastly adhered to until May when both projections were abruptly revised into deficits.

Fifth, the various governmental agencies should be encouraged to develop meaningful statistics on the quality of our credit structure. Admittedly, this is a difficult task, but a good beginning can be made by merely improving the current statistical series, which are incomplete and poorly benchmarked. It is unfortune that while we have gone through a period in which there has been a deterioration in credit quality, we know little about the borrowers, including individuals, business and local governments which are at the credit margin. Our credit markets will survive the current turmoil. However, the abuse of our credit markets must stop if the strength of our financial structure is to be preserved, if the financing of our social objectives is to be achieved, and if a broadly based and sustainable economic expansion is to follow the current economic slowdown.

Thank you.

(The prepared statement of Mr. Kaufman follows:)

PREPARED STATEMENT OF HENRY KAUFMAN

I want to thank you for inviting me to speak to you about the conditions in our money and capital markets. As noted by the Chairman in announcing these hearings, there are still some vexing and unresolved problems confronting us which deserve your attention.

In the financial markets alone, three unusual developments have accompanied the economic slowdown of the past nine months. One is the persistence of an extraordinarily high level of interest rates. High-grade corporate bonds are currently yielding somewhat above 9% as compared with 8.35% in early October 1969 when economic activity started to slow down. Long-term Government and municipal bond yields are also higher now than they were nine months ago. After several quarters of previous economic recessions, long-term interest rates were substantially below the levels which prevailed when the recession started. While it is true that short-term interest rates are below their 1969 peaks, they are nevertheless still very high and the net decline to date is far less than the drop which occurred in previous business cycle contractions.

A second unusual financial feature of the past nine months of business slowdown is the unexpected trends in the volume of various credit demands financed by the marketplace. This is especially noticeable in our long-term credit markets. Let me illustrate this by referring you to Table 1, which shows the net new volume of mortgage, corporate bond and municipal financing during the last three quarters of economic expansion in 1969 (namely, the first, second, and third quarters of that calendar year), and during the subsequent three quarters of business contraction as well as these financing trends around previous business cycle peaks.

As you may note, the net new volume of mortgage financing contracted net towards the close of the economic expansions in 1957, 1960, 1966 and 1969. Mortgage financing recovered sharply during the subsequent economic slowdown, except during the latest business decline. Net new mortgage financing, however, has confounded cyclical expectations, thus far, by continuing to fall.

The net new volume of corporate bond flotations declined net during the business recession in 1957–58 and 1960–61. However, during the mini-recession in 1967, corporate bond flotations rose sharply, and a spectacular increase has occurred in these demands since the peak in economic activity last year.

The net volume of municipal financing has increased significantly since the peak in economic activity in the third quarter of last year. However, a large part of the municipal financing thus far this year and in 1969 reflects a large volume of short-term tax-exempt notes, while long-term municipal bond financing continues to be moderate.

A third aspect accompanying the current business recession, unprecedented in the postwar period, is the increasing talk of a "liquidity crisis." This is a glibly used phrase and does not describe the essence of the problem. There is no evidence suggesting a malfunctioning of the most important elements of our credit structure—namely, the money market and the market for high-grade bonds. A large volume of transactions including new issues and secondary market transactions continues to be consummated daily in Treasury obligations and in high-grade corporates and municipals. Table 2 before you reveals that the net new volume of long-term market financing totalled an estimated $23.4 billion during the first half of 1970. This was just slightly below the first half record net long-term financing in the first half of 1969 and was above earlier comparable first half-years. Moreover, the total satisfied net credit demands were an estimated $29.4 billion during the first six months of 1970 and thus were also very substantial in historical perspective.

These total credit demands, however, were only partially financed in the traditional way, i.e., through our financial institutions. Important non-bank financial institutions continued to experience disintermediation. The tight monetary policy earlier this year limited sharply the availability of bank funds. Bank credit, including loan transfers to subsidiaries and bank holding companies, increased less than $1 billion in the first half of the year as compared with $5 billion and $7 billion in the same periods in 1969 and 1968, respectively. High market rates, however, encouraged individual investors to purchase directly a record $11.5 billion of fixed income securities.

The "crisis," if there is one, is with borrowers who cannot redress their liquidity because of the deterioration of their credit standing and, to some extent, with a few institutions having marginal and non-marketable assets. However, while this kind of illiquidity has its consequences, as I shall mention later, it has not and should not immobilize our national money and capital markets.

The causes of these financial stringencies are varied and date back to the decade just past. The virtually uninterrupted economic expansion of the past ten years fostered immense euphoria and in turn economic and financial excesses. The feeling of no real downside risk in business and investment decisions gradually gathered momentum in the 1960's. This sparked a boom in plant and equipment expenditures, and the bidding up of wages and prices. The expectation of continued substantial economic growth with no end to inflation encouraged many economic participants to act increasingly aggressive. At times national policies also abetted the euphoria in the economy. Economic participants began to conclude that our Government would accept an increasing rate of inflation and would not really discipline the emerging excesses. After all, the war was not financed through taxation but through deficits financed for the most part not by savings but by monetary expansion. A growing number of new and prospective governmental social programs encouraged business to resist restrictive stabilization programs, which in earlier years had effectively checked excesses. Why postpone a business activity or wage demand because of a short pause in economic activity if the boom will resume quickly? To many, economic prospects seemed virtually guaranteed. In a free society, such prospects always trigger dangerous excesses unless they are quickly countermanded.

It should not be surprising, therefore, that the laxities in the economy and national stabilization policies also caused their financial counterparts. I shall name just a few of these financial distortions.

The demand for credit did not abate quickly as interest rates increased. To some, the cost of money was a small price to pay to secure tomorrow's comforts, profits or markets. Thus, the balance sheets of some borrowers, including those of individuals, business and local governments, became heavily encumbered.

Some lenders and borrowers have relied more on the acquisition of liabilities as a source of liquidity than on the holdings of liquid assets.

The quest for performance resulted in some relaxation of credit standards. Equity inducements became an added inducement to the extension of credit. For

example, early this spring there were about $12.4 billion of outstanding publicly offered convertible bonds listed in Moody's Manual. Most of these were marketed since the mid-1960's. Only $1.4 billion or 12% of these issues have a credit rating of A and above, while $9.3 billion or 75% have ratings of Ba or less.

Non-bank financial institutions gradually allocated an increasing percentage of their net new funds for equity investments.

The seemingly assured future encouraged aggressive portfolio management in order to achieve high short-term performance. In this endeavor, the initial success of some portfolio managers encouraged others.

The demands on the credit markets were enlarged by the substantal needs of the Federal Government. While part of these requirements were designed to aid housing they have not increased the supply of savings, and it is therefore debatable that they aided housing to the full extent of the issues marketed by the agencies. Consequently, the competition for funds was additionally intensified, thereby raising the level of interest rates.

Unfortunately, the imbalances in our economy and financial markets have caused some hardships, penalties and losses. This is why it is important to prevent them from reoccurring. Fortunately, we will pass through this perod with the important sectors of our credit markets remaining viable and intact. The events of recent months have set in motion a series of reactions in the financial markets which within time will improve their functioning and stability.

The "go-go" era in portfolio management is rapidly coming to a close. As a result, more funds should become available for traditional investments such as fixed income securities. Individual investors have already expressed their increasing preference for high quality investments through their massive direct purchases of corporate bonds, municipals, U.S. Governments and Federal agencies.

I suspect that many financial institutions are in the process of reviewing their lending and investing practices with the objective of improving credit quality. If so, this would be the first time in the post-World War II period that many financial institutions have not become significantly more willing lenders as credit policy has eased. Previously, the upgrading of credit quality has taken place as credit conditions have tightened and not when they are in the process of easing.

The widening yield spread between highly rated and lower rated bonds clearly reflects the new preference for high quality credits. For example, for one pair of seasoned industrial bond issues—one Aaa and the other Ba—the yield spread, which has remained consistently in the 250 to 270 basis point range throughout most of this year, in June jumped into the 375 to 400 basis point range. In similar fashion, the yield spreads between two recently issued industrials, one issue rated Aaa and the other rated A, has widened from 75 basis points in April to almost 120 basis points in late June.

A most important development concerns the impact of declining stock prices and corporate profits as well as the new emphasis on marginal liquidity problems on business decisions. The financing of such transactions as mergers and stock market requirements is nearly at a standstill. In addition, the combination of tight money and the falloff in internal cash generation is most likely forcing many corporations to sharply curtail their capital outlays for the balance of the year and into 1971 beyond present survey estimates. This will gradually reduce the external financing needs of business and therefore free our credit markets to finance more of our housing and local government needs. During 1969 and 1970, the external financing requirements of business corporations will have averaged about $37 billion annually or 43% of all credit demands as compared with $12 billion or 21% in 1963. This is why the demands of other borrowers were curtailed in the last few years and were unhampered in 1963. An abatement of this massive volume of business financing in the months ahead should gradually help to reduce the strains in the bond market, lower interest rates, and redirect savings flows into other sectors.

My detailed estimates of the net credit flows for the second half of this calendar year are shown in Table 3. I estimate that the net volume of private mortgage financing will total nearly $12 billion or twice as large as during the first half but for the year as a whole will still be well below that of earlier years (see Table 4).

For reasons stated earlier, the net volume of corporate bond flotations should gradually moderate, totalling nearly $6.6 billion in the second half, still moderately large but down substantially from $12 billion in the first half.

Municipal bond offerings will accelerate somewhat in the latter part of this year. The expected improved availability of bank funds will probably allow municipalities to do more long-term and less short-term financing.

A dramatic slowdown now appears to be in process in commercial paper financing, which should continue for the remainder of the year. The limited liberalization of Regulation Q will enable banks to issue CDs and to lessen their dependence on the issuance of paper through their holding companies. The funding of corporate liabilities and the hesitance of some short-term investors in committing funds to this market should also limit commercial paper financing. To some extent, these developments will probably hold up the demand for both short-term and medium-term bank loans.

In contrast, the market financing demands of our Federal Government, including the requirements of the U.S. Treasury and the various Federal agencies, will be very large. As shown in Table 3, I have estimated these combined demands at $14.8 billion net, $3.2 billion larger than in the comparable period last year, and $2.1 billion higher than in the second half of 1968. Admittedly, about $8 billion or so represents the seasonal shortfall of Treasury tax collections but the remainder represents non-seasonal needs and thus pre-empts considerable money from other sectors of the credit market such as housing and state and local Governments.

On the supply side, the flow of funds into financial institutions should improve over the very weak inflow of the first half. In particular, the easing in monetary policy will most likely expand the availability of new bank funds by an estimated $25 billion, surpassing substantially the increase in bank credit for the previous twelve months by about threefold.

Nevertheless, in the second half of this year, individual investors will probably continue to make substantial direct purchases in fixed income securities, although not as large as in the first half. Currently, the yield on high-grade bonds is substantially above deposit rates. While I expect market interest rates to drop significantly by the end of the year, this yield spread will still be attractive enough in the interim for individual investors to channel funds directly into bonds.

My credit flow analysis for the balance of this year is in no way meant to suggest that the credit markets will be entirely free from occasional additional credit insolvencies. There may well be additional stringencies for marginal credits. This kind of problem cannot be quantitatively isolated from aggregate credit flow statistics.

In conclusion, I should like to make a few modest proposals for your consideration which, if adopted, would help to enhance the well-being of our financial system.

First, there should be a broader recognition among policymakers that each year we generate a limited, although large, volume of genuine new savings, which finances the demands for credit and thereby economic activity of all sorts. Enlarging the demands for credit does not generate a corresponding increase in the supply of savings unless national stabilization measures are adopted to generate the additional funds.

Second, in this connection, it would be extremely helpful if official economic forecasts would be supported by detailed credit flow estimates showing the credit demands to be generated by the economic projections for the period ahead and how these demands will be financed. If this kind of discipline has been applied during the past five years, the financial counterpart to the economic projections would have frequently revealed that the economic projections were not financeable without escalating interest rates sharply, without an inflationary increase in money supply and without the emergence of other distortions in the credit markets. Legislators should be told in detail whether or not economic prospects will fall within the resource capability of our financial system.

Third, we should improve our knowledge of the impact of the Federal Government on the economy and the credit markets. The budget should encompass all of the Federally sponsored programs which are now excluded, but still make demands on the economy and the credit markets. This is not to say that the programs outside the budget are not deserving but by including them the priorities of the Federal Government will be well defined and ranked. Indeed, an all-encompassing budget procedure would not only clearly show the priorities of the

Government but would be a start towards intermediate and long-range budgeting, which is an important prerequisite for effective fiscal stabilization policies.

Fourth, budgetary surveillance should be improved. It should become much more of a joint effort between the executive and the legislative branch. The trends in receipts and expenditures should be monitored and analyzed more frequently than takes place presently through the official annual and mid-year budget reviews. This year in particular the inadequacy of the current procedures contributed to additional stresses in the credit markets. In January, the annual budget review projected a budget surplus for both fiscal 1970 and 1971. These projections were steadfastly adhered to until May when both projections were abruptly revised into deficits.

Fifth, the various governmental agencies should be urged to develop meaningful statistics on the quality of our credit structure. Admittedly, this is a very difficult task, but a good beginning can be made by merely improving the current statistical series, which are incomplete and poorly benchmarked. It is unfortunate that while we have gone through a period in which there has been a deterioration in credit quality, we know little about the borrowers, including individuals, business and local governments which are at the credit margin. Our prime credit markets will survive the current turmoil. However, the abuse of our credit markets must stop if the strength of our financial structure is to be preserved, if the financing of our social objectives are to be achieved, and if a broadly based and sustainable economic expansion is to follow the current economic slowdown.

TABLE 1.—QUARTERLY PATTERN OF SELECTED CREDIT DEMANDS AROUND BUSINESS CYCLE PEAKS

[S.A. annual rates; in billions of dollars]

	2 quarters before	1 quarter before	Peak quarter	1 quarter after	2 quarters after	3 quarters after
Net new volume of mortgages:						
1957–58 (peak: 3d quarter, 1957)	11.0	9.5	10.7	10.5	11.5	14.1
1960–61 (peak: 2d quarter, 1960)	15.6	15.9	13.7	15.3	14.3	17.0
1966–67 (peak: 4th quarter, 1966)	20.1	15.1	12.8	15.5	18.1	23.4
1969–70 (peak: 3d quarter, 1969)	26.4	24.6	20.1	16.7	15.9	[1] 15.0
Net new volume of corporate and foreign bonds:						
1957–58 (peak: 3d quarter, 1957)	7.9	7.0	7.7	7.3	10.0	5.6
1960–61 (peak: 2d quarter, 1960)	5.2	5.5	4.3	6.0	6.5	4.1
1966–67 (peak: 4th quarter, 1966)	11.3	11.6	8.7	16.7	15.0	20.6
1969–70 (peak: 3d quarter, 1969)	17.4	15.7	14.2	12.4	16.8	[1] 27.5
Net new volume of municipal securities:						
1957–58 (peak: 3d quarter, 1957)	3.9	4.6	4.1	5.1	5.7	5.5
1960–61 (peak: 2d quarter, 1960)	4.7	5.2	5.2	5.6	4.9	5.2
1966–67 (peak: 4th quarter, 1966)	7.7	4.1	4.6	7.2	8.3	6.1
1969–70 (peak: 3d quarter, 1969)	10.2	9.8	6.7	7.1	8.8	[1] 10.0

[1] Estimated.

Source: Federal Reserve Board of Governors "flow of funds," except 1970 estimates.

TABLE 2.—1ST HALF CALENDAR YEAR, SUPPLY AND DEMAND FOR CREDIT

[In billions of dollars]

	1965	1966	1967	1968	1969	1970 estimate
Net investment demand:						
Mortgages publicly held [1]	12.1	10.6	7.4	10.3	12.0	6.0
Corporate bonds	4.1	6.1	7.2	6.5	7.5	12.0
State and local securities	3.2	3.8	5.4	5.0	4.8	5.0
Foreign bonds	.6	.5	.5	.4	.5	.4
Subtotal, long term	20.0	21.0	20.5	22.2	24.8	23.4
Net other demand:						
Other loans	12.4	11.8	2.0	8.6	14.7	−2.0
Open market paper	1.0	1.7	3.4	2.2	5.9	9.0
Publicly held Treasury debt	−5.7	−7.2	−12.5	−3.3	−13.7	−5.5
Publicly held Federal agency debt	2.3	5.1	−1.6	2.1	3.7	4.5
Total, net demand for credit	30.0	32.4	11.8	31.8	35.4	29.4
Net supply [2]:						
Mutual savings banks	1.9	1.1	2.6	1.7	1.6	1.2
Savings and loan associations	4.8	3.4	2.7	5.4	6.2	2.5
Life insurance companies	3.4	3.6	3.3	3.0	2.7	2.4
Fire and casualty insurance companies	.3	.6	.3	.8	.4	.8
Private noninsured pension funds	1.3	.8	.2	.6	0	.7
State and local retirement funds	1.5	1.4	1.5	1.7	2.0	2.2
Open-end mutual funds	.2	.6	−.4	.8	1.1	1.0
Total, nonbank investing institutions	13.4	11.5	10.2	14.0	14.0	10.8
Commercial banks	10.0	9.4	11.6	6.9	[3] 5.1	[3] .5
Finance companies	3.0	2.1	−.2	2.8	4.0	1.8
Business corporations	−1.7	.1	−2.5	4.0	4.8	3.5
State and local governments	2.6	2.4	.4	1.1	2.0	1.9
Foreigners	−.9	−1.3	.5	−1.9	−1.0	−.6
Subtotal	26.4	24.2	20.0	26.9	28.9	17.9
Residual: Individuals and miscellaneous	3.6	8.2	−8.2	4.9	6.5	11.5
Total, net supply of credit	30.0	32.4	11.8	31.8	35.4	29.4

[1] Memo on net new mortgages:

	1965	1966	1967	1968	1969	1970 estimate
Privately financed	12.1	10.6	7.4	10.3	12.0	6.0
Financed by Federal agencies	.3	2.0	.9	2.2	1.7	3.8
Total	12.4	12.6	8.3	12.5	13.7	9.8

[2] Excludes funds for equities, cash, and miscellaneous other demands not listed above.
[3] Includes loan transfers.

TABLE 3.—2D HALF CALENDAR YEAR, SUMMARY OF SUPPLY AND DEMAND FOR CREDIT

[Net increase; in billions of dollars]

	1965	1966	1967	1968	1969	1970 estimate
Net investment demand:						
Mortgages publicly held [1]	12.5	7.6	12.8	13.5	9.8	11.6
Corporate bonds	4.0	5.0	8.8	7.5	6.3	6.6
State and local securities	4.2	1.9	4.1	5.8	3.4	5.4
Foreign bonds	.6	.4	.7	1.0	.5	.8
Subtotal, long term	21.3	14.9	26.4	27.8	20.0	24.4
Net other demand:						
Other loans	12.8	2.5	8.7	17.4	10.4	12.5
Open market paper	—.3	2.7	.5	1.9	6.2	1.2
Publicly held treasury debt	3.3	5.3	15.9	9.4	7.2	11.6
Publicly held Federal agency debt	.6	—.3	5.3	3.3	4.4	3.2
Total, net demand for credit	37.7	25.1	56.8	59.8	48.2	52.9
Net supply: [2]						
Mutual savings banks	1.7	1.4	2.4	2.4	.7	2.6
Savings and loan associations	4.6	1.3	6.4	4.7	3.6	4.9
Life insurance companies	3.3	2.7	3.1	3.0	1.8	2.4
Fire and casualty insurance companies	.7	.9	1.0	1.1	1.2	1.9
Private noninsured pension funds	.8	1.1	.6	.7	1.0	.4
State and local retirement funds	1.3	1.4	1.5	1.9	1.6	1.7
Open-end mutual funds	.5	.9	—.1	.1	—.2	—.4
Total, nonbank investing institutions	12.9	9.7	14.9	13.9	9.7	13.5
Commercial banks	17.9	7.8	25.0	32.0	8.2	25.3
Finance companies	2.0	.2	.8	2.5	3.7	1.7
Business corporations	1.1	1.7	.5	2.7	4.1	0
State and local governments	—.7	—.1	—.7	—1.0	2.7	.9
Foreigners	.9	—.2	1.5	2.4	2.8	1.4
Subtotal	34.1	19.1	42.0	52.5	31.2	42.8
Residual: individuals and miscellaneous	3.6	6.0	14.8	7.3	17.0	10.1
Total, net supply of credit	37.7	25.1	56.8	59.8	48.2	52.9

[1] Memo on net new mortgages:

	1965	1966	1967	1968	1969	1970 estimate
Privately financed	12.5	7.6	12.8	13.5	9.8	11.6
Financed by Federal agencies	.7	1.4	1.7	1.3	3.6	2.2
Total	13.2	9.0	14.5	14.8	13.4	13.8

[2] Excludes funds for equities, cash and miscellaneous other demands not listed above.

TABLE 4.—FULL CALENDAR YEAR, SUPPLY AND DEMAND FOR CREDIT

[Annual net increases; in billions of dollars]

	1965	1966	1967	1968	1969	1970 estimate
Net investment demand:						
Mortgages, publicly held [1]	24.6	18.2	20.2	23.8	21.8	17.6
Corporate bonds	8.1	11.1	16.0	14.0	13.8	18.6
State and local securities	7.4	5.7	9.5	10.8	8.2	10.4
Foreign bonds	1.2	.9	1.2	1.4	1.0	1.2
Subtotal, long term	49.3	35.9	46.9	50.0	44.8	47.8
Net other demand:						
Other loans	25.2	14.3	10.7	26.0	25.1	10.5
Open market paper	.7	4.4	3.9	4.1	12.1	10.2
Publicly held treasury debt	−2.4	−1.9	3.4	6.1	−6.5	6.1
Publicly held Federal agency debt	2.9	4.8	3.7	5.4	8.1	7.7
Total, net demand for credit	67.7	57.5	68.6	91.6	83.6	82.3
Net Supply: [2]						
Mutual savings banks	3.6	2.5	5.0	4.1	2.3	3.8
Savings and loan associations	9.4	4.7	9.1	10.1	9.8	7.4
Life insurance companies	6.7	6.3	6.4	6.0	4.5	4.8
Fire and casualty insurance companies	1.0	1.5	1.3	1.9	1.6	2.7
Private noninsured pension funds	2.1	1.9	.8	1.3	1.0	1.1
State and local retirement funds	2.8	2.8	3.0	3.6	3.6	3.9
Open-end mutual funds	.7	1.5	−.5	.9	.9	.6
Total nonbank investing institutions	26.3	21.2	25.1	27.9	23.7	24.3
Commercial banks	27.9	17.2	36.6	38.9	[3] 13.3	[3] 25.8
Finance companies	5.0	2.3	.6	5.3	7.7	3.5
Business corporations	−.6	1.8	−2.0	6.7	8.9	3.5
State and local governments	1.9	2.3	−.3	.1	4.7	2.8
Foreigners	0	−1.5	2.0	.5	1.8	.8
Subtotal	60.5	43.3	62.0	79.4	60.1	60.7
Residual: individuals and miscellaneous	7.2	14.2	6.6	12.2	23.5	21.6
Total, net supply of credit	67.7	57.5	68.6	91.6	83.6	82.3

[1] Memo on net new mortgages:

	1965	1966	1967	1968	1969	1970 estimate
Privately financed	24.6	18.2	20.2	23.8	21.8	17.6
Financed by Federal agencies	1.0	3.4	2.6	3.5	5.3	6.0
Total	25.6	21.6	22.8	27.3	27.1	23.6

[2] Excludes funds for equities, cash and miscellaneous other demands not listed above.
[3] Includes loan transfers.

Chairman PATMAN (presiding). Thank you.

I thank Senator Proxmire for presiding at a time when it was impossible for me to be here. He is always very accommodating and I appreciate it very much, in this case in particular.

Senator Proxmire, you may interrogate first and each member will be allowed 10 minutes as heretofore on the first go-around. After that we will decide the time depending on the amount of time left.

Senator Proxmire?

Senator PROXMIRE. As expected, gentlemen, these papers are all very, very fine, very high grade and helpful and constructive.

Mr. Kaufman, I appreciate so much your emphasis on what we should do here in the Government to provide a better knowledge and understanding of the working of our credit markets. You are very specific in making recommendations. You pointed out how difficult this is but how necessary and desirable. I could not agree with you more.

You say in your prepared statement, Mr. Kaufman, that many corporations are sharply curtailing capital outlays. This is another way, it seems to me, of saying that monetary policy is working to stem inflation as its purpose. That is the price you have to pay for a restraint on the economy through monetary policies, liquidity shortage. That it what it means.

It took us a long time to get there and before we got there we had a lot of cheers from the financial community that we ought to have more monetary restraints until it affected them. Monetary restraint in the mass has affected housing primarily. You know the famous study by Sherman Maisel, a member of the Federal Reserve Board, that shows that in the 1966 credit crunch to cut back on the economy, that 70 percent of it was a cutback in housing, which constituted 3½ percent of the GNP. Corporations were virtually free to get funds, either through internal sources or through their much stronger connections with the banks. Now monetary policy is working on the corporations and the financial community sees it as a liquidity shortage, apparently an error in policy. Would you disagree with that view?

Mr. KAUFMAN. No. I share most of those views expressed by you, Senator. It is true that initially in periods of monetary restraint housing is hurt under our present procedures and it is at the same time true that lately the credit squeeze has fallen very heavily on business corporations, which is the very sector, of course, as it slows down its credit demands, will free money for the financing of other sectors such as I indicated, State and local governments, the housing area, and other socially desirable programs.

This is a torturous process. It is a difficult process. It means some losses. It means some hardships. But I do think policy is now hitting through into a very important area.

Senator PROXMIRE. Why does it not make sense to bring this restraining pressure on corporations at a time when you have an enormous expansion of capital goods, that is, investment in plant and equipment by business—beginning in 1964, 1965, 1966, we had tremendous increases and we have another increase breaking all records this year, at least, in dollar terms, and about the same I suppose, as last year in actual physical terms, but at a time when we are operating far below capacity and there seems to be no really rational reason for expanding plant and equipment except perhaps there is an anticipation of further inflation?

Overall, it seems to me, this is a wise policy.

Mr. KAUFMAN. Well, first of all, for a business corporation looking at the economic and financial scene and taking the experience of the past decade or so, there was as I indicated before, the feeling fostered that there would be uninterrupted economic growth. In a free marketplace such conditions create pressures to enlarge markets, to prepare for the markets of the future.

There were large wage demands, as you know. Cost pressures kept increasing. Competitive pressures were on business.

This was fostered, as I indicated to you before, by various excesses and expectations of a guaranteed future. Moreover, I must admit as an economist, the series on plant utilization which probably now shows plant utilization of below 80 percent is somewhat suspect. We don't know how good or how weak that series is. It should be revised.

I would admit that plant utilization is less than it was but I am not so sure that it is 75 percent today or 85 percent. It is unfortunate we do not have the proper data.

Senator PROXMIRE. But this data is the best we can get and it does seem to show at least a trend in the direction of utilizing less capacity.

Mr. Clausen, you seem to put considerable confidence in the President's recent announcement of a series of anti-inflation steps and you call for more aggressive moral suasion and you seem to feel—maybe I misinterpreted your remarks—that this constitutes the best way to slow inflation. But I understand what the President asked was three things: one, a productivity council, second, an inflation alert, and third, a system of monitoring Federal procurement to try to hold down the inflationary impact of Federal procurement.

How, should not the President, if he is really going to have effective moral suasion, name names? Should he not point to particular price increases and union demands and indicate why those are inflationary, if they are? If he is going to have any real effect, I think it is comforting for the President to make a statement that he hopes everybody will hold down their prices and will not have any inflationary wage demands but if he does not step in and bite the bullet, what real effect does it have?

Mr. CLAUSEN. Well, this gets down to the classic argument of direct controls.

Senator PROXMIRE. I am not talking about direct controls. I am not talking about mandatory controls. I am talking about the President really jawboning.

Mr. CLAUSEN. Yes, income policies is another term for it or guidelines or it could be a completely hands-off attitude by the administration. Admittedly it is a difficult thing.

Many business people point to the period from 1963 to maybe the latter part of 1965 when the guidelines worked so beautifully and they say let us have guidelines again, but I think if my economic understanding is sufficient that if ever there was a period in our recent economic history where we did not need guidelines it was in that period. They worked fine.

My point in my recommendation is that the administration should under these difficulties times, do a little more "jawboning," to use the word, moral suasion, and a productivity——

Senator PROXMIRE. When you say "jawboning", what are you talking about? Do you mean he should name names, that if the steel industry, for example, makes a price increase that is excessive he should say so and he should try to talk them out of it and talk them into a rollback?

Mr. CLAUSEN. I think appointing a productivity commission, because productivity is at the root of it. The root of inflation is the fact that prices and wages have outstripped productivity.

Senator PROXMIRE. That is true, I agree with that.

Mr. CLAUSEN. So, you appoint a committee to go to the root cause and deal with the real changes which are occurring now as I tried to make clear in my testimony, and to go to those basic causes and the basic cause of inflation is that productivity is not keeping up with wages. So, you appoint a productivity committee of knowledgeable people on all sides of the issues.

Senator PROXMIRE. They are going to meet sometime later in the year and make some kind of a finding but it would seem if you are going to be effective, what you have to do is move in sharply and swiftly in the specific areas where the wage demands or the price demands are developing. Otherwise, it is a matter of establishing a nice history that you can read about. It is after the fact.

Mr. CLAUSEN. The difficulty with that is that you pick on one industry. You do it arbitrarily and you cause inequities in that system without going to the real causes and you only postpone the real problems under a long——

Senator PROXMIRE. Well, I would say that would be correct if we were not, if we did not follow a fiscal policy and monetary policy that is restrictive.

Now, you seem to indicate in your remarks that you do not think the present fiscal policy is restrictive. If you recognize the full employment surplus analysis which I am sure you are aware of as an economist, the economists tell us that we are now running at this part of the fiscal year with a surplus, full employment surplus of about $7 billion and it will become much more restrictive, twice as restrictive in a sense after the first of calendar year will be running at $13, $14, $15 billion surplus and from a full employment standpoint.

Now, when unemployment has been increasing, last month there was a temporary, I hope it is not temporary but what seems to be a temporary drop in unemployment, but with unemployment likely to increase, this is a pretty cruel policy, it seems to me, to say that you have to tighten the screws even further on fiscal policy and monetary policy and then realize—both you and Mr. Regan seem to say—with the expectation that maybe eventually unemployment will improve, but in the short run it is going to increase as our solution for inflation.

Mr. CLAUSEN. I agree with some of the things that you said, Senator. I think it is necessary to keep in mind the reasons why we are having unemployment now. This is part of the results of the antidote which we are giving to the economy, the castor oil which we are pouring into the system, because inflation has to be licked and in order to do so we have to have tighter monetary policy and tighter fiscal policy.

At the same time, we are reducing the number of our soldiers in the Vietnam conflict and cutting back on defense spending. Both of these cause increases in unemployment and so there are justifications for the unemployment figure. The 4.7 figure where we stand currently is higher than what we would want it to be but recognizing that there are some regional dislocations and some of these are affecting, as you well know, our own region in California and on the west coast, that these are temporary and when the economy—the inflation can cool and the economy get back to a peacetime economy, employment will once again get into proper orbit.

I do not buy all the premises which you are making here. I think it would be wrong for the Government to come out with absolute guidelines because this is an arbitrary approach. I think zeroing in on the productivity base as the President has suggested is a proper course. I think, too, that slamming the brakes on too hard or going to direct controls or further credit controls is too hard. We want to avoid a recession and I think that the best course of action is to attempt to slow the economy gradually as we have.

Senator PROXMIRE. My time is up, Mr. Chairman.
Chairman PATMAN. Mr. Widnall?
Representative WIDNALL. Thank you, Mr. Chairman.
First, I would like to compliment all three of the witnesses. I think the statements have been excellent and they are very pointed as to what is going on in the economy.
Mr. Regan, I would first like to say that you in your testimony stated and I quote, you expect "housing should undergo a powerful surge."
Dr. Kaufman, you say the net volume of private mortgage financing will double during the second half of 1970. How soon do you expect the rate of housing starts to rise substantially?
Mr. KAUFMAN. I will answer that first. I think the rate of housing starts will begin to go up more startlingly certainly, in the fourth quarter of this year but I do not expect very much of an increase in the third quarter. There is an indication that permits have been going up irregularly here for a few months and that in turn would tend to indicate a revival in housing starts.
Also, I base that statement of a revival in the fourth quarter, not in the third quarter, on the fact that here in the month of July we are still seeing a large volume of corporate bond flotations. The July corporate bond flotations gross publicly offered will be about $2.1 billion, which is twice the monthly average of last year.
When corporate bond flotations are that large, it preempts a considerable volume of financing from other sectors. There is some indication now, as I indicated in my testimony, that this kind of financing will subside, particularly for high-credit borrowers, and, therefore, this is why I base my estimate of a revival in housing into the latter part of this year rather than into the early part of the second half of 1970.
Representative WIDNALL. Your comment, Mr. Regan?
Mr. REGAN. I would subscribe generally to what Dr. Kaufman has said. Our indications are that housing has made a slight upturn in the second quarter, housing starts, to be followed, we think, with a much greater increase in the final quarter of 1970 and the tremendous surge that I referred to in the early part of 1971.
Representative WIDNALL. I have heard some discussion lately about the number of housing starts that we have on an annual basis by the end of the year and the figure has been 1,700,000. Do you think that would be out of line?
Mr. REGAN. No. That is approximately the same rate as 1969 and I would think we would get back to that in the final quarter of this year.
Representative WIDNALL. Mr. Regan, you indicate you are shocked by some proposals to provide insurance for the individual investor against the failure of brokerage houses. You specifically single out certain proposals which would require Merrill Lynch to pay $2 million a year into an insurance fund to protect investors in brokerage houses and investment companies much less sound than your own. Do you feel some form of this type of insurance would be a wise idea?
Mr. REGAN. Yes, sir, I do, and we are in favor of insurance to protect investors.
As I testified before Senator William's subcommittee a few months ago, we are in favor of our own industry having a sufficiently large fund to take care of investors. I did not think then nor do I think now—although I understand that today our industry, the SEC and the

Treasury are going to tell Representative Moss that they are in agreement on this bill—that there is a need for a call on the Treasury for a billion dollars. I do not think such a sum is needed and I personally would prefer that our own industry stay away from calling on the Treasury Department for an insurance fund. I do not think the need has been demonstrated.

Representative WIDNALL. Do you have in mind any specific proposal that you think would be feasible?

Mr. REGAN. Yes. Our own industry should raise a fund of approximately $150 million. If this were ever exhausted, and my crystal ball is a little cloudy here, but I cannot see our industry failing to such an extent that over $150 million at any one time would be necessary. If that fund were getting toward the point of exhaustion, then I think it would be advisable for the SEC, our industry, and the Treasury to come to the Congress with a proposal, but not until that time.

Representative WIDNALL. Mr. Clausen, you say the liquidity squeeze is evident in many quarters. Do you believe this squeeze is widespread or concentrated in only a few firms?

Mr. CLAUSEN. No. I think the liquidity squeeze is evident in many sectors. If you think back to the close of World War II as an example and taking my own industry, the banking industry, when the loan deposit ratio which is a well known ratio in banking circles, then was 20 percent and today it is approaching 70 percent; when you think in terms of corporations when at the close of World War II the liquidity or the quick ratio of corporations was maybe a factor of four or five times what it is today—today cash and near-cash total current liabilities is something in the range of 15 to 20 percent; when you think of governments, State, local and county, and the liquidity of governments at the close of World War II and measure that in the terms of today, and then looking in the decade of the seventies what is expected and the social problems and the fact that we are caught up with inflation, rampant inflation now, and hopefully we will get back to creeping inflation because I do not think that inflation is something that can be absolutely solved but certainly we can control inflation in a better fashion than we have in the last 3 or 4 years—then, what we have been doing with respect to needs will look like child's play in the seventies. And so, therefore, my point is that we need to get the financial mechanism working like it has never worked before, because we have no room to increase the leverage, debt leverage, the liquidity leverage already existing all over. It is affecting individuals as well.

Representative WIDNALL. What, in your mind, has caused the current liquidity problem?

Mr. CLAUSEN. Well, several things. One thing, for the last 30 or 40 years the philosophic thrust of economic legislation has been designed to do but one thing and that is to get the country up out of the depths of depression and get the big economy going, and so now we have it up to 150 miles an hour or 125 miles an hour. It has been designed to get us to achieve the objectives of the 1946 act, full employment, and now we have full employment. And, so, the economy is just going and I submit that you need perhaps a different kind of economic thrust and philosophic legislation to maintain this kind of full employment and this kind of a going economy, than you need to attain those goals.

And so, therefore, I think there is a great opportunity for the Presidential financial commission to go back to a zero basis start and to ex-

plore what are our priorities and what are our needs for tomorrow and will the financial mechanism work and to look at it as a total compatible unit rather than saying here is something that does not work and we reach into the grab bag in a manner of speaking, and put a Band-Aid on it without looking to the basic thrust of where we are going and what is carrying us there.

Representative WIDNALL. Dr. Kaufman, would you comment on Mr. Clausen's remarks?

Mr. KAUFMAN. Well, it is my feeling that we were doing reasonably well in the United States in the early 1960's and as I indicated in my prepared remarks, the feeling gradually permeated the financial and economic markets that there were no downside risks, that to some extent the markets of tomorrow were assured, that to some extent Government would not discipline economic and financial participants. The war was not financed through taxation. And as a result, these exents, I think, contributed to a lot of economic and financial excesses.

Now, the problems that we have today are problems that come from this past period but I think many of us share in those problems. It is not just one-sided. There are problems in business. There have been problems in the credit markets and there have been problems in national stabilization policies. And I strongly feel that we have got to come to grips with those problems, particularly now as perhaps a new economic period of revival is ahead of us.

Congress must take action here together with the Executive of the country to formulate policies that will prevent the financial markets from being abused again. After all, in our financial markets, individual savers have never questioned the integrity of the dollar. There has been a free flow of money by individuals into deposit institutions, into saving institutions, into contractual savings institutions. In the past, there never has been any hoarding, there never has been any doubt about the viability of our financial structure. This confidence in our economy in our financial markets has been deteriorating in the last few years.

Representative WIDNALL. Thank you. My time is up.

Chairman PATMAN. Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Mr. Regan, you said that monetary and fiscal ease at too rapid a pace could throw away the benefit that should be coming from 18 months of restraints. We have recently seen some examples of both fiscal and monetary ease. The Federal budget for 1971 is now estimated by the administration to be facing a one and three tenths billion dollar deficit and by many of us as being substantially higher than that.

In your mind, is this a prospect for excessive fiscal ease and what magnitude of a budget deficit do you think would be reasonable during the current fiscal year?

Mr. REGAN. During the current fiscal year?

Senator JORDAN. Yes, sir.

Mr. REGAN. Senator, I would say that if under current circumstances the budget were to go out of—go into a deficit of more than $7 to $9 billion, that we would again be running the engine of inflation. I think that with the slowdown in the economy now that the recovery of the economy could absorb that type of deficit. Were it to go larger than that, then I would suggest that the Congress and the adminis-

tration would have to consider how they were going to finance any additional expenditures they were going to make.

Senator JORDAN. Do you think that high a budget deficit would fuel the fires of inflation at an alarming rate? Do you think we can handle it?

Mr. REGAN. $7 or $8 billion, I think we could handle; yes, sir. Over that I think it would—to use your adverb—become alarmingly high.

Senator JORDAN. In your statement you made an interesting series of comments about the message you get from your client constituency. All of us on this side of the table can understand what a constituency is, but it was interesting to me because you said you had a number of new accounts coming from people who have never been in the market before, as I understand it, and they were largely buying higher quality securities, both stocks and bonds, than they had heretofore, and you were encouraged by this new expression of interest by the heartland of America.

This is the first time I have heard that. I thought that was a good indicator that this situation might be turning around substantially.

Mr. REGAN. That is what is the surprising thing to us, Senator, and that is why I put it into my testimony because I think it is news, that the buyers of securities for the past few years are—the greatest proportionate increase has come from, let us say, west of the Alleghenies to the Rockies, from the Great Lakes to the gulf. This is where the largest proportionate increase in new investors has come and during the first 6 months of 1970, this very group continued to buy securities at an increasing rate. They are not as despondent as some investors and some of us are in the eastern seaboard or on the west coast.

Senator JORDAN. Some of the larger buyers are more timid than the heartland, the small people.

Mr. REGAN. I could use another adjective. I say the larger buyers are more shocked than people are that are of more moderate incomes just looking at the future very calmly and they do want to buy. This is a very encouraging sign to us.

Senator JORDAN. You analyzed the purchase by foreign investors of securities in this country as being on the net decline but not on an individual basis, principally because foreign mutual funds have been cashing in. Do you see a reversal of that trend?

Mr. REGAN. Well, as you know, a very large foreign mutual fund has had difficulties, which has been well publicized. This has been part of the problem. As a result of that, many foreign investors owning mutual funds that are primarily holders of American securities have started selling. This has caused the managers of those funds to have to liquidate the holding of U.S. securities they have had.

I think that if our stock market, now I am referring, to starts bottoming out and if they see that our dollar is becoming stabilized that foreign investors will again come into the market to a much larger extent than they are currently.

Senator JORDAN. Thank you.

Mr. Clausen, you stated at one point in your remarks that substantial pressures on the finance markets we have seen in the last few years will not soon disappear. We should endeavor to find ways to better allocate limited credit. Should we not also devote consider-

able attention to expanding the supply of savings available to meet future capital needs and in what specific ways might we promote a greater supply of savings?

Mr. CLAUSEN. I agree with your premise and endorse it 100 percent. Yes, by all means we should find ways to encourage additional savings. We should also find ways to make our market system more efficient and the various financial institutions comprising the mechanism to become more compatible and more cooperative within the system itself.

Now, you have asked a very tough question—how to increase savings. One of the questions which is asked by many is perhaps the disequanimity between the rates which banks are permitted to pay small savers as compared with the large volume savers, the money market, those investors who are in the money market instruments. As an example, those that are over $100,000 as compared with those that only have a thousand dollars.

Senator JORDAN. Yes.

Mr. CLAUSEN. The argument can be made that regulation Q, which is a principal tool of—has been a principal tool of the Federal Reserve Bank which no longer is as effective, really is a subsidy to the savings and loan institutions. Now, if banks were permitted to pay higher interest for the smaller deposits on the passbooks, this is one way to encourage more savings and this would be good for society. But by the same token, with the restrictiveness where savings and loans could put their proceeds from savings only into real estate, the spreads would become so small because we need to get the rates on real estate loans down as well, that this would be discriminatory to the savings and loans. Therefore, one of the hopes I have out of the Presidential Financial Commission would be that the savings and loans could conceivably be given broader powers and even full powers of commercial bank powers with all the detriments and full competition against the banks and then Q could be raised to allow more money to be paid for the small investor to accomplish the objectives which you described.

Senator JORDAN. All of you spoke about the need for more fiscal restraint. Would you agree that because there has been so little fiscal restraint we have probably had to overcompensate in monetary restraint?

Mr. CLAUSEN. I think I would agree with that a thousand percent. Fiscal policy, in my understanding of economics, should be used to take out the big swings and valleys in our economy and monetary policy to be used to fine tune the economy. And with the political system that we have, it has been very difficult for fiscal policy to be put-on-stream in a timely fashion and, therefore, the great burden of taking the impact of inflation and solving the problem of heavy inflation has fallen to the monetary policy side.

Senator JORDAN. Thank you.

Mr. Kaufman, you indicate that the Vietnam war was not financed through taxation but through deficits, financed for the most part not by savings but by monetary expansion. We do know that during the sixties the total deficit accrued to $57 billion and had to be financed some place. Of course, it had the highest priority in being financed.

To what extent, in your opinion, did this contribute to the existing inflation and do you think we are out of the woods on it yet?

Mr. KAUFMAN. Well, as you go back into the second part of the 1960's you had, for example, in 1967 a $37 billion increase in bank loans and investments. You had in 1968 a $39 billion increase in bank loans and investments.

Now, as to financing a Treasury deficit, you can finance it by increasing sharply the total availability of the money, which is inflationary. However, the U.S. Government is a very effective bidder for funds and you can still hold down the total availability of money and, therefore, let the U.S. Government bid for the funds and it truly will get them. Unfortunately, to some extent that was not followed.

I admit that the rate of inflation has remained very high and it has been much more nagging than in previous cyclical peaks of economic activity. I suspect that it is in the process of abating, but I also suspect that it is going to abate gradually and not rapidly. The GNP deflater which in the first quarter was around 6 percent, probably is down somewhat in the second quarter. I would expect it to be down to about 4 percent or a smidgen below as we turn toward the end of the year. Thus, some subsiding is in process, but certainly not the kind of decline that would be hoped for.

Senator JORDAN. It is going to require more discipline than we have evidenced yet.

Mr. KAUFMAN. It will certainly require a lot of action and alertness by our governmental leadership.

Senator JORDAN. Thank you. My time is up.

Chairman PATMAN. I would like to comment on Mr. Clausen's statement. I listened with great interest to your statement about regulation Q. I have often wondered how the savings and loans could compete with the commercial banks. Obviously, the commercial banks have a great advantage in some respect. They are the only institutions that can carry checking accounts and have many other advantages that the savings and loans do not have.

Now, it is possible that you mentioned something that should be given greater consideration and which would likely result in more of the savings and loans becoming really commercial banks. To my way of thinking, it would be a much preferable alternative to just crushing out the savings and loans. In last week's U.S. News & World Report there is an interview of Mr. Gaylord A. Freeman, Jr., of Chicago, head of the First National Bank. He answered a similar question this way:

> I think savings and loan associations should be given the chance to operate just like commercial banks with every power that we have and subject to the same regulations, limitations and taxes. I think we should welcome them.

You know, your statement attracted my attention where you said it would be helpful to the poor savers and would be in the general interest of all the people if that were done. I am inclined to agree with you. We have got to do something.

The Congress was in an embarrassing position on this question. We either had to permit discriminatory rates under regulation A, which would discriminate against the small lender, or investor in savings and loans, or we would have to have policies clear across the board, which would, unfortunately, wipe out a lot of savings and loans. Naturally, the latter was not desired by anyone and we agreed for the first time to a phrase "discriminatory rates" as written into

the law and we held out a long time on that. No one wanted it but at the same time, we had to do it in order to save some thrift institutions, and we put in a 1-year limit.

Mr. CLAUSEN. You are referring to the Interest Control Act of 1966?

Chairman PATMAN. Yes, sir; and it was with the understanding that the Federal Reserve and the Treasury would come up with some formula that would remove that discrimination. It was certainly not desired by anyone to permit lower income persons to only receive 5 percent interest and rich persons 7½ percent interest, or 50 percent more. We did not want that. But we got in a squeeze again and Congress passed it for 2 more years with the understanding we not do it any more. That provision will run out, I think, sometime in 1971. We must do something about this.

Now, if we were to adopt your suggestion and suggestion of the gentleman from Chicago, president of the First National Bank, it would probably result in most of the savings and loans being a part of the commercial banking system in a reasonably short length of time. But the question is whether or not that would be more in the public interest.

The question comes to my mind that if we were to attract the attention of poor people and small savers to the extent of giving them a larger amount of interest on the small amounts that they could save, it is possible that it would be sufficiently attractive to them to where they would be more prudent in their purchases and in their installment buying. High interest rates would increase their saving, and that would, of course, eventually result in something that would be very desirable. We should not have discrimination between the poor and the rich; correct?

Mr. CLAUSEN. Yes, sir. I am against discrimination in all forms.

Chairman PATMAN. Now, then, you say here in your statement:

> Commercial banks historically have been forced to bear the lion's share of the burdens of Federal monetary policy.

I just wonder if you are overlooking some very basic and meaningful policies that we have now. For instance, I think you will find from the reports of the FDIC—the Federal Deposit Insurance Corporation—for the last few years, that the banks have the privilege of using demand deposits free of charge. You know, there is a reason for that going back to when the FDIC was first created. Banks now have the free use of $225 billion a year. That is quite a large sum of money.

Now, the savings and loans and other financial institutions are not in on that at all. It is a great privilege and benefit that only the commercial banks have.

Now, in addition to that $225 billion, the banks have free use of tax and loan accounts of billions of dollars, and many other things, and they have some tax advantages. I would think that if a savings and loans received the same benefits that banks received under similar circumstances it is possible that they would pay an amount that compares favorably with what the banks pay now, but we will not argue that point. But do you not think instead of, "The commercial banks historically have been forced to bear the lion's share of the burdens of Federal monetary policy," that the saver, I mean, the person who

has demand deposits and receives absolutely nothing for their use by the commercial banking system, do you not think that they come nearer bearing the burdens of the Federal monetary policy than the commercial banks, Mr. Clausen?

Mr. CLAUSEN. No, sir, I disagree, Mr. Chairman. On the first point, the point of the fact that the banking system bears the burden of monetary policy as implemented by the Federal Reserve Board, this means that 15 to 20 years ago, about 55 percent of the total money flows passed through the commercial banking system, and the commercial banking system, of course, is under the influence of the Federal Reserve Board. Currently, it is less than 35 percent of the total monetary flows. And so what this means is that in the implementation of monetary policy, the Federal Reserve Board has to work harder and harder on a diminishing percentage of the total universe in order to make its monetary policies effective, because regulation Q and its open-market activities only affects the banking stream. It does not affect the $38 billion over in the commercial paper market.

On your point that banks have distinct and unique advantages in enjoying the free use of Government demand deposits and tax and loan accounts, it should not be overlooked that the banking system also has to provide plants and equipment and computers and people and provide services in exchange for those deposits in cashing Government checks and supporting Government markets and buying Government Treasury bills and things of that nature.

In addition, that it must stand and keep itself in such a position to be able to withstand the extreme withdrawals and the wide fluctuations in these balances which is a tremendous service for the Government.

The tax advantages that banks have—I do not know of any tax advantages that the banks have. The tax——

Chairman PATMAN. Well, now, let me tell you one. Banks are allowed a 2.4-percent deduction for losses, just an arbitrary deduction, has that been changed?

Mr. CLAUSEN. It is now. For the next 6 years it goes no more than 1.8 percent and thereafter——

Chairman PATMAN. I know, but that 2.4 percent is effective right now. I though that would encourage banks to be more liberal in making loans because in the event it is necessary, they could take a tax deduction. But I found out that just the opposite was true, that when you had that 2.4-percent deduction, which amounted to $700 million a year on an average, that the banks were just pulling that off the table into their own pockets and the people did not get the benefit of it. The deductions did not encourage more liberal loans.

Do you agree with that?

Mr. CLAUSEN. No, sir; I do not agree with that.

Chairman PATMAN. Well, you will admit that they claimed the $700 million, will you not?

Mr. CLAUSEN. I agree that the banking system needs to have reserves for losses.

Chairman PATMAN. I agree with you, too. I am for genuine reserves.

Mr. CLAUSEN. Particularly——

Chairman PATMAN. But to give them anticipated reserves for losses that do not occur is different.

Mr. CLAUSEN. Well, particularly in the light of when we are approaching a liquidity squeeze and, you know, when the sun is out and when the weather is just great is really not the time to set your course forever as witness some of the liquidity problems we have been suffering here.

Chairman PATMAN. Yes. My time has expired.

Senator Proxmire?

Senator PROXMIRE. Could you tell me, Mr. Clausen, how much the profits of the Bank of America increased last year?

Mr. CLAUSEN. 12 percent over the previous year.

Senator PROXMIRE. How much is that?

Mr. CLAUSEN. On an increase?

Senator PROXMIRE. How much in dollars?

Mr. CLAUSEN. We ended up with $153 million in profit last year and that was 12 percent over the previous year. So, 12 percent of x equals—it would take a while to figure it out. Not being a mathematician——

Senator PROXMIRE. Come on, now. You are the chief executive officer. You certainly watch your profits. You must know what your profit increased.

Mr. CLAUSEN. Roughly $3.98 a share to $4.48.

Senator PROXMIRE. How much in terms of overall? Was it an increase of $15 million, $10 million, $100 million? How much was it?

Mr. CLAUSEN. I would say about $15 to $18 million.

Senator PROXMIRE. $15 to $18 million. Thank you.

Now, I would like to get—to find out whether or not we are on all fours here. Your answers to Senator Jordan seem to differ from your answers to me. At the present time, as I understand it, we expect that we are having a deficit in the consolidated budget of $2 or $3 or $4 billion.

Mr. CLAUSEN. Yes.

Senator PROXMIRE. A surplus in the full employment surplus calculation of about $7 billion.

Now, does this mean in your view as an economist, and as the head of the biggest bank in the country that the Federal Government is exercising fiscal restraint or fiscal ease?

Mr. CLAUSEN. Well, I am not acquainted with your equation. First of all, I am not an economist. I am a banker.

Senator PROXMIRE. You are acquainted with the full employment surplus concept, are you not?

Mr. CLAUSEN. I am not acquainted with how you translate the 5 million unemployment last month and 4.7 percent unemployment——

Senator PROXMIRE. Well, that is a factor.

Mr. CLAUSEN (continuing). Into the dollars.

Senator PROXMIRE. But the assumption, is that you calculate what your deficit or surplus would be if the economy were operating on the basis of, say, 3.8 or 3.9 percent unemployment instead of a 4.7 percent unemployment. On that basis you determine whether or not the economy is exercising restraint? The question is how much restraint there is in getting back to a level of relatively full employment or high employment. On that basis my own judgment is that the Federal Government is exercising restraints on the economy. Is that your judgment or not?

Mr. CLAUSEN. I would say we are exercising restraint and the question is whether we should exercise greater restraint.

Senator PROXMIRE. All right. Fine.

Chairman PATMAN. Would you yield to me just for a moment? Would it be satisfactory to you gentlemen for members of the committee to submit questions in writing and that you will answer them when you look over your transcript?

Mr. CLAUSEN. Yes, sir.

Mr. KAUFMAN. Yes, sir.

(The following answers were subsequently supplied for the record by Mr. Clausen and Mr. Kaufman:)

A. W. CLAUSEN'S REPLIES TO THE QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. The recent bankruptcy of the $7 billion Pennsylvania Railroad and the reported liquidity problems of many other businesses raise a serious question of whether we should have a special way of providing financial help to businesses that find themselves in trouble by reason of tight money, whether or not these businesses are big or small. I have in mind something generally similar to the old Reconstruction Finance Corporation but not necessarily like it; an institution that would if credit is not available locally through financial institutions be able to extend help in the form of loans at reasonable rates of interest. Is it your opinion that we should have such a Federal National Bank, or similar institution?

Answer. There is no need to establish another government agency to handle these problems. A better course would be to work through the existing financial system. For example, if the Federal Reserve were to provide loan guarantees under grave emergency circumstances where all other lines of credit have been exhausted, and banks were allowed to establish a special bank examination category for troubled companies, then the necessary funds could be provided through the existing financial mechanism. Additionally, there are dangerous overtones for business and investor confidence connected with the establishment of something like a "Federal National Development Bank."

Question 2. Is it your view that interest rates at the present time are too high? If so, what are your recommendations to lower these rates?

Answer. Interest rates are high because they actually reflect the supply of demand for funds. They have not risen in a vacuum; incomes, wages and prices have all risen at the same time. Interest rates have been forced to their high level by the tremendous demand for funds and the recent tight money policies of the Federal Reserve. The best procedure to lower interest rates is to reduce the inflation which is built into the level of interest rates. The Administration is on the right track to solve the short-run problems, but our economy has a built-in depression-born inflationary bias which means some basic reforms are needed to prevent inflation from becoming a chronic problem.

Question 3. Our housing industry is in a serious state of depression and we are falling far short of our housing goals—goals that a few years ago were set forth as fundamental to our national interest. Under present interest rates, a person who buys a $20,000 home with a traditional mortgage term of 30 years under present rates of interest would be compelled to pay not only the $20,000 for the home but $38,000 for the interest, a total of $58,000. It has been proposed that in order to channel more vitally needed funds into housing, some provision be made for utilizing pension funds. I have introduced a proposal in the Congress that would require them to invest a small percentage of their assets in a public bank which in turn would be able to make housing loans. What is your opinion of some such means of using pension funds?

Answer. I am generally opposed to this sort of direct intervention into the private sector because it doesn't solve the problem. Forcing funds to flow from one investment to another only causes the shortage problem to show up elsewhere. Then some more special intervention would be required to chase this problem to still another sector.

Question 4. Under present law, Delaware corporations are able to participate in far reaching mergers and formation of conglomerates and to get around state laws on such questions as branch banking and other reasonable limitations. Should not the Congress take some action to restrict the power of such corporations in order to bring them more in conformity with the laws of the states in which they operate?

Answer. Congress should restrict itself to regulating areas of interstate commerce where conglomerates and mergers are clearly detrimental to the public good. These areas are largely spelled out in existing statute or fall under the preventive jurisdiction of existing regulatory bodies.

Question 5. Unemployment is already too high and is in danger of increasing further. Millions of people have been thrown out of work. What in your opinion should be done to alleviate unemployment?

Answer. In the short run, proper and judicious use of monetary and fiscal policy should be sufficient to return the economy to full employment from its temporary slowdown. In the longer run, we need to strengthen unemployment compensation programs to minimize the unnecessary hardships of unemployment, especially when that unemployment arises as a result of changes in government policies. At the same time we should expand retraining programs and placement services so that when people are structurally or cyclically unemployed, they can be protected and returned to the ranks of the employed much faster.

Question 6. What should be done about the trend toward forming one bank holding companies? Do you believe that this should be restrained? In view of the fact that banks are franchised by public authority to carry out monetary functions that are basic legislative powers, should they not be required to stay exclusively in the banking business and not be permitted to engage in other forms of business and in effect go into competition with their own depositors?

Answer. Bank of America is on record as favoring a change in existing bank holding company legislation to include one-bank holding companies. Holding companies permit the performance of financially related services which are complementary to the narrow traditional definition of banking. The provision of these new services is in response to strong demands of customers whose needs are increasingly complex and financially inter-related. In short, the public will be better served and U.S. businesses better able to meet domestic and international competition.

Question 7. What do you believe to be the best course of action to deal with the inflation that now afflicts our economy so badly?

Answer. In the short run, government should coontinue to exercise moderate monetary ease and move toward a more restrictive fiscal policy. The proper short-run steps have been taken, and the results are coming, but in this case they are particularly slow. In the longer run, to avoid such severe recurrences we need: (1) a stricter priority system for Federal spending to avoid inflationary deficits; (2) a reformed and broadened set of monetary tools which cover all the sources of credit to reduce the policy lag.

Question 8. Should the government provide special low rates for housing through such devices as providing assistance through the Federal Reserve System on the basis that would keep these funds and rates segregated from the rest of the Federal Reserve operations?

Answer. No. This is an inefficient way to provide a subsidy and it has inflationary overtones as well. If we want to aid housing, a better course would be to put it on a priority list for Federal spending and make allowances for it in the regular budget process. Creating special funds would only inflate the construction sector still further and not solve any of the basic problems. Most important, the rise in building and construction costs must be checked or else no practical financial solution to housing will be attainable. The best course to pursue is to control inflation, because it is inflation and the attendant high rates and tight monetary policy which really adversely affect housing. Proper control of inflation through responsive monetary and fiscal policy offers the best prospect of revitalizing the housing industry.

Question 9. Is the market rate of interest really fair when you consider that the demand for money comes from large corporations which are not really inhibited by high interest rates; from lenders who obtain very high rates from their borrowers; and from financial speculators and others who are not deterred by high interest rates, whereas the purchasers of homes and the cities and communities of the country are very adversely affected by high rates? Does not the market work in an inequitable way to provide funds to the former while driving out the latter group? Is this in the best interest of the nation?

Answer. In the first place it is incorrect to say that high interest rates do not deter or inhibit large institutional borrowers. Declining cash flow and the problems brought on by tight money mean that many large borrowers cannot afford funds and are driven out of the market by high interest rates. Part of the problem of allegedly inequitable treatment by the market is that different borrowers use varying institutional instruments to approach the market. This problem will be

resolved over time and in the interim it is better that changes in the market allocation of funds be accomplished by a public political process rather than by tampering with the workings of the private sector market. A large supply of funds directed through the banking system which traditionally is the major source of funds for small borrowers would help alleviate the problem.

HENRY KAUFMAN'S REPLIES TO THE QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. The recent bankruptcy of the $7 billion Pennsylvania Railroad and the reported liquidity problems of many other businsses raise a serious question of whether we should have a special way of providing financial help to businesses that find themselves in trouble by reasons of tight money, whether or not these businesses are big or small. I have in mind something generally similar to the old Reconstruction Finance Corporation but not necessarily like it; an institution that would if credit is not available locally through financial institutions be able to extend help in the form of loans at reasonable rates of interest. Is it your opinion that we should have such a Federal National Development Bank, or similar institution?

Answer. I feel that we should not set up a Federal National Development Bank for the purpose of resolving the liquidity problems of some business corporations. The American economic system is based on risk and reward, that it to say, uncertainty. In this system, the prudent business is rewarded with profits and the imprudent is disciplined with losses. It is this discipline which limits business excesses and in the long run forces business to act judiciously. Consequently, the efficiency of our economy will be jeopardized if Government funds support corporations which have made inappropriate business and investment decisions. Such Governmental funds would tend to support inefficiency and not efficiency. Such funds would also contribute to bidding up of goods and services, especially at a time when financial resources may be scarce and might be needed to finance socially desirable programs such as housing or state and local governments.

To be sure, our Government does have some responsibility in seeing that businesses are kept intact where the national interest might be involved. In this connection, considerable safeguards are currently available. The Federal Reserve has broad lending powers. The Federal Home Loan Bank can make funds available to the savings and loan associations. The Small Business Administration provides credit to small enterprises and various programs are available for farm assistance. In addition, our laws appear to be sufficiently flexible to allow the continued service of insolvent corporations performing an essential public service.

Question 2. Is it your view that interest rates at the present time are too high? Is so, what are your recommendations to lower these rates?

Answer. I agree that interest rates at the present time are too high. The current levels, however, are the aftermath of a period of economic and financial excesses of the past. Interest rates will decline appreciably with the abatement of inflation which can come about through effective fiscal and monetary policies including the clearcut intention of our Governmental leadership to stress programs fostering economic stability. In addition, the proposals which were made in my formal presentation before the Joint Economic Committee would help to enhance the well-being of our economy and our financial structure. These proposals were:

"First, there should be a broader recognition among policymakers that each year we generate a limited, although large, volume of genuine new savings, which finances the demands for credit and thereby economic activity of all sorts. Enlarging the demands for credit does not generate a corresponding increase in the supply of savings unless national stabilization measures are adopted to generate the additional funds.

"Second, in this connection, it would be extremely helpful if official economic forecasts would be supported by detailed credit flow estimates showing the credit demands to be generated by the economic projections for the period ahead and how these demands will be financed. If this kind of discipline had been applied during the past five years, the financial counterpart to the economic projections would have frequently revealed that the economic projections were not financeable without escalating interest rates sharply, without an inflationary increase in money supply and without the emergence of other distortions in the credit markets. Legislators should be told in detail whether or not economic prospects will fall within the resource capability of our financial system.

"Third, we should improve our knowledge of the impact of the Federal Government on the economy and the credit markets. The budget should encompass

all of the Federally sponsored programs which are now excluded, but still make demands on the economy and the credit markets. This is not to say that the programs outside the budget are not deserving but by including them the priorities of the Federal Government will be well defined and ranked. Indeed, an all-encompassing budget procedure would not only clearly show the priorities of the Government but would be a start towards intermediate and long-range budgeting, which is an important prerequisite for effective fiscal stabilization policies.

"Fourth, budgetary surveillance should be improved. It should become much more of a joint effort between the executive and the legislative branches. The trends in receipts and expenditures should be monitored and analyzed more frequently than takes place presently through the official annual and mid-year budget reviews. This year in particular the inadequacy of the current procedures contributed to additional stresses in the credit markets. In January, the annual budget review projected a budget surplus for both fiscal 1970 and 1971. These projections were steadfastly adhered to until May when both projections were abruptly revised into deficits.

"Fifth, the various governmental agencies should be urged to develop meaningful statistics on the quality of our credit structure. Admittedly, this is a very difficult task, but a good beginning can be made by merely improving the current statistical series, which are incomplete and poorly benchmarked. It is unfortunate that while we have gone through a period in which there has been a deterioration in credit quality, we know little about the borrowers, including individuals, business and local governments which are at the credit margin."

Question 3. Our housing industry is in a serious state of depression and we are falling far short of our housing goals—goals that a few years ago were set forth as fundamental to our national interest. Under present interest rates, a person who buys a $20,000 home with a traditional mortgage terms of 30 years under present rates of interest would be compelled to pay not only the $20,000 for the home but $38,000 for the interest, a total of $58,000. It has been proposed that in order to channel more vitally needed funds into housing, some provision be made for utilizing pension funds. I have introduced a proposal in the Congress that would require them to invest a small percentage of their assets in a public bank which in turn would be able to make housing loans. What is your opinion of some such means of using pension funds?

Answer. Forced allocation of the pension fund resources will make housing investment the most undesirable portfolio investment among institutional investors. This technique does not increase the total supply of new savings. Consequently, it will tend to increase the level of interest rates because business corporations will go elsewhere in order to attract the funds which heretofore had been made available by pension funds. Thus, this kind of allocation of credit may actually trigger an outflow of funds from deposit institutions and a higher level of policy loans at life insurance companies. It is debatable, therefore, whether or not this allocation will actually increase net the total volume of mortgage financing.

Question 4. Unemployment is already too high and is in danger of increasing further. Millions of people have been thrown out of work. What in your opinion should be done to alleviate unemployment?

Question 5. What do you believe to be the best course of action to deal with the inflation that now afflicts our economy so badly?

Answer to questions 4 and 5. I feel that the problems of unemployment and of inflation both require common remedies. As the current financial and economic excesses abate, we should not tolerate the re-emergence of inflation. In the interim, the unemployment programs might be bolstered if unemployment rises significantly above current levels. I also feel that our Government should enforce vigorous price and wage discipline when both wages and prices are not arrived at competitively. I am not suggesting "jawboning" or wage and price controls but rather the willingness of our Government to put both business and labor on notice that it will use its power to enhance market competition whenever wage and price increases are above productivity standards.

Senator PROXMIRE. You say we are exercising restraints; we should exercise greater restraints. At the present time, we have more than four million unemployed. You indicated we are going to have more unemployed as more are discharged from the military services. Secretary Laird said a million people are going to be discharged in the next

few years. We expect a cutback of military defense contracts some. You know in California how that is going to affect you.

Mr. CLAUSEN. Yes, sir.

Senator PROXMIRE. Under those circumstances, do you really think it is wise for us to exercise greater restraints and if so, is this not going to be coming out of the people who are unemployed who are not going to be Senators and bank presidents?

Mr. CLAUSEN. Senator, I think the basic problem of the United States is inflation and we need to correct that and get it under control. I do not think we are going to completely solve our inflation problem. Not only does it affect all of us here in the United States but it affects the financial mechanism on the international side and the strength of the dollar. And in order to control inflation, we need to have fiscal restraint and monetary restraint.

Senator PROXMIRE. Well, certainly if that is all you are going to have I would agree. That is the reason why some of us are pressing so hard for effective wage-price guidelines in our view, for effective jawboning and perhaps for credit controls and other methods that would achieve some degree of restraint over prices without taking all of it out on the unemployed.

I understand your view, but it seems to me, if I were working in a plant and they were laying people off in an automobile plant or steel plant or in some of these other areas, I would be very concerned with the policy that would be likely to throw me out of work.

Mr. CLAUSEN. Well——

Senator PROXMIRE. These are the people being thrown out of work. It is not hard for me to make that decision because I am not going to be thrown out of work that way and you are not but these other people are.

Mr. CLAUSEN. Certainly, everyone deplores the fact that there must be unemployment in a land as great as the United States and we start with that premise, but everything is also relative and certainly I think we need to be mindful and remember that in the early part of the sixties we had unemployment of a significantly higher factor than what we are presently experiencing when we did not talk in terms of recession, when we had unemployment in excess of 5½ percent.

Senator PROXMIRE. Unemployment was declining during most of that period. How would you feel about a policy of having the Government determine that it would do its very best in terms of providing jobs of last resort as necessary, stimulating the housing industry in every way they knew how if unemployment got above 5½ percent? Do you think that would be a wise policy or do you think we ought to go higher if necessary, to stop inflation?

Mr. CLAUSEN. Well, that is a moot point—5½ percent, 6 percent unemployment, that is where we were in the early part of the sixties. If it is a temporary thing to get rid of the cancer that you have to cut out a part of the body it is going to hurt temporarily. I want to cut the cancer out.

Senator PROXMIRE. I do not know——

Mr. CLAUSEN. But if the patient is going to survive in the process, I think we have got to do it.

Senator PROXMIRE. All right, this hinges, this depends, and you and Mr. Regan both seem optimistic that this is temporary. Mr. Regan

indicated he thought we were going to get a big increase in housing. I would like to know how. Are we going to get it because interest rates are going to drop in 1971? Certainly what keeps people from buying homes now is that interest is so high that as Secretary Romney testified to us, only 20 percent of the people in the country can afford to buy a new home. Until you get a real moderation in interest rates you are just not going to be able to get any kind of an increase in housing and I do not see any indication that you are going to get interest rates down, say, into the 7 or 7½ percent area considering where they are now for mortgages. Do you think they are going to drop that much, Mr. Regan?

Mr. REGAN. If I could go back to my original testimony, we anticipate one full percentage decline by the end of 1970 in prime bond rates at this particular moment. Mortgage rates will tend to follow this as it is a leading indicator for all of——

Senator PROXMIRE. Is it not true that mortgage rates are very sluggish and much slower in changing than prime rates?

Mr. REGAN. Oh, yes.

Senator PROXMIRE. Prime rates will come down quickly.

Mr. REGAN. That is right, very definitely, but it is our feeling, and if I heard what Dr. Kaufman said correctly, also that more money will be available later this year and definitely in the first 6 months of 1971 as the bond market demand side subsides because of business cutting back on its plant and expenditure ideas.

Senator PROXMIRE (presiding). Well, I hope they do, but—I hope that you are right but I fear that we are just speculating that business is going to cut back sharply on plant and equipment, that will become available in housing. It is not automatic.

Mr. REGAN. I agree it is not automatic.

Senator PROXMIRE. And unless interest rates fall, housing will not greatly improve. We are putting an awful lot of faith in a prediction of what is going to happen to the economy after 6 months from now.

You know of the study made by the Bureau of Economic Research a few years ago, predictions by the top people in business and government and academic communities. The bureau found the predictions were really good for a 6-month period but after 6 months you might as well flip a coin.

Mr. REGAN. That is right.

Senator PROXMIRE. So, your expectations that housing is going to be very good in 1971, the economy is going to move ahead, may turn out to be true but it is a guess.

Mr. REGAN. All predictions have to be more of a guess.

Senator PROXMIRE. Especially these long-range predictions.

Mr. REGAN. Exactly.

Senator PROXMIRE. Something else I cannot resist. When I was at Harvard Business School, Banking Professor Ebersole used to ask the class at the beginning of the year how many students in the class thought the stock market was coming up for the coming academic year, to raise their hands. Then he'd ask, "Now, I want all those who think the market is going to drop to raise your hands." And he would say, "Thank you, gentlemen, I have my financial plans made for the coming year." He said, "I have done this for 20 years, I have never been wrong. Whenever the majority said the stock market is going up,

I sell. Whenever the majority said the stock market was going down, I buy."

Now, there is an odd-lot system, I understand, in the market that whenever the small investor is buying, expecting the stock market to go up, the odd-lot followers sell because the majority is always wrong. You are telling us now that because millions of small investors are buying, you anticipate that the economy is going to look better and the stock market is going up.

On the basis of history and the basis of the success of the odd-lot system, is that not a pretty flimsy reliance?

Mr. REGAN. How long do I have for an answer? [Laughter.]

There are many theories of the stock market, including one a few years ago that was based upon the comic pages, but as to——

Senator PROXMIRE. Ladies hem lines.

Mr. REGAN. Yes, sir, very definitely, although they are said to follow us rather than leading indicators. [Laughter.]

Senator PROXMIRE. They are leading some of us.

Mr. REGAN. As far as the stock market theories are concerned, this odd-lot theory has been practiced on Wall Street by quite a few people, that you do the opposite of what the little man is doing and you may always be right. That may be well on a temporary basis but if you look at the history of stock prices over the years, all during the early sixties the odd-lot person was a buyer. As I have indicated in my testimony the odd-lot person is normally a buyer of stocks. They seldom sell. They have been right in the market except on temporary basis when you get a tremendous selloff in the market but again as the market comes back again they have held through it, they go on to bigger and better heights, which is exactly what happened in the 1962 decline.

Now, what is encouraging to me about this is that all the so-called professionals, the go-go boys, all this sort of thing, who were supposedly so right, so sophisticated, they knew so much more than the little man. They all got trapped, too, in the market, so no matter what system they were using it was not a successful one.

I think the person who buys good stocks and holds them is going to be proven to be correct.

Senator PROXMIRE. I would not argue with that and I think it may well be that the smaller investor is going to be right this time. All I say is that you just cannot rely very much on that kind of indicator, that the stock market is going to move ahead or the economy looks good because there is some confidence on the part of the small investors.

Mr. REGAN. I misled you if you thought that was my sole reliance. No, there are many other things I rely on for stock market anticipation.

Senator PROXMIRE. Mr. Clausen, you seem to place a tremendous amount of emphasis on this productivity council the President is calling on and I think it would be good to have it but as I understand it, scientists have made studies of productivity for years. They indicated in the twenties the increase in their productivity averaged around 3 percent, in the sixties about the same. There are temporary fluctuations depending on the business cycle but why would a study of productivity be so helpful to us right now in stemming inflation? We know that in some industries it is very great, productivity increases, in others zero, maybe negative. Why would a study be the answer?

Mr. CLAUSEN. I think particularly one of the areas in which productivity increases are not so great is in the industry which I represent, the service industry.

Senator PROXMIRE. What about the industry I represent, Government?

Mr. CLAUSEN. That was another one. So, therefore, I think a new approach to the problem, a rethinking of the problem to see whether with the modern tools we have, management techniques, whether we cannot in these industries which have been laggards on productivity, find ways to increase it. I would welcome that as an executive of a fairly large institution in the service industry. And so, I do place reliance on that.

I think there should be greater moral suasion by the Government than what we have and I think——

Senator PROXMIRE. You say that you do not want the President to designate any specific firm. What can he do that he is not doing?

Mr. CLAUSEN. Well, I think he can appoint a production commission, Senator, and——

Senator PROXMIRE. He has appointed a lot of commissions.

Mr. CLAUSEN. To have it meet now and to zero in on the basic causes of inflation—but not just rely on that solely.

You need a combination of fiscal restraints and monetary restraints and you need certainly not to have it so tight that we are going to lose the patient in the process, and that was the point.

If I may go back to your point on real estate and on loans and just to make the point that not all of the problems of real estate are on the interest side because this is caught up in this inflation web, too. The cost of land has gone up, the cost of construction has gone up with the wage pushes, and taxes have gone up as well as interest. All of these combinations have caused buyer resistance—not just the interest.

Senator PROXMIRE. My time is up.

Mr. Widnall?

Representative WIDNALL. Thank you.

Dr. Kaufman, you indicated that the upgrading of credit quality by financial lenders that normally occurs in a period of credit tightening did not take place in the recent period. How did financial institutions react as credit became increasingly more scarce?

Mr. KAUFMAN. Well, the question, of course, here involves a period of time. In the latter part of the 1960's there was still good money availability. There was also a large demand for credit. But financial institutions did cut back their liquidity, the traditional liquidity. Their balance sheets on the asset side showed, of course, declining holdings of U.S. Government securities and to some extent declining holdings of other short-term marketable assets.

On the other hand, their balance sheets also showed substantial increase in the kind of investments that were more marginal than the investments which they used to make in the 1950's and in the early sixties. We had, for example, in a good part of the second half of the sixties a substantial volume of convertible bond financing which I referred to in my prepared text. There are now outstanding roughly $13 billion of convertible bonds publicly offered. Most of these were issued in the later part of the 1960's and over $9 billion of that $13 billion has a credit rating of BA, or less. That is not a high credit rating.

Many of these went into the portfolios of various individual investors and institutional investors. Moreover, there were mortgages financed with equity kickers. Some mutual funds were very active in the purchases of unseasoned securities. All of it, of course, reflected a desire for high performance over a short-term period. That kind of high performance for a short-term period, of course, was motivated by profits but profits that seemed to be assured because we were in a period where inflation was rampant. We were in a period where economic prospects of the 1970's looked exceedingly good and I think that there are very few financial institutions today as well as borrowers that show the same quality of credit on their balance sheets as they did 10 years ago or let us say, in the 1950's. But most of that deterioration, I believe, took place in the last 5 to 6 years.

Representative WIDNALL. My next question was going to be why did they not upgrade the quality of the loans and securities they held? I think you already answered that.

You say quite rightly that a growing demand for credit does not automatically increase the supply of savings and there is a definite prospect of a continued short fall between demand and supply of money and credit over the next decade. What measures would you suggest to help expand the savings available?

Mr. KAUFMAN. Well, I as you know, made several suggestions. Several other additional suggestions would be as follows: In order to generate savings you must have some sort of confidence in the stability of the economic and financial mechanism. So, curtailing the rate of inflation has to be a high priority in generating an increased volume of savings.

Secondly, I do believe that proper budgetary policies for the U.S. Government stimulate savings and here is where I differ perhaps with some for the period immediately ahead. I believe that the budgetary deficit that is coming on here in the period of the new fiscal year will go to the financing of consumption expenditures. In the United States we need capital formation. If we had a limited deficit or a surplus in the period ahead, that would mean substantial savings really would be freed so that investors would be buying tax exempts, would be buying mortgages, and would be buying other obligations that finance capital formation.

A large Federal deficit prevents that kind of capital formation.

I also think, of course, you can give some consideration to whether or not specialized institutions might not require or any institutions financing socially desirable programs might not get some tax incentives in order to do so. This area should be reviewed. It has not been given too much consideration.

Those are about my ideas.

Representative WIDNALL. Just one further question of you, Dr. Kaufman. How might we insure a more efficient allocation of available funds among competing demands for credit?

Mr. KAUFMAN. One way to me would be that our Federal Government in its budget which should be very all-encompassing, ranks the priorities of its spending. Now, if defense spending is very important, it deserves to be put high. If Congress and the people of the United States feel it is less important, it ought to be down in the list. And if housing is important, the need for education is important, it ought to show up very clearly in the budget of the Federal Government.

Right now these things do not show up clearly in terms of ranking or in priority because the budgetary procedure to me, is not clear cut, is not defined. The unified budget was an attempt to do so, but it has become less informative since many Federal programs have been debudget. Again, they may be deserving but they should be in there right on the front of the budget, not at the end of the appendix to the detailed budgetary statement.

Representative WIDNALL. That is all. Thank you.

Senator PROXMIRE. Along that line you apparently then would encourage us to have in addition to the regular budget, a tax expenditure budget and also an attempt to show the effect of regulatory policy perhaps on the distribution of resources in the country?

Mr. KAUFMAN. Yes, I would, Senator. I think that would be highly desirable.

In addition, Senator, I would feel that early in the calendar year when the Federal budget emerges, the Appropriation Committees, the taxation committees, get together and mail out a prospective budget with the cooperation from the executive branch, and agree to a spending ceiling and then as new appropriations come in, if they go above the spending ceiling perhaps they should be so voted on and then the raising of that spending ceiling ought to be voted on, too, at that same instant.

Senator PROXMIRE. That is a good suggestion. We go part way now for the first time but we have not voted on raising the spending ceiling and I think that is an excellent modification.

I have just one other question, Mr. Regan, for you. Many of us are concerned and I am sure you are, too, with the fact that we not only have a liquidity problem; we also have an undercapitalization problem for American corporations. I think Dr. Kaufman's statistics bring out the fact that we follow a direct route rather than an equity route. You are the head of the biggest brokerage house in the country. What do you feel we can do, if anything, on the part of the Government to encourage freely, of course, without any kind of Government controls or anything of that kind, to encourage firms to finance through the stock market through an equity route rather than to continue to go more and more heavily in debt?

Mr. REGAN. I would suggest that if the Federal Government, all branches of it, could create an atmosphere that would cause the stock market to bloom rather than to decline, this in itself will solve the problem.

Senator PROXMIRE. How do we do that?

Mr. REGAN. I would suggest, Senator, that a little more rapport between Wall Street and Washington were needed. I am afraid at times, as I tried to suggest in my talk, that Washington seems to overlook the 30 million American stockholders and many of their plans and they act as if all of the stock buying and the like, were confined to a few extremely wealthy, greedy people somewhere east of the Hudson.

I think that as soon as the Congress realizes the tremendous potent power there is in the American stockholders as a group and where they are located and who they are, then I think they will take steps to make this understanding of the stock market on the part of people here in Washington a lot more viable.

Senator PROXMIRE. In specific terms do you mean, for example, tax breaks on dividends or something of that kind?

Mr. REGAN. Yes, sir. The capital gains tax, for example. We have recently been through that battle, as you know, the last time. But this capital gains tax keeps increasing from now until 1972. This has to be detrimental to equity financing. If people cannot make a capital gain on what they are buying, why buy it? Things of that nature.

Now, if we can get interest rates down—at the current moment individuals are buying bonds and rightly so, when they can get 9 to 9½ percent rates of interest on high credit ratings.

Senator PROXMIRE. They also get a good capital gain.

Mr. REGAN. Probably. This being the case they are rightly buying bonds.

Now, as the interest rates come down and if business conditions improve, corporate executives keep their eye fairly well on the stock market also and if they see that the ratio or the price they can get for their equity has risen they will definitely take that route.

Senator PROXMIRE. Do you gentlemen have any other observation you would like to make on this?

Mr. KAUFMAN. On equity financing?

Senator PROXMIRE. On what we can do to encourage equity financing and help create a counter-constructive economy.

Mr. KAUFMAN. Well, I think that there will be a larger volume of equity financing in the period ahead by necessity. There has been, as you indicated, substantial increase in the volume of debt financing, particularly in the last 10 years, by business corporations. For the first time I think in the postwar period business corporations are beginning to recognize that the preservation of a good credit rating is extraordinarily important. Today a corporation with a credit rating of BAA or less has a very difficult time raising long-term debt in the open market. Heretofore, 10 years ago, it seemed there was an unlimited supply of funds available and, therefore, I would expect two things to happen. Corporations with high credit ratings, for example, utilities, which are doing so already, will offer a substantial volume of equity financing in order to preserve that rating, and in addition, I would assume that many of the lower and medium rated corporations who do not have access anymore to straight debt financing, will gradually be forced to increase their stock financing and build up their capitalization ratios.

Senator PROXMIRE. Well, gentlemen, thank you very much. This has been most informative and competent testimony you have given us and I am very grateful. I did not mean by my questions to be hostile and I am sure members of the committee feel the same way.

Tomorrow we will reconvene here to hear three experts on antitrust and structural issues, Chairman Budge, SEC, Assistant Attorney General Richard McLaren, and Caspar Weinberger, Chairman, Federal Trade Commission.

(Whereupon, at 12:05 p.m., the committee was adjourned, to reconvene, at 10 a.m., Friday, July 10, 1970.)

THE 1970 MIDYEAR REVIEW OF THE STATE OF THE ECONOMY

FRIDAY, JULY 10, 1970

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

The Joint Economic Committee met, pursuant to recess, at 10:05 a.m., in room S-407, the Capitol Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, and Widnall; and Senators Proxmire, Javits, Miller, Jordan, and Percy.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman, economist; and George D. Krumbhaar and Douglas C. Frechtling, economists for the minority.

Chairman PATMAN. The committee will please come to order.

Today the committee continues its hearings into the state of the economy at midyear and what to do about it. We have been asking witnesses what was wrong with the economy and what should be the future course of our policy.

Today we have asked our three witnesses to concentrate on structural issues, and the ways in which imperfections in the economy affect our ability to bring inflation to an end without unbearable, prolonged unemployment. It is, of course, simple to prescribe policies for a completely competitive and perfectly flexible economy that responds at once to even small changes in policy. It is much more difficult to deal with the complex and imperfect organization of the real world economy in which monopolies, price fixing, and unfair practices exist.

We know that these factors work against our policies to control inflation. For that reason we feel it necessary to inquire into the Government's policies designed to minimize these undesirable economic practices.

We have invited today Mr. Hamer H. Budge, Chairman of the Securities and Exchange Commission, and former Congressman from Idaho; Mr. Richard W. McLaren, Assistant Attorney General, Antitrust Division of the Department of Justice; and Mr. Caspar W. Weinberger, Chairman of the Federal Trade Commission.

We are grateful to you for taking the time from your busy schedules to assist the committee in its deliberations.

We will hear from each of you in turn and then we will throw the hearings open to questioning under the 10-minute rule. Your statement will be printed in full in the record and I will ask each of you to summarize the high points of your statement in not more than 20 minutes, if you can do so without doing violence to your text.

Chairman Budge, you may proceed in your own way, sir.

STATEMENT OF HON. HAMER H. BUDGE, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY ANDREW BARR, CHIEF ACCOUNTANT; GENE L. FINN, CHIEF ECONOMIST; RALPH C. HOCKER, ASSOCIATE DIRECTOR, DIVISION OF CORPORATION FINANCE; AND IRVING H. POLLACK, DIRECTOR OF TRADING AND MARKETS DIVISION, SECURITIES AND EXCHANGE COMMISSION

Mr. Budge. Mr. Chairman, I am delighted to be with you this morning with the members of the staff of the Commission. I would like, with your permission, to commence at the section of my prepared statement, which relates to the securities markets themselves.

Mr. Chairman, our securities markets are today responding to current conditions in the economy as well as to expectations of future business developments. Many people have for the first time discovered that free markets can go down as well as up. This is particularly true as it affects the securities industry where there has been first a tremendous growth and then a decline in volume accompanied by very significant changes in trading patterns. This growth and change is attributable in large measure to the rapid increase in participation in the equity markets by financial institutions. By financial institutions I am referring particularly to banks, insurance companies, pension funds, and mutual funds.

All of these institutions have experienced remarkable growth in themselves and they have, in addition to their heightened interest in equities, increased the activity within their individual portfolios. How fundamental and how permanent these changes in character are to be is still not clear. The Commission expects to have some answers as to their effect on the markets, and some related subjects such as their effect on the companies in their portfolios, when its study of institutional investors is completed late this fall.

But our continuing analyses of developments suggest that beneath the obvious cyclical movements important structural changes are occurring. The volume of shares traded on all registered stock exchanges rose 159 percent between 1964 and 1968, but has since declined to where volume during the first 5 months of this year was 18 percent less than during the comparable 1968 period. The volume decline has accompanied an 18-month period of declining stock prices during which time prices of stock listed on the New York and American Stock Exchanges declined 38 and 43 percent, respectively.

As the overall volume was rapidly increasing and then leveling off, the mix of volume was significantly changing. While we have seen block volume (trades of 10,000 shares or more) on the New York Stock Exchange rise from less than 3 percent of total volume in 1964 to 16 percent today, the number of transactions on the New York Stock Exchange tape was 3.0 million transactions in the first 5 months of this year compared with 4.3 million in the comparable period of 1968, a drop of some 28 percent. In the last 2 years, the 100-share round lots are down 35 percent and the odd-lot volume is down 36 percent. On the other hand, transactions of 10,000 shares and over have more than doubled during this same 2-year period.

During the past several years, the market for stocks has become increasingly more institutionalized to where institutions now account for over 60 percent of the dollar value of public trading on the New York Stock Exchange. The size of institutional orders has also risen substantially and over 70 percent of them are for over 1,000 shares. This indicates why the number of trades has declined more than share volume over the last 2 years.

The progression from the historical auction market involving many daily trades in most securities to the few trades of many shares is a phenomenon which, if continued, will have deep-seated and perhaps ominous effects on our securities markets and on the securities industry generally. Its tangential effects, such as those on the issuing companies themselves, are certain to be a matter for concern.

We have also noted that the portfolio turnover of the institutions continued to increase until the first quarter of this year. Leading that increased portfolio activity were the mutual funds, whose annual turnover rate increased from 22 percent in 1964 to 56 percent a year ago, and is at a current rate of 44 percent. Institutions as a group have been heavy net buyers of stocks in recent years, and in fact their net acquisitions have been larger each year since 1963 with a record $9.6 billion total added last year by private noninsured pension funds, open-end investment companies, and insurance companies (both life and property and liability companies). This was more than a fifth greater than in 1968. Moreover, while these investors have reduced their portfolio activity this year below the rate of late 1969 their net stock purchases in the first quarter of this year were still significantly greater than in the comparable 1969 period.

I might add as being of interest, Mr. Chairman, that just in the month of May of this year the pension funds were net purchasers of equity securities of approximately $900 million.

It is not unusual for volume to fluctuate substantially from day to day and for sizable cyclical movements to occur. Back in 1962, when institutions were a much less important factor than they are now, the 27-percent decline in stock prices was accompanied by a 12-percent decline in volume and the high volume day was 6.5 times that of the low volume day. In fact, a 1965 study conducted for the New York Stock Exchange estimated, on the basis of experience to that date, that by the year 1975 the exchange could expect average daily volume as high as 10 million shares. Volume was then averaging 6 million shares. As we now know, with the benefit of hindsight, we were just beginning a period of accelerated institutional activity, and average daily volume rose to nearly 13 million shares in 1968, and one day that year it exceeded 21 million shares. The industry did not gear up quickly enough to handle adequately the rapid growth in trading. By the time the volume leveled in 1968 and early 1969, the industry was in the midst of the back office problem and experiencing sharply increasing costs reflecting a lower efficiency in operations as well as an accelerated inflation in service costs. Employment costs account for about 40 percent of those costs of broker-dealers which do not vary directly with revenue.

Even before the back office problems were eased, the industry was in the throes of a decline in stock prices and volume which resulted in substantial declines in both commission revenue, and revenue from

dealer activities. While we estimate that the gross revenue of securities firms doubled from 1964 to 1968, it declined by about one-fifth in 1969. More recent figures indicate that the decline accelerated this spring. During April broker-dealer revenues were approximately 38 percent below 1968 levels. In May with the transactions surcharge in effect for the full month revenues were 32 percent below 1968 levels. If the surcharge had not been in effect, May revenues would have been 9 percent lower than they were.

As one might expect, the rather extensive losses incurred by broker-dealers in some cases have affected their net capital positions. Under the Securities Exchange Act of 1934 brokers and dealers are required to meet certain minimum standards regarding the maintenance of net capital in order to help assure that firms have sufficient liquid assets to cover their current indebtedness. Generally speaking, this rule prohibits a broker-dealer from allowing his aggregate indebtedness to exceed net capital by more than 20 to 1 and provides that, with certain minor exceptions, every firm maintain a minimum net capital of $5,000. The thrust of this rule is on liquidity toward the end that broker-dealers at all times may be sufficiently liquid to meet promptly the demands of customers. The net capital rule, however, cannot guarantee complete protection especially when circumstances are changing rapidly. It is to protect investors in such situations that a broker-dealer insurance program such as is now being considered is needed.

The growth of conglomerates and other merger activity also had its impact on the securities markets over the past couple of years. The volume of securities registered with the Commission for the purpose of making exchange offers increased from $880 million in calendar 1966 to $11.2 billion in 1968 and reached $9.4 billion in the first 6 months of 1969. Total registrations in these calendar periods were $31.6 billion, $68.3 billion, and $48.9 billion. However, there has been a substantial decline in the volume of registrations for exchange offer purposes since mid-1969, as merger activities have tapered off. The volume of securities registered for such purposes dissipated to a virtual trickle by the fall of 1969, reflecting tax changes and other factors including the general decline in stock prices that began at the end of 1968.

In addition to the expanded use of debt securities incident to exchange offers, there were also substantial amounts of liabilities incurred for the purpose of making cash tender offers. Between August 1968, when the first registration of a cash tender offer was filed under the take-over-bid legislation, and February 1970, we estimate that $2.5 billion in cash tender offers were filed with the SEC. The greater portion of such volume occurred within the first year after enactment of the statute. The current volume of cash tender offers is not substantial. Many of these were financed through bank loans, which were often unsecured.

The increase in merger activities and conglomerate activities of companies subject to our jurisdiction have accentuated problems in three principal areas of accounting and financial reporting:

(1) There was an increasing need by investors for more detailed disclosure of the operations of companies which have become diversified through internal or external expansion.

(2) Investors have had difficulty in evaluating the dilutive impact

of the great variety of complex securities on the earnings per share data of companies which have issued them in business combinations.

(3) Abuses have arisen in the accounting for business combinations so that the substance of the transactions and the earnings of the combined companies are not always clearly presented in the financial statements issued to the investors.

We have adopted amendments to our registration forms which extended our requirements for disclosures by registrants on their diversified operations. A similar amendment is under consideration for the annual report form filed by the registrants. We also expect that registrants will provide comparable disclosures in their reports to shareholders, and considerable progress of this nature has been made.

In regard to the accounting problems, we have been working with the profession to improve the standards for reporting earnings per share data and the accounting for business combinations.

It being of interest to the committee, Mr. Chairman, I would like to mention that the amount of securities registrations has really increased precipitously in the last few years. For example, in the fiscal year 1965 in dollar amount there were $19.1 billion registered with the Commission. By 1966 that figure had grown to $31.1 billion. In 1967 it was $36.1 billion. In 1968 it was $54 billion. And by 1969 it had grown to $86.8 billion registered in 1 year. In the fiscal year 1970 this declined somewhat to $67 billion which was still, of course, a very, very substantial increase over the dollar figure of $19 billion in 1965, just 5 years previous.

In conclusion, I would like to emphasize that the stock markets and the securities industry which services those markets play a key role in economic change; but that role is an adaptive one. The function of the market and the adjunct financial services is to facilitate the exchange of securities and thus the flow of capital to corporate business. It is the action of issuers of securities and the interaction of investors which make up the markets. Congress recognized this adaptive role of the securities markets and the securities industry when it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. The recurring theme of those acts is the maintenance of fair and orderly markets and the protection of investors. The substantial changes occurring in the securities industry and markets reflect this adaptation to basic economic changes. When we consider both the substantial changes which have occurred and the orderly manner in which they occurred, we can appreciate the underlying strength of our capital markets. Nevertheless, changing circumstances reveal areas where improvements are needed and the Commission is endeavoring to keep abreast of such changes.

Thank you very much, Mr. Chairman.

(The prepared statement of Mr. Budge follows:)

PREPARED STATEMENT OF HON. HAMER H. BUDGE

Mr. Chairman and Members of the Committee; it is a pleasure to be here this morning. It is not often the Commission has the opportunity to appear before this Committee.

In recent weeks a great deal has been said and written about corporate liquidity and we recognize that this is a topic of considerable interest. For a number of years the Commission has prepared and published, on a regular basis, aggregate data on the working capital position of corporate business. This is done not only for the Commission's own use but as part of its role in providing economic and financial data under the general statistical program of the government.

Questions of corporate liquidity have important implications for the financial and capital markets. In my testimony before the House Subcommittee on Commerce and Finance in early 1969, I pointed out that the acquisition and merger movement was carrying with it strong financial implications. Companies were buying other companies or merging with other companies because there were substantial immediate financial advantages. The Commission submitted supplemental information which showed that the increasing reliance on debt to finance acquisitions was having the effect of increasing the leverage in the overall corporate asset structure. As a result of Congressional action last year, particularly tax legislation, as well as economic and market changes, that factor which contributed to the deterioration of corporate liquidity has been effectively halted.

The S.E.C.'s principal concern under the statutes it administers has been the problems engendered by the use of complex securities and the accounting and related disclosure thus created. We recognize, however, that questions of overall corporate liquidity also have important implications for the financial and capital markets.

Corporate Liquidity and Disclosure

Over the years the Commission has been vigorous in pressing for appropriate disclosures to protect investors when a company is in financial difficulties. Such disclosures are of great concern to the investing public and we believe management of a public company has the responsibility to make prompt announcement of pertinent facts rather than to delay disclosure until the occasion of the company's next annual or other periodic report. The principal securities exchanges take a similar view.

When appropriate we have used our authority under the Securities Exchange Act of 1934 to suspend trading in securities of particular companies on national securities exchanges or in the over-the-counter markets, pending disclosure to the investing public of material facts regarding the financial condition of the company involved, or we may compel disclosure by means of administrative proceedings.

Factors bearing upon the liquidity of a business enterprise include not only profits or losses but the inflow of collections from sales to customers, the availability of credit from suppliers, banks or other lenders and the availability of equity financing. Developments as to some of these factors is apparent to management and others over a period of time. The development as to others may be sudden and their appearance may surprise management. Moreover, news of cash stringency in an enterprise quite understandably tends to increase the need for cash and to reduce the amount of credit available.

The Commission's principal device for securing disclosure of the liquidity characteristics of the financial position of a business enterprise is the requirement that the balance sheet of the enterprise, usually a consolidated balance sheet of a parent and its subsidiary companies, set forth, in some detail, the current assets and current liabilities of the enterprise.

Information is required with regard to the aggregate amount of maturities and sinking fund requirements for each of the next five years and with respect to firm commitments for the acquisition of permanent investments and fixed assets, or for rental or construction of assets. Information is also required with respect to assets subject to lien and with respect to the occurrence of any event of default or breach of covenant with respect to indebtedness.

These requirements are set forth in the Commission's Regulation S–X governing the form and content of financial statements filed with the Commission. While financial statements in annual or other reports to security holders are not required to contain all of the detail provided by Regulation S–X, such security holder reports may not be inconsistent with the financial statements filed with the Commission.

Issuers of securities traded on a national securities exchange and issuers with assets in excess of $1 million having a class of equity securities held by 500 or more persons, that is companies subject to Sections 12(b) and 12(g) of the Securities Exchange Act of 1934, are required to file annual reports with the Commission which include balance sheets as described above. Further, such issuers are required to disclose material facts with regard to a default on indebtedness in a current report on Form 8–K not later than the tenth day of the month following the occurrence of an event of default.

A type of disclosure problem which sometimes arises involves a company which has suffered losses and the continuation of its business is dependent upon attaining sufficiently profitable operations or additional capital so that the company

will be in a position to satisfy its liabilities as they become due. Under date of February 19, 1970, the Commission issued a public release commenting that while it does not intend to preclude companies with pressing financial problems from raising funds from public offerings of securities, it feel that an accountant's report cannot meet the certification requirements of the Securities Act of 1933 unless a company can arrange its affairs so that the immediate threat to continuation as a going business is removed. In other words, the independent accountant must be satisfied that it is appropriate to use conventional principles and practices for stating the accounts on a going concern basis before a registration statement under the Securities Act can be declared effective.

The Commission is presently considering a proposal to require listed companies and over-the-counter companies which are subject to Section 12(g) of the Securities Exchange Act to file quarterly reports which would disclose results of operations for the period, short term loans, notes, etc. and long term debt and shareholders equity at the end of the period. Also under consideration is a proposal that annual reports filed with the Commission set forth a statement of the source and application of funds by the enterprise to which they relate for the last two fiscal years.

DEVELOPMENTS IN THE TRADING MARKETS—GROWTH IN VOLUME AND CHANGES IN PATTERN

Our securities markets are today responding to current conditions in the economy as well as to expectations of future business developments. Many people have for the first time discovered that free markets can go down as well as up. This is particularly true as it affects the securities industry where there has been first a tremendous growth and then a decline in volume accompanied by very significant changes in trading patterns. This growth and change is attributable in large measure to the rapid increase in participation in the equity markets by financial institutions. By financial institutions I am referring particularly to banks, insurance companies, pension funds and mutual funds. All of these institutions have experienced remarkable growth in themselves and they have, in addition to their heightened interest in equities, increased the activity within their individual portfolios. How fundamental and how permanent these changes in character are to be is still not clear. The Commission expects to have some answers as to their effect on the markets, and some related subjects such as their effect on the companies in their portfolios, when its study of institutional investors is completed.

But our continuing analyses of developments suggest that beneath the obvious cyclical movements important structural changes are occurring. The volume of shares traded on all registered stock exchanges rose 159 percent between 1964 and 1968, but has since declined to where volume during the first five months of this year was 18 percent less than during the comparable 1968 period. The volume decline has accompanied an 18-month period of declining stock prices during which time prices of stock listed on the New York and American Stock Exchanges declined 38 and 43 percent, respectively.

As the overall volume was rapidly increasing and then leveling off, the mix of volume was significantly changing. While we have seen block volume (trades of 10,000 shares or more) on the New York Stock Exchange rise from less than three percent of total volume in 1964 to sixteen percent today, the number of transactions on the New York Stock Exchange tape was 3.0 million transactions in the first five months of this year compared with 4.3 million in the comparable period of 1968, a drop of some 28 percent. In the last two years, the one-hundred-share round-lots are down 35 percent and the odd-lot volume is down 36 percent. On the other hand, transactions of 10,000 shares and over have more than doubled during this same two-year period.

During the past several years, the market for stocks has become increasingly more institutionalized to where institutions now account for over 60 percent of the dollar value of public trading on the New York Stock Exchange. The size of institutional orders has also risen substantially and over 70 percent of them are for over 1,000 shares. This indicates why the number of trades has declined more than share volume over the last two years.

The progression from the historical auction market involving many daily trades in most securities to the few trades of many shares is a phenomenon which, if continued, will have deep seated and perhaps ominous effects on our securities markets and on the securities industry generally. Its tangential effects,

such as those on the issuing companies themselves, are certain to be a matter for concern.

We have also noted that the portfolio turnover of the institutions continued to increase until the first quarter of this year. Leading that increased portfolio activity were the mutual funds, whose annual turnover rate increased from 22 percent in 1964 to 56 percent a year ago, and is at a current rate of 44 percent. Institutions as a group have been heavy net buyers of stocks in recent years and in fact their net acquisitions have been larger each year since 1963 with a record $9.6 billion total added last year by private noninsured pension funds, open-end investment companies and insurance companies (both life and property and liability companies). This was more than a fifth greater than in 1968. Moreover, while these investors have reduced their portfolio activity this year below the rate of late 1969 their net stock purchases in the first quarter of this year were still significantly greater than in the comparable 1969 period.

It is not unusual for volume to fluctuate substantially from day-to-day and for sizeable cyclical movements to occur. Back in 1962, when institutions were a much less important factor than they are now, the 27 percent decline in stock prices was accompanied by a 12 percent decline in volume and the high volume day was 6.5 times that of the low volume day. In fact, a 1965 study conducted for the New York Stock Exchange estimated, on the basis of experience to that date, that by the year 1975 the Exchange could expect average daily volume as high as ten million shares. Volume was then averaging six million shares. As we now know, with the benefit of hindsight, we were just beginning a period of accelerated institutional activity, and average daily volume rose to nearly 13 million shares in 1968, and one day that year it exceeded 21 million shares. The industry did not gear up quickly enough to handle adequately the rapid growth in trading. By the time the volume leveled in 1968 and early 1969, the industry was in the midst of the back office problem and experiencing sharply increasing costs reflecting a lower efficiency in operations as well as an accelerated inflation in service costs. Employment costs account for about 40 percent of those costs of broker-dealers which do not vary directly with revenue.

Even before the back office problems were eased, the industry was in the throes of a decline in stock prices and volume which resulted in substantial declines in both commission revenue, and revenue from dealer activities. While we estimate that the gross revenue of securities firms doubled from 1964 to 1968, it declined by about one-fifth in 1969. More recent figures indicate that the decline accelerated this spring. During April broker-dealer revenues were approximately 38 percent below 1968 levels. In May with the transactions surcharge in effect for the full month revenues were 32 percent below 1968 levels. If the surcharge had not been in effect, May revenues would have been 9 percent lower than they were.

As one might expect, the rather extensive losses incurred by broker-dealers in some cases have affected their net capital positions. Under the Securities Exchange Act of 1934 brokers and dealers are required to meet certain minimum standards regarding the maintenance of net capital in order to help assure that firms have sufficient liquid assets to cover their current indebtedness. Generally speaking, this rule prohibits a broker-dealer from allowing his aggregate indebtedness to exceed net capital by more than "twenty-to-one" and provides that, with certain minor exceptions, every firm maintain a minimum net capital of $5,000. The thrust of this rule is on liquidity toward the end that broker-dealers at all times may be sufficiently liquid to meet promptly the demands of customers. The net capital rule, however, cannot guarantee complete protection especially when circumstances are changing rapidly. It is to protect investors in such situations that a broker-dealer insurance program such as is now being considered is needed.

The growth of conglomerates and other merger activity also had its impact on the securities markets over the past couple of years. The volume of securities registered with the Commission for the purpose of making exchange offers increased from $880 million in 1966 to $11.2 billion in 1968 and reached $9.4 billion in the first six months of 1969. Total registrations in these periods were $31.6 billion, $68.3 billion and $48.9 billion. However, there has been a substantial decline in the volume of registrations for exchange offer purposes since mid-1969, as merger activities have tapered off. The volume of securities registered for such puropses dissipated to a virtual trickle by the fall of 1969, reflecting tax changes, and other factors including the general decline in stock prices that began at the end of 1968.

In addition to the expanded use of debt securities incident to exchange offers, there were also substantial amounts of liabilities incurred for the purpose of making cash tender offers. Between August 1968, when the first registration of a cash tender offer was filed under the take-over-bid legislation, and February 1970, we estimate that $2.5 billion in cash tender offers were filed with the SEC. The greater portion of such volume occurred within the first year after enactment of the statute. The current volume of cash tender offers is not substantial. Many of these were financed through bank loans, which were often unsecured.

Accounting Aspects of Conglomerate Activities

The increase in merger activities and conglomerate activities of companies subject to our jurisdiction have accentuated problems in three principal areas of accounting and financial reporting.

(1) There was an increasing need by investors for more detailed disclosure of the operations of companies which have become diversified through internal or external expansion.

(2) Investors have had difficulty in evaluating the dilutive impact of the great variety of complex securities on the earnings per share data of companies which have issued them in business combinations.

(3) Abuses have arisen in the accounting for business combinations so that the substance of the transactions and the earnings of the combined companies are not always clearly presented in the financial statements issued to the investors.

We have adopted amendments to our registration forms which extended our requirements for disclosures by registrants on their diversified operations. A similar amendment is under consideration for the annual report form filed by the registrants. We also expect that registrants will provide comparable disclosures in their reports to shareholders, and considerable progress of this nature has been made.

In regard to the accounting problems, we have been working with the profession to improve the standards for reporting earnings per share data and the accounting for business combinations.

Conclusion

In conclusion, I would like to emphasize that the stock markets and the securities industry, which services those markets, play a key role in economic change; but that role is an adaptive one. The function of the market and the adjunct financial services is to facilitate the exchange of securities and thus the flow of capital to corporate business. It is the action of issuers of securities and the interaction of investors which make up the markets. Congress recognized this adaptive role of the securities markets and the securities industry when it enacted the Securities Act of 1933 and the Securities Exchange Act of 1934. The recurring theme of those Acts is the maintenance of fair and orderly markets and the protection of investors. The substantial changes occurring in the securities industry and markets reflect this adaptation to basic economic changes. When we consider both the substantial changes which have occurred and the orderly manner in which they occurred, we can appreciate the underlying strength of our capital markets. Nevertheless, changing circumstances reveal areas where improvements are needed and the Commission is endeavoring to keep abreast of such changes.

Chairman PATMAN. Thank you, Mr. Budge. We will expect, of course, to ask you some questions later.

Mr. McLaren, we are delighted to have you, sir, and you may proceed in your own way. Your entire prepared statement will be placed in the record. I assume it will be all right for any member who so desires to ask you a question in writing and that you will answer it when you look over your transcript for approval.

Mr. McLAREN. Sure, Mr. Chairman.

Chairman PATMAN. Will that be satisfactory, Mr. Budge?

Mr. BUDGE. Yes, sir.

Chairman PATMAN. Fine. Go right ahead, Mr. McLaren.

STATEMENT OF RICHARD W. McLAREN, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE; ACCOMPANIED BY ARTHUR CANTOR, SPECIAL ASSISTANT; AND PAUL BRANDON, ECONOMIST AND STATISTICIAN

Mr. McLAREN. Thank you, Mr. Chairman. I have with me this morning Mr. Arthur Cantor, my special assistant; and Mr. Paul Brandon, economist and statistician of Harvard University. I may want to call on them in the question period.

Chairman PATMAN. We are glad to have them, sir.

Mr. McLAREN. I have a prepared statement and I will try to summarize to save time, as you have suggested, Mr. Chairman.

As you know, the antitrust division is charged, along with the FTC, with the task of protecting the basic national policy of competition. To this end we seek out and prosecute anticompetitive practices, particularly price fixing, and we seek to preserve competitive market structures primarily by opposing certain mergers and the creation of monopolies.

Also, since Government regulation restricts competitive freedom, we appear as advocates for competition before the regulatory agencies, and we urge that regulation be confined to those areas where it is necessary to make the regulatory scheme effective.

Thus, the antitrust division is not an inflation fighting agency.

However, today, at the committee's request, I would like to focus on the effects of concentrated markets on the current inflation. I would also like to comment on some of the suggestions which have been made for combating inflation, and on certain aspects of our program which we hope may directly contribute to this effort.

It is generally recognized, I think, that concentrated markets, in which a few firms account for most of the business, are less responsive to competitive forces than unconcentrated ones. As a result, prices in concentrated industries tend to be higher relative to costs than in unconcentrated industries.

The question which concerns us today is whether prices in concentrated industries move up more rapidly than the average during the inflationary period.

In an effort to answer this question, I asked Dr. Leonard Weiss of the University of Wisconsin, who has been my special economics assistant this past year, and members of the antitrust division staff to conduct a statistical study of recent price changes in both concentrated and unconcentrated industries. The nature of this study and its findings are set out in some detail in the appendix to my prepared statement, and I will merely summarize them here.

Dr. Weiss and the staff selected for study those industries for which the Bureau of Labor Statistics had published wholesale price indexes. There were 43 such industires for the 1963 to 1967 period, and 82 for the 1967 to 1969 period.

The concentration factor in these industries—the share of the market held by the four largest firms—varied widely, from 13 percent in fabricated pipe and fittings to 95 percent in receiving-type electron tubes.

The staff first simply compared price changes and levels of concentration in these industries. It found no significant correlation be-

tween industrial concentration and price changes for the overall period 1963 to 1968, when prices were relatively stable.

During the more inflationary years, 1967 to 1969, it found that prices rose a good deal less in concentrated industries than in the more competitive sector. In other words, there was a negative relationship between concentration and price changes in this period.

Of course, concentration is not the only factor which may be expected to influence industry price changes. In order to isolate the effect of concentration, to the extent we could, the staff tried to account for other factors by developing indexes of unit labor costs, unit material costs, and physical output or demand for 1963 to 1968, the last year for which such data are available.

These other factors did explain much of the difference in price changes in these industries, but even after taking them into account, prices in 1967–68 rose significantly less, the more concentrated the industry. In other words, it appears that rather than contributing to inflation, concentration probably damped its effect through 1968 and perhaps through 1969.

While at first this finding may seem surprising, in fact, the economists advise me, it follows the classic pattern of wartime excess demand inflations. When shortages develop, prices rise rapidly in unconcentrated markets, like beef and lumber, for example, but the leading firms which must make conscious decisions on price in oligopolistic markets seem to adjust with a lag, perhaps, we may speculate, with an eye to public relations.

Our shortages have largely abated now, the economists indicate, and there should not be much more inflation in the more competitive or unconcentrated markets.

On the other hand, the lag in price adjustments in concentrated industries, as noted in our staff study, may mean, and perhaps it would be beter to say might mean, that prices will keep on rising in these markets for a period of time.

Now, if I may interpolate one caveat, our study did not investigate the possible effect of imports on prices in concentrated industries, and we think this is probably a good subject for another study.

Now, moving on to the section of the prepared statement, where we have set forth why we do not think that price and wage controls, either across the board or in the concentrated and unionized sector, as suggested by some, provide the solution to the current inflation problem.

First, the costs of controls are very high. They require a big bureaucracy of price fixers and extensive machinery for changes and adjustments.

Second, any concern about competition is suspended for the duration of controls. The price control authorities and the industry members, in effect, get together and negotiate prices and, as we learned from the NRA and OPA programs, there is a real danger that the habits of cooperation among competitors will survive after controls go off.

Third, even in the regulated industries, price controls have often worked quite imperfectly, and I think that is an understatement, despite well-developed, specialized regulatory machinery. Any attempt to regulate the whole oligopolistic and unionized sector seems bound to work even less well, and the vast unconcentrated sector, where inflation has been most acute, poses even greater problems of control.

It just doesn't seem to us worth all of this merely to postpone the remaining price and wage adjustments in concentrated and unionized industries.

We would be trying to put a lid on an inflation whose main cause, excess demand, is already behind us. Moreover, I think that we should be especially slow to erect unwieldy control machinery when real prices even now may be well below reported list prices, as a New York Times article indicated last Sunday.

Now, in the prepared statement, I have set forth a range of policies which we believe are likely to be more effective and more relevant for the future than controls.

Let me summarize.

First, we should continue to be particularly diligent in seeking out and prosecuting anticompetitive practices. This applies particularly to the collusive setting of fees in service industries. Here is where the economists tell us prices have risen most drastically, and State as well as Federal laws can be used for this purpose.

Second, we should critically reexamine our fair trade laws. Studies show that prices for fair traded items are higher in States with effective resale price maintenance statutes than in those with no such legislation.

Third, we should continue to avoid international trade barriers so that price increases are restrained not only by domestic but by foreign competition, an especially important factor in concentrated industries, where domestic competition is obstructed by high barriers to entry. I do not mean that we should hold still for dumping or that we should not press for reciprocal access to other nations. But even where protective action is essential, government-negotiated voluntary quotas would be preferable to mandatory quotas. and I should think that tariffs would be preferable to any kind of quotas since they allow for increased supplies as prices rise.

Fourth, we should step up our efforts in the consumer protection field. If Congress will pass the legislation we have urged, I believe that the Justice Department will be a very effective champion for the consumer in the regulated as well as the unregulated sector. With the experience we have had as advocates for competition, I think we can also do this efficiently without a big budget, and without imposing burdens on business that would provide the occasion for more price increases.

The Antitrust Division is conducting one new program in the area of price fixing which we hope may prove to be of great benefit to the consumer in these times of high prices. We are comparing the prices and price movements of locally produced products in major cities and metropolitan areas; that is, one with another.

If our studies reveal significant departures from the price norm we will then determine whether the higher price levels are the result of normal economic factors as, for example, cost differences from market to market, or are produced by collusion. If the latter, of course, we will promptly prosecute.

Point 4, what can be done about the concentrated industries, where the inflation problem is likely to be most severe or, perhaps that is too strong a word, where the inflation problem is more likely to continue in the near future?

I have already noted the importance of a free trade policy in reducing the market power of domestic oligopolies, and we will certainly continue to keep close tabs on their practices.

We will continue our strong antimerger policy which, at the least, should prevent further concentration, and we will bring monopolization suits when we find violations.

In the long run legal action, plus competition and innovation, I believe, will erode concentration. But we recognize that these policies are not likely to change the oligopolistic character of the industries involved in the short run. The deconcentration of these industries is a desirable goal but it cannot be accomplished quickly and it therefore does not offer immediate help towards stopping the present inflation.

To sum up, fiscal and monetary policy seems to us to offer the greatest promise in our efforts to bring inflation under control. A more competitive economy would be more flexible and respond more readily to changes in monetary and fiscal policy. But I do not believe that we can realistically hope to do much about the present inflation by attempting to change industry structure.

Our continuing program, however, should make such problems easier to handle in the future. If we eliminate Government and private restrictions on price competition whenever we can, I think we will be making a valuable contribution in the fight against inflation. I think it would be a disservice to reverse direction and seek to impose regulatory controls on the national economy.

Now, Mr. Chairman, I received from your staff a list of questions that I understand you would like to have answered during these hearings, if possible.

A number are outside the antitrust sphere. I would like to say on the question with respect to one-bank holding companies, we are still very hopeful to see legislation this year. Personally, I am disappointed in the Senate bill. I think that the grandfather date set up into mid-1969 is too late a date, and I think the Williams amendment provides a very substantial loophole which would permit conglomerate companies to have very large banking interests, and I think that would, at least, in part, defeat the purposes of the legislation.

I testified this spring before the Senate Banking and Currency Committee. Of course, I testified before your committee a year ago, and in summary, I hope that we will see a flexible bill. I hope that it will place discretion in the Federal Reserve Board, and that it will permit finance and finance-related activities by banks within reason, so that they will contribute to competition, but so that competition may not be adversely affected by the entry of banks into too broad a field. I would be happy to furnish a copy of my Senate testimony before the Banking and Currency Committee if the Chairman would like to have it.

Chairman PATMAN. Yes, sir. Would it be all right to place it in the record in connection with your prepared statement?

Mr. McLAREN. Yes, indeed, Mr. Chairman.

Chairman PATMAN. It will be inserted.

Mr. McLAREN. Thank you, Mr. Chairman.

(The prepared statements of Mr. McLaren follow:)

PREPARED STATEMENT OF RICHARD W. McLAREN

I am grateful for the opportunity to participate in this Committee's mid-year review of our economy. This is a subject of the most serious concern not only to the Congress but to the Administration and to the nation at large.

Our basic national economic policy, repeatedly declared by Congress and constantly guarded by the courts, is competition. This policy, first set out in the Sherman Act, was well described by Mr. Justice Black some twelve years ago in the *Northern Pacific* case.[1] He said:

The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions. . . .

The Antitrust Division is charged with the task of protecting the basic national policy of competition. To this end, we seek out and prosecute anticompetitive practices, such as price fixing, division of markets, boycotts, reciprocal dealing and tying arrangements. We also seek to preserve competitive market structures by opposing certain mergers and the creation of monopolies. Finally, since government regulation restricts competitive freedom, we appear as advocates for competition before the regulatory agencies and we urge that regulation be confined to those areas where necessary to make the regulatory scheme effective.

The Antitrust Division is not primarily intended to be an inflation-fighting agency. Our jurisdiction is subject to significant limitations; our main instrument—litigation—is inherently slow and uncertain; and our resources are quite modest. But the continuing goal of a vigorous antitrust program—to promote an efficient and healthy free competitive economy—makes a vital contribution to our economic progress.

Today, at the Committee's request, I would like to focus on the effects of concentrated markets on the current inflation. I would also like to comment on some of the suggestions for combating inflation and on certain aspects of our program which we hope may directly contribute to this effort.

It is generally recognized that concentrated markets, in which a few firms account for most of the business, are less responsive to competitive forces than unconcentrated ones.[2] As a result, prices in concentrated industries tend to be higher relative to costs than in unconcentrated industries.[3] The question which concerns us today is whether prices in concentrated industries move up more rapidly than the average during an inflationary period.

In an effort to answer this question, I asked Dr. Leonard Weiss, of the University of Wisconsin, who has been my Special Economics Assistant this past year, and members of the Antitrust Division staff, to conduct a statistical study of recent price changes in both concentrated and unconcentrated industries. The nature of this study and its findings are set out in some detail in the Appendix to my prepared remarks. I will merely summarized them here.

Dr. Weiss and the staff selected for study those industries for which the Bureau of Labor Statistics had published wholesale price indexes. There were 43 such industries for the 1963–1967 period, and 82 for the 1967–1969 period. They are all listed in Table 1 of the Appendix. The concentration factor in these industries—the share of the market held by the 4 largest firms—varied widely, from 13% in fabricated pipe and fittings to 95% in receiving-type electron tubes.

The staff first simply compared price changes and levels of concentration in these industries. It found no significant correlation between industrial concentration and price changes for the over-all period 1963–1968, when prices were relatively stable. During the more inflationary years, 1967–1969, it found that prices rose a good deal *less* in concentrated industries than in the more com-

[1] Northern Pacific Ry. Co. v. United States, 356 U.S. 1, 4 (1958).
[2] See United States v. Phila. Nat. Bank, 374 U.S. 321, 363 (1963).
[3] A number of economic studies have reached this conclusion. See *e.g.*, Bain, *Industrial Organization*, 2d ed., pp. 445–452; Collins and Preston, *Concentration and Price-Cost Margins in Manufacturing Industries*.

petitive sector. In other words, there was a negative relationship between concentration and price changes in this period.

Of course, concentration is not the only factor which may be expected to influence industry price changes. In order to isolate the effect of concentration, the staff tried to account for other factors by developing indexes of unit labor costs, unit material costs, and physical output (or demand) for 1963 to 1968, the last year for which such data is available. These other factors did explain much of the difference in price changes in these industries. Even after taking them into account, however, prices in 1967–1968 rose significantly *less*, the more concentrated the industry. In other words, it appears that, rather than conrtibuting to inflation, concentration probably damped its effect through 1968, and perhaps through 1969.

While at first this finding may seem surprising, in fact it follows the classic pattern of wartime, excess-demand inflations. When shortages develop, prices rise rapidly in unconcentrated markets, like beef and lumber, but the leading firms which must make conscious decisions on price in oligopolistic markets seem to adjust with a lag, perhaps with an eye to public relations.

Our shortages have largely abated now, the economists indicate, and there should not be much more inflation in the more competitive markets. On the other hand, the lag in price adjustments in concentrated industries, as noted in our staff study, may mean that prices will keep rising in these markets for a period of time.

II

What can be done about it? Some people have been calling for price and wage controls, either across the board or in the concentrated and unionized sector. This seems to me a drastic and unwise way of dealing with the problem, and I would like to indicate why I think this is so.

Price and wage controls can indeed suppress inflation for a while, as we saw during World War II and the Korean War, but the costs of controls are high. They create a big bureaucracy of price fixers. The bureaucracy cannot just freeze prices and wages and make the freeze stick—there are all sorts of adjustments needed, because prices and costs were out of balance in some industries to start with, or wages in some jobs seem out of line with others, or just because situations change. We could expect thousands of lobbyists to descend on the price and wage controllers and on Congress in attempts to influence those adjustments.

And, of course, any concern about competition is suspended for the duration of controls. The price control authorities and the industry members in effect get together and negotiate prices; and, as we learned from the N.R.A. and O.P.A. programs, there is a real danger that the habits of cooperation among competitors will survive the period of controls.

We have had considerable experience with price controls in some of the regulated industries. They have often worked quite imperfectly there, in spite of fairly simple products and well-developed, specialized regulatory machinery. An attempt to regulate the whole oligopolistic and unionized sector seems bound to work even less well. And the vast unconcentrated sector, where inflation has been most acute, poses even greater problems of control.

It just does not seem worth all this merely to postpone the remaining price and wage adjustments in concentrated and unionized industries. We would be trying to put a lid on an inflation whose main cause—excess demand—is already behind us. Moreover, we should go slow on erecting unwieldy control machinery when "real" prices may be well below advertised "list" prices—in many industries, discounts and "terms" are where real competition is.

III

I believe there is a range of policies which are likely to be more effective and relevant for the future than controls in achieving stable economic growth, and I would like to mention some which lie within the Justice Department's area of activity.

1. We should continue to be particularly diligent in seeking out and prosecuting anticompetitive practices. For example, federal and state authorities should work to eliminate arrangements for the collusive setting of fees in service industries. Here is where prices have risen most drastically. We have filed cases against pharmacists', pathologists', and real estate agents' associations, and we continue to warn against fixed fee arrangements. We are also working closely with the Justice Department Criminal Division in the field of infiltra-

tion of legitimate business by organized crime. Where such infiltration occurs, we find that it brings with it many anticompetitive activities—often at the retail level, and usually enforced by strong-arm methods. In a moment I shall describe a new effort by the Antitrust Division in the area of price fixing.

2. We should critically reexamine our fair trade laws. Studies show that prices for fair traded items are higher in states with effective resale price maintenance statutes than in those with no such legislation.

3. We should continue to avoid trade barriers so that price increases are restrained not only by domestic but by foreign competition—an especially important factor in concentrated industries, where domestic competition is obstructed by high barriers to entry. I do not mean that we should hold still for "dumping", or that we should not press for reciprocal access to other nations. But it does mean that, in my view, this is a very unpropitious time to be erecting rigid new barriers to imports. Even where protection is essential, government-negotiated voluntary quotas would be preferable to mandatory quotas, and I should think that tariffs would be preferable to quotas, since they allow for increased supplies as prices rise.

4. We should step up our efforts in the consumer protection field. If Congress will pass the legislation we have urged, I believe that the Justice Department will be a very effective champion of the consumer in the regulated as well as the unregulated sector. With the experience we have had as advocates for competition, I think we can also do this efficiently, without a big budget and without imposing burdens on business that would provide the occasion for more price increases.

The Antitrust Division is conducting a new program in the area of price fixing which we hope may prove to be of great benefit to the consumer in these times of high prices. We are comparing the prices and price movements of locally produced products in major cities and metropolitan areas. The products selected for study have a significant effect on the cost of food and housing, which are major factors in the cost of living. In general, these products are processed in local markets by a large number of relatively small firms. If our studies reveal significant departures from the price norm in a given area, we will then determine whether the higher price levels are the result of normal economic factors or are produced by collusion. We will promptly prosecute any unlawful conduct we detect.

IV

What can be done about the concentrated industries, where the inflation problem is likely to be most severe in the near future? I have already noted the importance of a free trade policy in reducing the market power of domestic oligopolies. We will certainly continue to keep close tabs on these industries and respond quickly to any evidence of price fixing we detect. We will continue our strong anti-merger policy, and we will bring monopolization suits when we find violations. But we recognize that these policies are not likely to change the oligopolistic character of the industries involved in the short run. Deconcentration of these industries is a desirable goal, but it cannot be accomplished quickly, and it therefore does not offer immediate help toward stopping the present inflation.

The Department of Justice is following a policy of preventing mergers among important and viable competitors in markets that are concentrated or where concentration is threatened. This should at least prevent further concentration, and it should permit the gradual erosion of existing concentration as a result of new entry, new technology and internal rivalry. We also hope to induce procompetitive new entry, either *de novo* or by foothold acquisitions, by preventing the largest firms in the nation from taking over leading firms in concentrated industries. The entry of National Steel into basic aluminum production after acquiring an interest in Southwire Corporation is just the sort of deconcentration we have in mind.

One thing that is not feasible under present law is the wholesale dissolution of oligopolistic firms. Companies with very high market shares may be sued under Section 2 of the Sherman Act if they can be shown to have attained or maintained monopoly power by improper means—for example, by pricing policies designed to prevent new entry or eliminate competitors, by sales policies that tie most customers to them, or by patent restrictions. When we find such practices we will sue and if the firm involved is in a dominant position there is a good chance that we will seek dissolution.

Such suits are infrequent however. Firms with very large market shares generally are very careful to avoid the sort of conduct that would put them in

jeopardy. When we do bring a suit it is almost always a long and costly process. And if we win the courts may be reluctant to grant dissolution because of the possible disruption, that may result.

Even where dissolution has been decreed it has not always been easy to accomplish. Indeed it has often proved extremely difficult to get effective divestiture even in merger cases where the standard of proof is more easily met. Once an illegal merger is consummated it is very difficult to unscramble the two firms' employees customers and assets and to find a suitable buyer for the part to be divested. For this reason we often seek preliminary injunctions to keep the companies separate while the case is being litigated. As the law now stands, however, there is considerable doubt whether we can appeal from the denial of a preliminary injunction, so the effectiveness of this procedure is limited. Congress now has before it proposed legislation to amend the Expediting Act which, among other things would make such appeals possible, and I hope it will be enacted soon.

V

To sum up: fiscal and monetary policy seem to us to offer the greatest promise in our efforts to bring inflation under control. A more competitive economy would be more flexible and respond more readily to changes in monetary and fiscal policy, but I do not believe that we can realistically hope to do much about the present inflation by attempting to change industry structure. Our continuing program should make such problems easier to handle in the future.

If we eliminate Government and private restrictions on price competition whenever we can, I think we will be making a valuable contribution in the fight against inflation. I think it would be a disservice if we reverse direction and seek to impose regulatory controls on the national economy.

Appendix

The Role of Concentration in Recent Inflation

1. Background: The inflation of the 1950s

Reexamination of the "administered inflation" of 1953–1958 seemed at first to show no significant relationship between price change and concentration,[1] but when changes in direct costs were allowed for, there turned out to be a significant tendency for prices to rise more, the greater the degree of industrial concentration.[2] A similar set of tests for the subsequent several years (1959–1963), however, showed no inflationary effect for concentration. These results were interpreted at the time to indicate that rising prices in concentrated industries during the 1950s were a temporary, delayed reaction to the inflations of World War II and the Korean War, during which periods the more concentrated industries had experienced relatively smaller price increases than the competitive sector.[3]

2. The recent inflationary period

The role of concentrated industries in recent inflation has been examined following approximately the procedures used in the studies of the 1950s and early 1960s. Price data is now available for selected four-digit SIC industries from the Bureau of Labor Statistics for 43 industries for the years 1963–1969 and for 82 industries for 1967–1969.[4] Cost data are available for most of these industries from the Bureau of the Census through 1968.[5] The latest four-firm concentration ratios available are those reported for four-digit industries for 1966,[6] except for eight industries with regional or local markets, for which 1963 figures were used.[7] See Table 1.

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[1] H. J. DePodwin and R. T. Seldon, "Business Pricing Policies and Inflation," *Journal of Political Economy*, April 1963.

[2] L. W. Weiss, "Business Pricing Policies and Inflation Reconsidered," *Journal of Political Economy*, April 1966, pp. 180–181.

[3] Ibid., pp. 183–186.

[4] BLS, *Wholesale Prices and Price Indexes*, Table 6, and *Monthly Labor Review*, August 1965.

[5] Bureau of the Census, *Censuses of Manufactures*, 1963 and 1967 and *Annual Surveys of Manufactures*, 1968. The 1967 Census and the 1968 *Annual Survey* data are from preliminary reports.

[6] Bureau of the Census, *Annual Survey of Manufactures*, 1966.

[7] Senate Judiciary Committee, *Concentration Ratios in Manufacturing Industry:1 963*, Tables 25 and 26. For the eight industries with regional or local markets, concentration ratios were obtained by taking weighted averages of either the divisions, states, or SMSAs (see Table 1).

The following variables were derived for each industry studied:

Pt/Po = the ratio of the price index for year t to price in year o.

St/So = the ratio of shipments in year t to shipments in year o.

$\frac{Qt}{Qo} = \frac{St/So}{Pt/Po}$ the ratio of shipments of industry in year t deflated by Pt to shipments in year o deflated by Po.

CMt/CMo = the ratio of the cost of materials in year t to cost of materials in year o.

MHt/MHo = the ratio of production worker man-hours in year t to man-hours in year o.

CLt/CLo = the ratio of total payroll in year t to that in year o.

Wt/Wo = the ratio of total production worker payroll in year t to year o.

$\frac{CMt/CMo}{Qt/Qo}$ = the ratio of unit materials cost in year t to that in year o.

$\frac{CLt/CLo}{Qt/Qo}$ = the ratio of unit labor cost in year t to that in year o.

$\frac{Qt/Qo}{MHt/MHo}$ = the ratio of output per man-hour in year t to that in year o.

$\frac{Wt/Wo}{MHt/MHo}$ = the ratio of the wage rate in year t to that in year o.

Ct/Co = four-firm concentration ratio in 1966.

The price ratios were regressed on concentration and on the control variables for 1963–1968 and 1967–1968, and on concentration alone for 1963–1968, 1967–1968, and 1968–1969. The results are shown in Table 2.

Our studies show that concentration has a negative but statistically non-significant effect on price changes in the 1963–1968 period. But for periods after 1967, concentration has a statistically significant negative effect, whether or not unit costs and demand change are taken into account. This is quite different from the 1953–1958 period, when concentration had a positive effect, and from the 1959–1963 period, when it had no significant effect.

It would appear that concentration had a restraining effect on inflation up to 1968 and perhaps through 1969. Unlike the 1950s, the effect of concentration on price change holds up when wage and productivity change are substituted for unit labor costs.

Thus it appears that oligopoly had the effect of damping the inflation of the late 1960s. In light of the experience of the 1950s, the result may be another "administered inflation" in the early 1970s. It seems clear, however, that we should avoid drastic deflationary policies or direct controls aimed at "preventing" an inflation the causes of which have already occurred.

TABLE 1

SIC code	Industry	4-firm concentration ratio	P 68 / P 63	P 68 / P 67	P 69 / P 68
3498	Fabricated pipe and fittings	13	1.210	1.074	1.093
2426	Hardwood dimension and flooring	15		1.063	1.093
2013	Sausages and other prepared meats	16		1.012	1.228
2015	Poultry dressing plants	17	1.048	1.055	1.127
2311	Men's and boys' suits and coats	17	1.185	1.061	1.121
3111	Leather tanning and finishing	19	1.103	1.018	1.068
2327	Men's and boys' separate trousers	20		1.021	1.040
3941	Games and toys	22		1.035	1.026
2033	Canned fruits and vegetables	24		1.053	1.004
3533	Oilfield machinery	24	1.119	1.058	1.092
2321	Men's and boys' shirts and nightwear	25	1.083	1.025	1.067
3315	Steel wire and related products	26		1.014	1.070
3317	Steel pipe and tubes	26		1.020	1.067

See footnotes at end of table.

TABLE 1—Continued

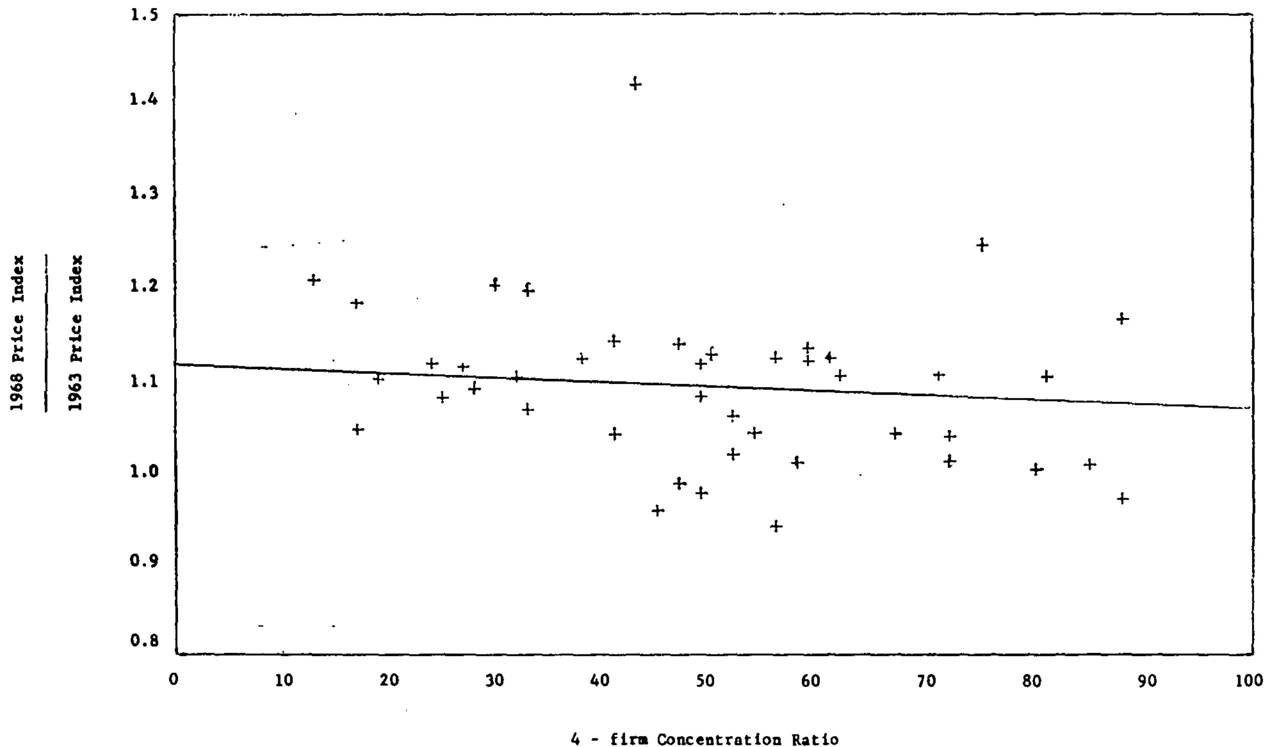
SIC code	Industry	4-firm concentration ratio	P 68 / P 63	P 68 / P 67	P 69 / P 68
2011	Meatpacking plants	27	------	1.016	1.128
2381	Dress fabric and work gloves	27	1.116	1.041	1.075
2328	Men's and boys' work clothing	28	1.092	1.030	1.042
2521	Wood office furniture	30	1.204	1.036	1.088
2098	Macaroni and spaghetti	31	------	1.002	1.016
3271	Concrete block and brick	[1] 32	1.105	1.043	1.042
2036	Fresh or frozen packaged fish	[2] 33	1.198	1.073	1.147
2254	Knit underwear mills	33	------	1.031	1.030
3259	Structural clay products n.e.c	33	1.070	1.012	1.018
3316	Cold finishing of steel shapes	34	------	1.040	1.086
2091	Cottonseed oil mills	38	1.125	1.034	.913
2083	Malt	41	------	.971	1.000
2084	Wines, brandy, and brandy spirits	41	1.043	1.033	1.027
3255	Clay refractories	41	1.144	1.073	1.088
3493	Steel springs	41	------	1.022	1.045
2322	Men's and boys' underwear	42	------	1.027	1.044
3351	Copper rolling and drawing	43	1.423	1.071	1.222
2044	Rice milling	45	.959	1.030	.973
2069	Shortening and cooking oils	47	1.141	.981	1.083
3431	Metal sanitary ware	47	.989	1.018	1.074
2871-2	Fertilizers and mixing fertilizers	[3] 49	.978	.991	.858
3312	Blast furnaces and steel mills	49	1.064	1.024	1.072
3537	Industrial trucks and tractors	49	1.119	1.049	1.083
2061	Raw cane sugar	50	------	1.032	1.015
2515	Mattresses and bedsprings	[3] 50	------	1.025	1.043
3576	Scales and balances	50	1.130	1.040	1.081
3339	Primary nonferrous metals, n.e.c	51	------	1.143	1.102
3674	Semiconductors	51	------	.956	1.004
2911	Petroleum refining	[3] 52	1.021	.978	1.016
3273	Ready-mixed concrete	52	1.063	1.029	1.065
3519	Internal combustion engines, n.e.c	52	------	1.035	1.061
3613	Switchgear and switchboard apparatus	52	------	1.032	1.027
2654	Sanitary food containers	53	------	1.010	.998
3496	Collapsible tubes	54	1.045	1.053	1.036
2822	Synthetic rubber	56	.942	.988	1.007
3261	Vitreous plumbing fixtures	56	1.126	1.027	1.065
3562	Ball and roller bearings	56	------	1.014	1.049
2092	Soybean oil mills	57	------	.960	1.020
3673	Electron tubes transmitting	57	------	1.009	1.018
2121	Cigars	58	1.012	1.008	1.056
2052	Cookies and crackers	59	------	1.031	1.052
2131	Chewing and smoking tobacco	59	1.137	1.006	1.082
3221	Glass containers	59	1.123	1.072	1.071
3333	Primary zinc	60	------	.978	1.147
3263	Fine earthenware food utensils	61	1.126	1.042	1.066
3251	Brick and structured clay tile	62	1.107	1.038	1.062
2062	Cane sugar refining	63	------	1.021	1.069
3534	Elevators and moving stairways	63	------	1.024	1.075
2647	Sanitary paper products	64	------	.991	1.077
3612	Transformers	66	------	1.033	.945
2082	Malt liquors	[3] 67	1.044	1.015	1.026
2063	Beet sugar	68	------	1.024	1.037
3652	Phonograph records	71	1.108	1.044	1.031
2892	Explosives	72	1.014	1.013	1.029
3121	Industrial leather belting	72	------	1.097	1.072
3241	Cement, hydraulic	[1] 72	1.041	1.022	1.087
2271	Woven carpets and rugs	75	------	1.009	1.005
3262	Vitreous china food utensils	75	1.248	1.091	1.099
3635	Household vacuum cleaners	78	------	1.010	.987
3272	Concrete products, n.e.c	79	------	1.005	1.026
3275	Gypsum	80	1.005	1.030	.990
2111	Cigarettes	81	1.106	1.022	1.080
2823	Cellulosic manmade fibers	85	1.010	1.003	1.004
2824	Organic fibers, noncellulosic	85	------	.979	.999
2073	Chewing gum	88	.972	1.001	1.002
3692	Primary batteries, dry and wet	88	1.168	1.001	1.037
3672	Cathode ray picture tubes	89	------	.927	.926
3641	Electric lamps	93	------	1.038	.943
3671	Electron tubes, receiving type	95	------	1.050	1.144

[1] Weighted average of States.
[2] Weighted average of SMSA's.
[3] Weighted average of geographic divisions.

TABLE 2.—REGRESSION AND CORRELATION COEFFICIENTS RELATING P_t/P_o TO INDICATED INDEPENDENT VARIABLES

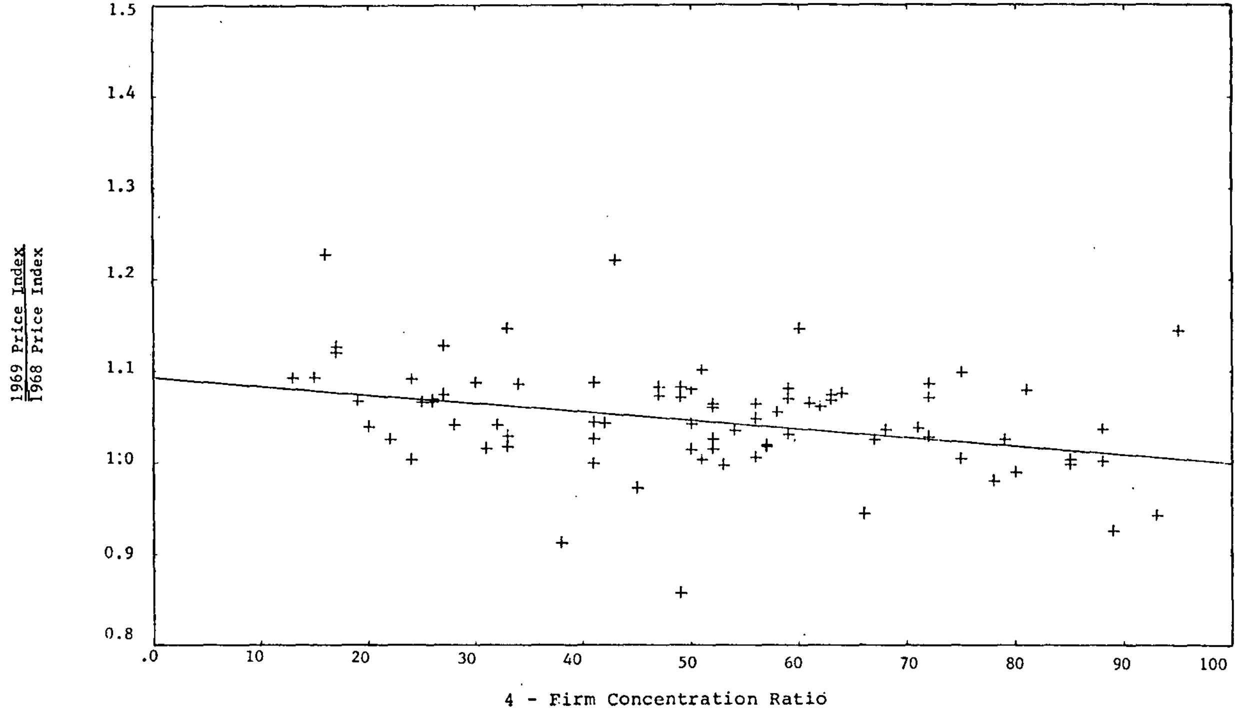
R^2 and degrees of freedom	Year		Constant	Independent variables					
	t	o		C_{66}	$\frac{Q_t}{Q_o}$	$\frac{CM_i}{CM_o} / \frac{Q_t}{Q_o}$	$\frac{CL_i}{CL_o} / \frac{Q_i}{Q_o}$	$\frac{Q_t}{Q_o} / \frac{MH_i}{MH_o}$	$\frac{W}{W_o} / \frac{MH_t}{MH_o}$
0.26	1968	1963	1.1510	−0.00113					
43−2=41				(.00065)					
0.34	1968	1963	1.1648	−.00112	−0.00919				
43−3=40				(.00064)	(.00651)				
0.79	1968	1963	.6508	−.00052	−.02553	0.51950	−0.05023		
43−6=37				(.00046)	(.00639)	(.07735)	(.07713)		
0.79	1968	1963	.5639	−.00042	−.02535	.51459		0.02922	−0.00062
43−7=36				(.00047)	(.00731)	(.07985)		(.06201)	(.13983)
0.25	1968	1967	1.0449	−.00038					
82−3=79				(.00017)					
0.25	1968	1967	1.0460	−.00038	−.00089				
82−4=78				(.00017)	(.00272)				
0.51	1968	1967	.8282	−.00041	−.00087	.11910	.09670		
82−6=76				(.00016)	(.00363)	(.03227)	(.05509)		
0.62	1968	1967	.9265	−.00037	.01169	.11746		−.08344	.07697
82−7=75				(.00014)	(.00486)	(.02933)		(.02135)	(.02232)
0.28	1969	1963	1.2602	−.00205					
43−2=41				(.00109)					
0.34	1969	1967	1.1428	−.00128					
82−2=80				(.00040)					
0.32	1969	1968	1.0943	−.00087					
82−2=80				(.00029)					

Concentration Ratio vs. Price Ratio
1968/1963
With Regression Line, Holding Ratios of Unit Labor Cost,
Unit Materials Cost, and Shipments Constant at their Averages

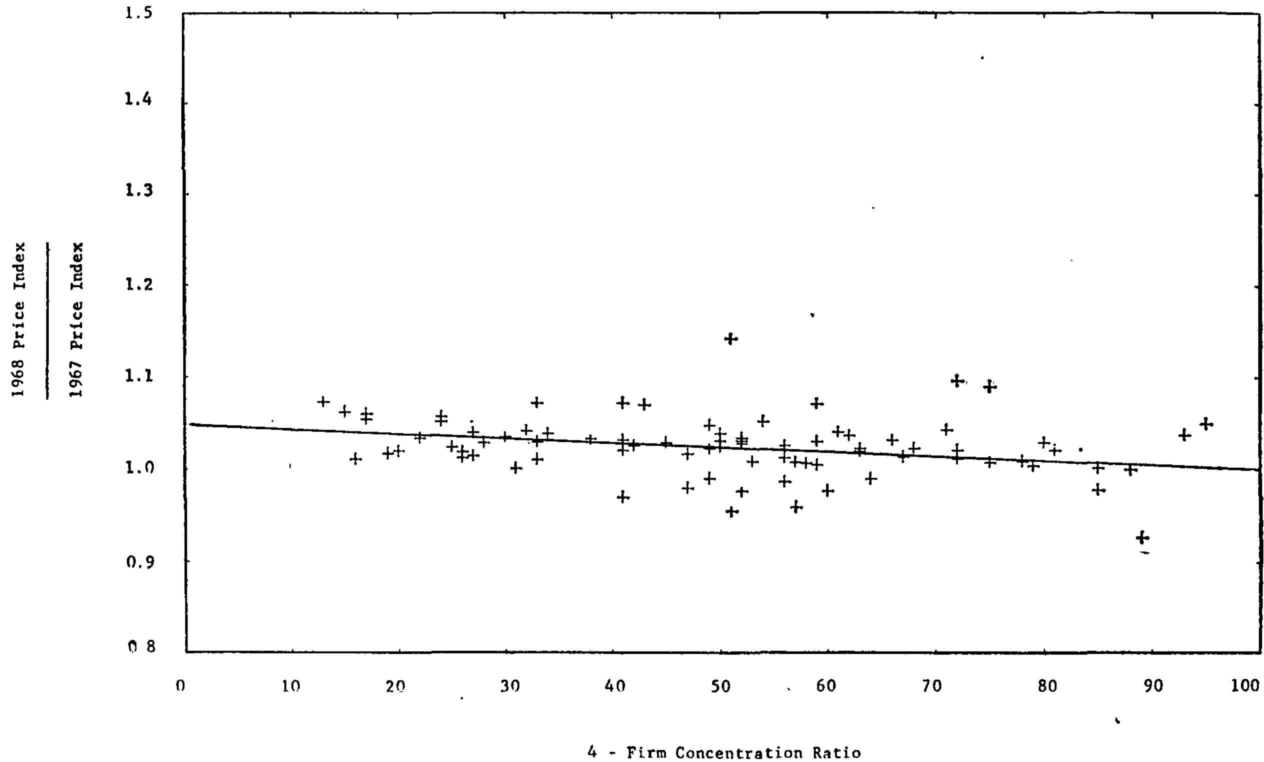


Concentration Ratio vs. Price Ratio

1969/1968
with Simple Regression Line



Concentration Ratio vs. Price Ratio
1968/1967
With Regression Line, Holding Ratios of Unit Labor Cost,
Unit Materials Cost, and Shipments Constant at their Averages



PREPARED STATEMENT OF ASSISTANT ATTORNEY GENERAL RICHARD W. McLAREN BEFORE THE SENATE BANKING AND CURRENCY COMMITTEE ON LEGISLATION TO AMEND THE BANK HOLDING COMPANY ACT—MAY 18, 1970

I appreciate the opportunity to appear before the committee to discuss this important subject. A little over a year ago, I testified before the House Banking and Currency Committee on this legislation. I pointed out at that time the rapid expansion of the one bank holding company movement, and stated my view that there was a definite need for legislation on the subject. I remain of the view that legislation is needed to insure that the bank holding company does not become a vehicle for imposing irreversible adverse effects on the nation's economic, social and political environment.

As I noted last year, we have in this country a traditional policy of separating commercial banking from other areas of economic activity. This policy rests on a number of considerations: first, the desire to insure the solvency of banks; second, a fear that affiliation between banking and non-bank institutions would impair competition by creating unjustified competitive advantages; and third, a general concern about over-all economic concentration in the society. This traditional policy is reflected with particular clarity in the Glass-Steagall Act of 1933, in which Congress prohibited banks from engaging in the securities business in order to avoid repetition of a history of abuses in the 1920s.

I believe that this traditional policy is sound. It would be particularly undesirable to have banks become the centers of much larger industrial-commercial groups, after the pattern of Japan and a number of other countries. Because of their unique position and power over money and credit, banks are particularly suited to become the keystones of powerful economic combinations, much as they are in Japan and other countries. We believe that the development of such combinations would be unfortunate, and completely inconsistent with past Congressional efforts to forestall increasing concentration—including the 1950 Celler-Kefauver Act, amending Section 7 of the Clayton Act, the Bank Holding Company Acts of 1956 and 1966, and the Bank Merger Acts of 1960 and 1966.

On the other hand, banking is not a static form of activity; modern bankers are offering a variety of specialized services which would have been entirely unknown to their predecessors of a few generations ago. There is a good economic case for providing greater flexibility as to the financial areas which banks and their affiliates are permitted to enter—provided this can be accompanied with adequate safeguards for competition and other interests. Innovation in financial fields should be encouraged. It seems particularly desirable to permit banks to enter other financial markets when competition is weak, or where banks can be expected to offer real efficiencies.

What is required, therefore, is legislation that will provide a mechanism for allowing bank expansion in areas where it is desirable, while minimizing competitive risks. We believe that the Administration proposal effectively accomplishes this balancing function.

There are, of course, important competitive risks involved, and these are of particular concern to the Justice Department. I discussed these risks at some length in my testimony before the House Committee on Banking and Currency. Basically, they spring from the fact that banks enjoy a significant degree of economic power, particularly in local markets where banking alternatives are few Banks are protected by regulation from free entry of other competitors, and therefore from the full rigors of unregulated competition. In times of tight money, banks ration a scarce and essential commodity. Many banking customers do not possess the same degree of financial sophistication as do the banks with which they deal, a situation that allows for at least the subconscious exercise of economic power. Even in normal times, relationships with all customers tend to be continuing ones, for there is relatively little effective opportunity for "shopping around" for credit. Changing banks is inconvenient and requires disclosures of sensitive competitive information needed for credit evaluation. Moreover, permanent relationships are regarded as hedges against hard times, when periodic limitations on the supply of available funds, imposed by regulatory authorities or general economic conditions, raise the possibility of informal credit rationing. In such circumstances, long standng customers obviously have a natural advantage.

The economic power enjoyed by banks is substantially enhanced by the fact that commercial banking markets are *local* markets for most customers. Competitive alternatives in local markets are few, and entry of new competitors is frequently restricted by legislative provisions or regulatory action. For substantial classes of financial customers in such markets, unable to journey conveniently and economically to distant metropolitan areas, local banks can be the sole suppliers of the services needed.

Bank expansion in other areas permits the carryover of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature—adverse competitive effects that would tend to develop naturally without actual overt use of the economic power carried over from the banking sphere. I refer to a voluntary form of reciprocity or tie-in effect, where a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.

This can be illustrated by looking at an example I used in my testimony last year. A potential loan applicant might *voluntarily* place his casualty insurance business with a bank affiliated insurer in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in; competition in the tied product (insurance) would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. If a pattern of such bank-insurance affiliations developed, the problem would become more serious, increasing the degree of market foreclosure in the tied field.

Such voluntary tying, or "tying effect" as we called it in a recent case, is the product of market structure, not misconduct. This structural problem is intensified because present antitrust remedies appear inadequate to deal directly with it. There simply is no illegal practice or conduct for a court to enjoin. We believe that bank acquisitions presenting such structural dangers may be challenged under present antitrust law, particularly Section 7 of the Clayton Act Section 7 is an important weapon. Under it, we can challenge bank acquisitions which eliminate substantial direct horizontal competition in any particular financing field; we can challenge mergers which involve significant vertical foreclosure; and we can challenge product extension mergers which involve significant loss of potential competition or create dangers of tie-ins or reciprocity.

For example, in 1969, we challenged the acquisition of Chubb Corp. by First National City Bank of New York on the grounds of possible tying and other leverage; the bank abandoned the acquisition, after learning of our opposition, before a formal complaint was filed.

On April 24 of this year, we filed a complaint challenging the proposed acquisition of American Credit Corporation, a $400 million institution operating in sales and consumer financing, factoring and insurance, by the Wachovia Corporation, parent company of the largest commercial bank in the southeast. In this case, we allege that the proposed acquisition will eliminate actual and potential competition in various fields, as well as enhance the power of Wachovia and American to employ tying and benefit from tying effect. As this litigation is pending, I would not wish to comment further upon it.

These cases involve big national enterprises, with anticompetitive effects in various markets, large and small. While the same types of theories could be applied to deal with regional and local market situations, the Antitrust Division simply would not have the time and resources to apply even a well established merger theory to the many anticompetitive acquisitions that might occur in local or relatively local markets. And as I have indicated, local markets present perhaps the greatest competitive risks because banking alternatives are few in many such markets; yet customers in these smaller markets should be just as entitled to the benefits of competition as those affected by the largest nationwide acquisitions.

In the circumstances, we feel very strongly that the present regulatory scheme must be extended to the extent necessary to screen acquisitions and lighten the load on the Antitrust Division in this area. There are also other considerations.

The structure of financial markets tends to be an enduring one; and divestiture tends to be difficult. This places a premium on acting now rather than later. In other words, let's tend to the barn door and the fences before the stock has run off.

To summarize, since bank expansion into other fields involves inherent competitive risks unrelated to even the best intentions of the bankers, it should be authorized only where it can be shown to present advantages to the public in the form of greater efficiencies or otherwise, and only under proper safeguards. The dangers are no less from the great one bank holding companies than from multiple bank holding companies, and like safeguards should be provided. Therefore, what is needed, it seems to us, is a bill that is firm, yet flexible; that provides standards and procedures under which bank affiliation with a particular type of financial enterprise will be carefully scrutinized, and under which competitive risks will be weighed against expected benefits.

Pending Legislation

There are three bills pending before the committee, H.R. 6778 as enacted by the House of Representatives, S. 1664 (which is the Administration Bill) and S. 1052 (introduced by Senator Proxmire). All of these bills would close the "one bank holding company" loophole in the Bank Holding Company Act of 1956. H.R. 6778 and S. 1664 would also amend the provisions of that Act dealing with non-banking activities of bank holding companies by requiring regulatory approval of bank entry into related financial fields under standards which differ in their precise wording, but which are essentially similar in substance. In addition, H.R. 6778 would absolutely proscribe bank expansion into certain activities. S. 1052 is essentially a stop-gap measure; it would leave present law governing bank entry into other areas intact pending further study of the matter by a newly created Presidential Commission on Banking.

There are some important differences between these various pieces of legislation. I propose to discuss each of them separately, covering: (1) substantive legal standards covering bank entry into non-banking fields (2) the administrative procedures governing such entry (3) the question of grandfathering and (4) the question of whether to have stop-gap or permanent legislation at this time.

1. Substantive Standards Governing Bank Expansion

S. 1664 would amend Section 4(c)(8) of the Bank Holding Company Act of 1956 to permit control by a bank holding company of any company (other than a securities firm) determined "(1) to be financial or related to finance in nature, and (2) to be in the public interest when offered by a bank holding company or its subsidiaries." It requires the three banking agencies to establish guidelines giving consideration to "any potential anticompetitive effects of a bank holding company engaging in any proposed type of activity." Each agency is also obliged to apply an antitrust type standard to individual transaction.[1]

Thus, the banking agencies are clearly required to give full weight to competitive considerations. In addition, the "public interest" standard makes absolutely clear that expansion into a particular non-banking activity should be authorized only where affirmative advantages to the public can reasonably be established.

We regard the public interest standard as being particularly important. As the Supreme Court has said, the term "public interest" "is not a concept without ascertainable criteria"[2] and the public interest standard makes allowance for competitive needs, as the Supreme Court has recognized on a number of occasions.[3]

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[1] "The appropriate banking agency shall not approve—

"(a) any retention or acquisition under this clause which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize any part of trade or commerce in any part of the United States, or

"(b) any retention or acquisition under this clause whose effect in any line of commerce in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade."

[2] *New York Central Securities Corp.* v. *United States*, 287 U.S. 12, 25 (1932).

[3] "We therefore hold that the antitrust test formulated by the Commission is an appropriate refinement of the statutory 'public interest' standard." *Federal Maritime Commission* v. *Aktiebolaget Svenska Amerika Linien*, 390 U.S. 238, 246 (1968). See also *United States* v. *Radio Corp. of America*, 358 U.S. 334, 351–2 (1959). For a recent holding of the United States Court of Appeals for the District of Columbia to the same effect, see *Northern Natural Gas Co.* v. *Federal Power Commission*, 399 F. 2d 953, 960 (1968).

H.R. 6778 contains both a general standard for bank expansion and a specific list of prohibited activities. The general provisions do not seem to me to be substantially different in effect from those in S. 1664, and therefore I would find either set of general provisions acceptable. The express list of prohibited activities has no counterpart in S. 1664 and it seems quite unsatisfactory from the standpoint of general policy. I will discuss both aspects of H.R. 6778 briefly.

H.R. 6778 as enacted would add a new Section 4(e) to the Bank Holding Company Act of 1956 to provide that a holding company "may carry on any activity of a financial or fiduciary nature" provided that the Federal Reserve Board finds that (i) the activity is "functionally related to banking" and (ii) it "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition or gains in efficiency that outweigh possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices."

Under either H.R. 6778 or S. 1664, bank affiliates could be authorized to enter other financial areas where such entry would tend to promote competition and economic efficiency, or at least make more efficient use of existing bank facilities, due allowance having been made for any adverse effects on competition.

Either bill would preserve all antitrust remedies for particular situations, and would allow unencumbered challenges under the antitrust laws of bank holding company acquisitions in non-banking areas even after regulatory approval.

Both bills also make considerations of size relevant in determining the likely effects of any proposed activities. S. 1664 provides that "limitations on permissible activities may be established on the basis of any relevant factors, including the size of [the] bank holding company or its subsidiary banks, the size of any company [to] be acquired or retained, and the size of communities in which such activities should be permitted." Under the wording of S. 1664, it would therefore be possible, where appropriate, for the banking agencies to distinguish between *de novo* entry into a field and entry by acquisition, since this is clearly a relevant factor in appraising competitive effects.

In like manner, H.R. 6778 specifically states that "in orders and regulations . . . the Board may differentiate between activities commenced de novo and activities commenced by the acquisition, in whole or in part, of a going concern."

To summarize, the general standards in both bills seem to provide a flexible and fair means by which the regulatory agency involved can take into account a whole variety of relevant considerations and authorize activities by bank affiliates in areas where the public interest will be served.

Let me now turn to the specific activities which H.R. 6778 would bar banks from entering. In our view, this is a very serious, and indeed overriding, defect in H.R. 6778. It would prohibit banks and bank affiliates from:

(1) engaging in the securities business (including mutual funds);

(2) engaging in insurance (other than credit life insurance) as principal or agent;

(3) operating a travel agency;

(4) providing auditing or other accounting services;

(5) providing data processing services—other than (a) payroll services or (b) leasing of computer capacity;

(6) leasing of property (except where such lease in effect constitutes a sale).

We believe these absolute proscriptions are inflexible and unsound. They are at cross purposes with what should be the basic intent of the bill—to permit bank entry into related financial activities where adverse economic effects would be insubstantial and where advantages to the public interest would be great. We do not believe that economic evidence justifies a legislative conclusion that *any* bank affiliated entry into any of these areas in *any* market would necessarily have adverse effects outweighing possible benefits. The better alternative would be to eliminate these proscriptions, enabling the regulatory agency to apply the general standards of the statute in a non-discriminatory manner. Indeed, that agency may ultimately decide that some or all of the activities enumerated in H.R. 6778 should be out of bounds for banks, but one of the bill's most important features, flexibility, would be preserved. Such a course would permit banks to demonstrate, now or in the future, that their entry into these activities in a given manner would be in the public interest. It would also prevent immediate adverse competitive effects in the markets legislatively insulated from bank competition, effects which would attend the absolute removal of a whole class of potential entrants. Accordingly, we strongly urge passage of a

bill that does *not* contain a list of specified activities which are arbitrarily and unconditionally proscribed for banks.

It is true that the Congress in 1933 enacted § 20 of the Glass-Steagall Act (12 U.S.C. § 377) preventing banks and their affiliates from engaging in the securities business—a restriction which we both continue to support and have specifically embodied in S. 1664. This Glass-Steagall prohibition, however, was based on substantial evidence of abuses in the 1920's which were found to have contributed to the ill health of the banking industry by the end of that decade. In our view, such absolute legislative proscriptions should be rare exceptions, justified only when convincing evidence is adduced proving the absence of any possible beneficial effects which might outweigh adverse consequences. No such evidence is present to support the prohibitions in H.R. 6778.

S. 1052, which I will discuss in more detail in a moment, would not change the existing substantive provisions of the Bank Holding Company Act of 1956 regarding bank activity in non-banking fields.

2. The Administrative Procedures Governing Bank Entry into other Fields

H.R. 6778 provides that all regulatory decisions regarding bank holding company acquisitions and activities would be made by the Federal Reserve Board. Under S. 1664, approval of entry by bank holding companies into related financial fields would be sought from one of three Federal banking agencies, *i.e.*, the Federal Reserve Board, the FDIC or the Comptroller of the Currency, depending on the preponderance of the assets of the company's banking subsidiaries. However, the appropriate agency could only approve activities unanimously determined by all three to meet the statutory criteria. We recognize that there are certain arguments to be made in favor of this three-agency approach, and we do not oppose it. However, we believe that regulation of related financial activities by bank holding companies by the Federal Reserve Board alone is superior, and thus prefer H.R. 6778 (and S. 1052) to S. 1664 in this limited respect. Single agency administration is clearly simpler than three-agency administration. The Federal Reserve Board, which includes several distinguished professional economists, is well qualified to make such decisions. The Board's present responsibilities over bank acquisitions by multi-bank holding companies. as well as the financial, fiduciary, or insurance activities of such companies presently permissible under Section 4(c)(8), have given it substantial experience and expertise in areas which will be useful in administering the types of arrangements which would be established under either H.R. 6778 or S. 1664. Moreover, in our view, the Board has done a generally sound and responsible job of handling bank acquisitions under the competitive tests established under the Bank Holding Company Acts of 1956 and 1966 and the Bank Merger Acts of 1960 and 1966; there is no reason to believe that it would not carry forward such experience and policy in applying the new competitive tests for non-bank acquisitions which would be established by either S. 1664 or H.R. 6778.

Consistency and predictability in agency administration is desirable, especially if banks continue to seek entry into related financial fields at their present pace. We believe that a single agency is likely to lead to greater consistency and predictability. Although S. 1664 would require the establishment of guidelines by unanimous agreement of the three banking agencies, it is not unlikely that differing conceptions of the importance of relevant factors, including competition, could lead to differing interpretations of those guidelines. This, in turn, could lead to "forum shopping", and we think holding companies should not be encouraged to alter the character of their banking affiliates in order to seek the most favorable forum in which to present their cases for certain types of expansion.

Finally, I would like to point out that under either bill, approval of subsequent *bank* acquisitions by all bank holding companies would remain the responsibility of the Federal Reserve Board. Thus, under S. 1664, a large number of such companies would find their banking and non-banking activities regulated by two different federal agencies. This situation would waste agency expertise developed in the markets served by a given company, as well as introduce multiple regulators and uncertainty into the operations of bank holding companies. To summarize, we believe that regulation of related financial activities should be the responsibility of a single banking agency, and that the Federal Reserve Board is the most qualified to be that agency.

3. The "Grandfather" Clause Question

The other major substantive difference between S. 1664 and H.R. 6778 as passed by the House involves the "grandfather clause" governing activities of bank

affiliates in other financial fields. Unlike H.R. 6778, S. 1664 would protect investments of one-bank holding companies as of June 30, 1968, while preventing any further expansion outside approved areas. In selecting this date, the Administration has sought to strike an equitable compromise between disturbing long-standing investments, on one hand, and the need to prevent wholesale avoidance of the policies of the new legislation, on the other. The date of June 30, 1968, was selected—and is supported by us—on the ground that it predated the wave of one-bank holding company formations by the nation's largest institutions. This wave was touched off by the announcement on July 3, 1968, that First National City Bank of New York intended to take this route as a means of expanding its activities outside the banking field. Thus, the "grandfather clause" in the Administration bill would not affect about 680 older one-bank holding companies controlling total bank deposits of less than $18 billion, while leaving the new rules in the bill fully applicable to the 200 or so new one-bank hoding companies controlling over $160 billion[4] in deposits. The latter group includes all the very largest banks which have announced formation of one-bank holding companies. We believe that this compromise is fair, but that it would be undesirable to place the date later than June 30, 1968. Accordingly, we oppose the January 1, 1969 cut-off date in S. 1052, as being too late a date.

Much more serious is the May 9, 1956 "grandfather clause" date in H.R. 6778. I fully endorse Dr. Walker's comments in opposition to this grandfather date. It is quite unnecessary to accomplish the purposes of this bill to go back fourteen years to 1956, and require divestiture of acquisitions made during that long period. Moreover, there would be a considerable element of unfairness in doing so, since the Congress decided in 1956 to exclude one-bank holding companies from the Bank Holding Company Act.

4. The Question of Whether to have Stop-Gap or Permanent Legislation at This Time

This question is raised by S. 1052. This bill (introduced by Senator Proxmire) would close the "one bank" loop-hole in the Bank Holding Company Act of 1956 by making one-bank holding companies subject to the same limitations now applied to multiple bank holding companies. In other words, under S. 1052, bank entry into non-bank activities would be governed by the substantive rules set forth in Section 4(c) (8) of the 1956 Act[5] and the Federal Reserve Board would have exclusive jurisdiction. The bill would also create a National Commission on Banking to study the role of banking in the national economy, including restrictions on banks engaging in non-banking activities and restrictions on bank holding companies.

Unlike S. 1664 and H.R. 6778, S. 1052 contains no substantive standards for regulating entrance of banks into related financial activities. It is more of a stop-gap measure designed to elicit more information before establishing legislative standards in this area. Of course, S. 1052 does bring one-bank holding companies within the scope of some regulation, and thus in part satisfies the urgent need for legislation in this area. However, we believe that the rapid trend toward entry of banks into related financial fields requires both greater flexibility than the present law provides and some Congressional guidance over regulatory decisions at this time.

Certainly a bill of the type we urge, which establishes flexible standards, and does not absolutely proscribe or authorize bank entry into specified areas, would not be inimical to further study in the area by a National Commission on Banking. Both the Congress and the regulatory agency (or agencies) given responsibility would be able to consider and implement the eventual findings and recommendations of the Commission.

In concluding, let me say that I remain of the view that legislation is urgently needed to close the one-bank holding company loophole in the Bank Holding Company Act of 1956 and to provide reasoned guidance to the entry of banks into related financial fields. Although the Anti-trust Division has continued and in some ways strengthened its efforts to prevent the development of anticompetitive

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[4] At the end of 1969, there were more than 890 one-bank holding companies controlling deposits of about $180 billion. *Recent Changes in the Structure of Commercial Banking*, 56 F.R.B. 195, 200 (March, 1970).

[5] Present Section 4(c)(8) permits a bank holding company to engage in activities "of a financial, fiduciary, or insurance nature" which the Federal Reserve Board determines "to be so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto. . . ."

concentrations of economic power—with their attendant social and political implications—since I testified on this matter a little over a year ago, it is clear the continuing developments make such legislation important.

Chairman PATMAN. For obvious reasons I am very much interested in the testimony of you two gentlemen, and each of your prepared statements is very fine, very comprehensive, and I appreciate very much your appearing before this committee.

Mr. Budge, you made one statement in your prepared statement that I would like to pursue just a moment. It says "companies were buying other companies or merging with other companies because there were substantial immediate financial advantages."

Now that is well known, of course, but the specific facts are not too well known. Would I be imposing upon you too much to ask you to insert in connection with your remarks a statement showing the advantage to the companies involved in these mergers?

Mr. BUDGE. I shall be happy to do so.

Chairman PATMAN. Including the different tax advantages and fringe benefits not only for the year of the merger or of the undertaking by the conglomerate but also in subsequent years.

Mr. BUDGE. Yes, sir.

(The following information was subsequently supplied for the record by Mr. Budge:)

GENERAL FINANCIAL AND TAX BENEFITS AVAILABLE TO ACQUIRING COMPANIES

There are immediate financial advantages available to firms which are selective in their acquisition programs. Aside from the obvious financial advantage in acquiring firms which are undervalued by the market, there are also possible advantages in terms of liquid assets which can be acquired or in terms of leverage which can be obtained by acquiring a firm whose capital structure contains considerable liquid assets and/or a low amount of debt. Moreover, there also are apparent improvements in per share earnings that can be obtained in the process of a merger.

As an illustration of the latter point, consider a merger involving two companies whose total earnings are about equal and that each company is earning one dollar per share on one million shares of common stock, but that the stock of the acquiring company sells at 30 times earnings while the common stock of the target company sells at 15 times earnings. If a merger takes place through an exchange of stock based on market value, i.e., one share of the acquiring company for each two shares of the target company, the total earnings of the surviving company doubled, while the total outstanding shares have only increased 50 percent. Therefore, as a result of the mathematics of the exchange process, the earnings per share of the acquiring company would jump from one dollar per share to $1.33 per share. Under normal market conditions, the price/earnings ratios of the surviving firm would adjust downward in the market according to traditional theory of corporate finance unless the merger were expected to result in a higher rate of profitability for the combined firms. However, in the more speculative market of the mid-1960's, there appeared to be a "magic" about reported increases in earnings, irrespective of the source, and these downward adjustments in P/E ratios were delayed until the conglomerate merger movement was brought under public questioning by many sources several years ago.

During the last half of 1968 and the earlier part of 1969, however, there was a trend toward the increasing use of debt securities to finance acquisitions as compared with the use of currently available cash, the cash provided by the acquired company, or the stock of the acquiring company. One apparent reason for the increasing use of debt financing in those years may have been the fact that the tax laws *appeared* to encourage this method of financing to some stockholders. To the extent that an acquiring firm used debt instead of equity in the acquisition process and subsequently was able to pay interest rather than an equal amount of dividends, the net income of the surviving company would be increased because of the tax benefits which allow interest as a deductible expense. Moreover, in the years ahead, following the merger, interest payments

remain a deductible expense, and at the same time, there are relatively fewer shares of common stock of the surviving company outstanding on which to base per share earnings. Thus the surviving company's stock may be more highly leveraged.

As an illustration of how this type of exchange could benefit both the low net tax shareholders of the target firm and the acquiring firm, take the earlier example and assume that each firm has a 50 percent tax rate. The acquiring firm could exchange $15 million in bonds bearing an eight percent interest rate, giving the shareholders of the target firm securities with a face value equivalent to the market value of their stock and annual interest equal to 120 percent of the earnings of their firm and, at the same time, increase by 40 cents the per share earnings of the acquiring firms—seven cents a share more than a straight stock exchange would provide. Of course the U.S. Treasury would lose $600 thousand in tax revenue a year by this type of exchange as compared with an exchange of stock.

The Tax Reform Act of 1969 contained provisions to discourage debt-financed corporate acquisitions by disallowing interest deductions under specified circumstances for debt used for acquisition purposes. This may have had a mitigating effect on the use of debt for acquisition purposes. Since mid-1969, and particularly in recent months, there has been a sharp decline in registrations with the Commission of debt securities for purposes of exchange.

Chairman PATMAN. Let's see now, you mentioned, Mr. Budge, the value of new stock issues being registered with the SEC. The amount has gone up tremendously each year and each month, and I assume each day.

I notice you said something about $800 million in connection with the purchase by funds of different types. Would you repeat that statement; I didn't get it all.

Mr. BUDGE. That figure of $900 million related only to the pension funds. They were in the month of May net purchasers of equity securities in the amount of approximately $900 million.

Chairman PATMAN. How does that compare with months before and subsequent to that time?

Mr. BUDGE. It is substantially greater.

Chairman PATMAN. Substantially greater. Just the month of May?

Mr. BUDGE. Yes, sir.

Chairman PATMAN. This year, 1970?

Mr. BUDGE. Yes, sir.

Chairman PATMAN. Yes.

Mr. BUDGE. I would be happy to insert in the record the net purchases of each of the classes of institutions if you would like that.

Chairman PATMAN. If you will please, please insert it at this point, Mr. Budge.

(The following information was subsequently supplied for the record by Mr. Budge:)

STOCK TRANSACTIONS OF SELECTED FINANCIAL INSTITUTIONS: 1969–1970

During the past two years, the Commission staff has been developing monthly data on the stock transactions of five major financial intermediaries; i.e., private noninsured pension funds, open-end investment companies, closed-end investment companies, life insurance companies and property and liability insurance companies. This was undertaken as an expansion of a quarterly program which was begun in the early 1960's.

Transactions data on these institutions suggest that their transactions may have had a stabilizing influence during this period. They have been net accumulators of stock at an increasing rate all during the stock market decline. Net stock acquisition of these five institutions totaled a record $9.7 billion last year, one-fifth more than in 1968. Moreover, while the volume of trading by these institutions has declined below their 1969 rate during the first five months of this year,

most of the reductions were in disposals of stocks resulting in substantially larger net additions to portfolio holdings of stocks than in the comparable 1969 months. In fact, in the month of May alone noninsured private pension funds added nearly $900 million to their holdings of common stock—substantially more than a year earlier—and net acquisitions of all of these institutions combined in the first five months were 30 percent larger than for the same period last year.

GROSS PURCHASES, SALES, AND NET ACQUISITIONS OF COMMON STOCK BY SELECTED INSTITUTIONS

[In millions of dollars]

	Monthly 1970				
	January	February	March	April	May
1. Private noninsured pension funds:					
A. Purchases	1,430	1,230	1,470	1,280	1,370
B. Sales	840	960	1,010	820	470
C. Net purchases	590	260	460	460	900
2. Open-end investment companies:					
A. Purchases	1,400	1,580	1,500	1,340	1,120
B. Sales	1,430	1,540	1,260	1,160	1,190
C. Net purchases	−30	40	240	180	−80
3. Life insurance companies:					
A. Purchases	280	270	380	350	250
B. Sales	140	150	180	120	80
C. Net purchases	130	120	200	220	170
4. Property and liability insurance companies:					
A. Purchases	230	280	340	310	270
B. Sales	210	150	180	250	100
C. Net purchases	30	130	160	60	180
5. Closed-end investment companies:[1]					
A. Purchases	40	40	30	40	30
B. Sales	20	30	30	40	30
C. Net purchases	20	10	([2])	([2])	([2])
6. Total:					
A. Purchases	3,380	3,390	3,730	3,310	3,040
B. Sales	2,650	2,830	2,670	2,400	1,870
C. Net purchases	740	560	1,060	920	1,170

[1] Data reported monthly by approximately 20 companies.
[2] Less than $5,000,000.

Source: Office of Policy Research, Branch of Capital Markets, Securities and Exchange Commission, July 1970.

GROSS PURCHASES, SALES, AND NET ACQUISITIONS OF COMMON STOCK BY SELECTED INSTITUTIONS

[In millions of dollars]

	Monthly 1969												
	January	February	March	April	May	June	July	August	September	October	November	December	Year
1. Private noninsured pension funds:													
A. Purchases	1,350	1,120	1,220	1,180	1,260	1,430	1,200	1,080	1,090	1,420	1,250	1,620	15,230
B. Sales	940	690	750	950	1,040	800	790	800	800	1,040	740	930	10,270
C. Net purchases	410	440	470	230	220	630	420	280	300	370	510	690	4,960
2. Open-end investment companies:													
A. Purchases	2,020	1,600	1,570	1,860	2,170	2,260	1,700	1,410	1,870	2,230	1,680	1,680	22,060
B. Sales	2,360	1,430	1,530	1,650	1,750	1,800	1,680	1,430	1,540	2,080	1,240	1,380	19,850
C. Net purchases	−340	170	40	210	420	470	20	−20	340	150	440	300	2,210
3. Life insurance companies:													
A. Purchases	310	250	320	250	320	360	230	320	170	300	360	510	3,700
B. Sales	100	170	160	100	140	260	180	200	190	250	160	270	2,180
C. Net purchases	200	70	170	160	180	100	60	120	−20	50	200	240	1,520
4. Property and liability insurance companies:													
A. Purchases	280	220	270	280	220	470	330	230	390	230	370	490	3,870
B. Sales	190	110	220	250	210	250	190	170	520	290	170	310	2,880
C. Net purchases	90	110	50	40	10	220	140	60	−130	−60	200	180	900
5. Closed-end investment companies:													
A. Purchases	50	80	60	80	60	70	50	40	50	70	50	30	690
B. Sales	60	50	40	60	70	60	40	40	60	60	30	30	580
C. Net purchases	−10	30	20	10	−10	20	20	0	−10	10	20	10	100
6. Total:													
A. Purchases	4,010	3,270	3,450	3,660	4,020	4,590	3,520	3,080	3,580	4,250	3,710	4,320	45,460
B. Sales	3,640	2,450	2,700	3,020	3,200	3,160	2,870	2,640	3,110	3,720	2,340	2,910	35,770
C. Net purchases	360	820	750	640	820	1,430	650	440	470	530	1,370	1,420	9,690

Source: Office of Policy Research, Branch of Capital Markets, Securities and Exchange Commission, May 1970.

Chairman PATMAN. Did the Securities and Exchange Commission have any forewarning of the difficulties of the Penn Central Transportation Co., and did the SEC take any steps to protect the investors in this corporation?

Mr. BUDGE. I had no personal knowledge. Now whether there was knowledge within the staff, Mr. Chairman, I just don't know. I know of no steps which were taken as a result of such knowledge, assuming that there was knowledge on the part of the staff.

Chairman PATMAN. Do you know of any current investigation that is being conducted by the SEC in regard to any part of the Penn Central?

Mr. BUDGE. Of course, the historical position of the Commission has been that it does not affirm or deny whether or not investigations are under day. We have had, however, for a few weeks an investigation as to the reporting practices of the Penn Central and other railroads, at least one other railroad, with regard to the allocation of passenger revenues and costs vis-a-vis freight allocations.

Chairman PATMAN. I believe it was at the first meeting called at the request of the White House that the information was disclosed that last year, 1969, the Penn Central had about $50 million in income from unrelated businesses. Is that approximately correct?

Mr. BUDGE. I am not familiar with those figures, Mr. Chairman.

Chairman PATMAN. Yes, sir. All right. Thank you. You are cooperating with the congressional committees, both in the House and the Senate on information that is requested by these committees, I assume.

Mr. BUDGE. Yes, sir; including this committee.

Chairman PATMAN. I thought it would be fine if you would respond to questions that our committee asked you to reply to, and you have given us all the information we have requested, and we appreciate it very much.

Mr. BUDGE. Thank you, Mr. Chairman.

Chairman PATMAN. Now then, Mr. McLaren, I have been impressed with the forthright attitude that your antitrust section has taken on many issues, particularly before our Committee on Banking and Currency in the House on many different issues that you have handled, and your testimony has always been forthright and very helpful and constructive.

It appears there are a number of basic and very important antitrust issues involved in the Penn Central case and I would like to know whether or not your office is conducting or planning to conduct any investigation into the antitrust aspects of the Penn Central case.

Mr. MCLAREN. Mr. Chairman, there is quite a history of interest in the Penn Central situation in the Antitrust Division. This was largely determined before my time. We have not, as of the present time, started anything new. We will, of course, be watching for anything that seems to call for us to take an interest in it. However, the chairman may remember we argued the merger of the Northern Lines last fall in the Supreme Court. I think a fair interpretation of the Court's decision in that case is that these rail mergers are the business of the ICC rather than the Justice Department; so long as ICC takes into account the competitive factors, it may make its determination on broad public interest grounds as it views the public interest. Therefore, we are moving rather slowly in this field.

Chairman PATMAN. Although I do not impugn the motives or the intentions of the fine Banking and Currency Committee of the Senate in passing on the one-bank holding company bill, and I know they acted conscientiously from their viewpoint, I am disappointed, as you indicated you are, in the bill that was reported. We still have some chance, I think, for improvements on the floor of the Senate, but I don't feel that the bill as it now stands would answer the problem that it was originally intended to meet. When the bill was introduced, it was intended to close one loophole. Now, if I understand it correctly, it has not closed that loophole but has broadened it considerably and has also created, I am afraid, many other loopholes. So I share your hope that something will be done about it before it passes the Senate.

Personally, I think that bankers have the most lucrative privilege that has ever been granted to any group and by any country since the beginning of civilization. They can create money for the country, and without cost, of course, under limitations that are considered fair and reasonable. I have no reason to oppose this and do not oppose it if used in consideration of the public interest. With all the moneymaking privileges and fringe benefits that banker's have, I have a feeling that this franchise is so lucrative that they should be happy with pursuing their business, with the privileges now granted to them by law.

Right now we have a situation like this, and I want to ask each one of you witnesses to give me some comment on it. I am not sure that savings and loans, for instance, or thrift institutions can survive indefinitely with the kind of competition that banks are allowed under the law to furnish. Only the banks can offer checking accounts. That means that the banks have about $225 billion at all times free of any interest cost. This situation was brought about by a quirk, I guess I will call it, in the original Federal deposit insurance law. I was here when the law was passed, and I was one who signed a petition that we would not adjourn Congress until we had an FDIC. We actually got an FDIC Act passed which was temporary, only providing for $2,500. In order to get that it was necessary for us to agree that there would be no interest on demand deposits.

At that time the question didn't mean much, and there was not much objection to it, but now it means billions of dollars a year, and that is just one of the benefits that commercial banks have over the savings and loan associations.

I shall not proceed on this further but I just wanted to emphasize that this is an issue that we have got to solve and solve sometime in the near future.

All right, Senator Javits, you may interrogate the witness.

Senator JAVITS. Thank you, Mr. Chairman.

First, I would like to welcome both witnesses who are very distinguished Americans and important Government officials, and thank them for their testimony which I join with Chairman Patman in commending as of a very high level. I have also read Mr. Weinberger's prepared statement and, though I may not be here when he makes it, I wish to express the same view of his testimony.

In addition Hamer Budge is a very old friend and colleague of mine and it is a special pleasure to have him here.

I wanted to address just one question to you, Mr. Budge, if I may. That is, what order of priority do you think is required in the legisla-

tion presently before the Congress to insure dealer-broker relations with their customers? You refer to such legislation in your prepared statement in which you say that a broker-dealer insurance program is now being considered.

Now my information from the Street, and that is my constituency, is that such legislation is needed on the very highest priority. This is not to alarm but rather to reassure the investment community, especially the small investor, that he does not face some danger from the flank, along with the rise and fall of securities.

Would you comment, Chairman Budge, on the priority that should be accorded this legislation to install this insurance scheme?

Mr. BUDGE. Senator, the Commission feels that this legislation should deserve the highest priority.

Senator JAVITS. I too think that it is critically important.

Mr. BUDGE. We think it is essential.

Senator JAVITS. I know that your statement will have an effect on the Congress. I certainly agree very strongly with you. The people who are trading in securities also agree with the Commission thoroughly.

Now turning to you, Mr. McLaren, I note a very interesting thing, sir. I note that you come out flatly and strongly—in the interests of competition abatement of inflation and as a barrier to runaway prices—against new barriers to imports.

The administration, on the other hand, has spoken before the House Ways and Means Committee in favor of a quota bill of the kind which seems to be flatly in opposition to this concept that you set forth and with which I thoroughly agree.

Could you give us any clarification of this apparent contradiction.

Mr. MCLAREN. I don't think, Senator, that they are inconsistent. The point I am making is that particularly where we have concentrated industries in this country, we may have effective competition if we have imports that are coming in and furnishing the additional competition to bring competition up to an acceptable level. I think it can cause real difficulties and problems if we shut off that source of competition, and what I have said in my prepared statement is, in effect, let's continue to follow the policy of free trade, which has been the policy of this Nation for the last 30 years.

I have also said, however, as I think you have noted, in my prepared statement, that where we do have to have some protection against particular imports, whether it be because of dumping or because certain nations will not reciprocate on an open door policy or for whatever reason, if protective action is essential, my very strong feeling is that tariffs rather than quotas are the better method of attacking the problem.

I think that in the one instance that you mentioned, quotas under consideration, I still hope that the turn may be to tariffs, because as prices rise, additional supply can come on the market and tend to damp down the inflationary pressure.

Senator JAVITS. Well, Mr. McLaren, since you are an official of the Government in the executive department, I would not wish to put words in your mouth about the contradiction between this and the policy of the President. Therefore, I will say it. I think there is a contradiction, a serious one, because you yourself in the prepared state-

ment indicate that in oligopolistic markets prices tend to adjust more slowly. Mr. Weinberger in his statement speaks of textiles as being a concentrated industry. My own Governor, Rockefeller, of New York, points out the fantastic increases in retail prices of 50 percent in the prices of certain cuts of beef (nonprime), and almost 80 percent in the price of hamburger over the decade of the 1960's. Due, of course, are increases far in excess to the increases in the Consumer Price Index. I would take your statement as a very strong endorsement of a position against mandatory quotas coming from the antitrust end of our Government in light of the bills which are pending that seek to impose quotas as the cure for the sudden impact of imports.

Furthermore, as I understand it you do favor strengthening of existing law in respect to dumping, reciprocity, and government negotiated voluntary quotas and tariffs, and I agree with that.

Mr. McLAREN. May I say, Senator——

Senator JAVITS. Please.

Mr. McLAREN (continuing). I think that you misunderstood my reference to the meat industry. That is an example of a nonconcentrated——

Senator JAVITS. I know, but you say yourself that price adjustments, even in the nonconcentrated industries, lag because there are leading firms which must make conscious decisions on prices in oligopolistic markets, and they seem to adjust to the lag with an eye to public relations. Even there there is a price effect.

Mr. McLAREN. There is a lag in the concentrated industries, but in meat which is unconcentrated, the price and cost relationships adjust almost day to day. It is almost immediate.

Senator JAVITS. I agree, and we have seen a rapid upward spiral in meat prices which hurts the average family and housewife almost from the day the meat quotas were put into effect. Now, the other question I would like to ask you is a little longer range. I think I still have 2 or 3 minutes so I hope you will keep your answer relatively short.

Isn't it a fact, Mr. McLaren, that for reasons of efficiency and automation at home, and for reasons of competition abroad, which in turn directly affects our international balance-of-payments position, and considering the fact that even the merchandise trade balance is not nearly as favorable to us as it was, that we must now look to some new concept in the antitrust laws? The old antitrust concept, that if you kept conditions competitive and avoided monopolies, that automatic adjustments would bring out the best there is in an economy, really can no longer be relied upon, either in terms of domestic efficiency or in terms of the foreign competitive position.

Mr. McLAREN. No——

Senator JAVITS. You yourself admit that, it seems to me, in your conclusions in which you say the following:

"To sum up, fiscal and monetary policy seem to us to offer the greatest promise in our efforts to bring inflation under control" and so on.

Mr. McLAREN. That is in the short range, Senator.

Now, I must respectfully disagree with your statement, and particularly on foreign commerce. I think that all you have to do is to compare the record that the United States has made under competition with the records made by any foreign nation, under cartelism

or national socialism or what have you, and I think you have your answer.

I think it is very largely attributable to competition. I think it would be a disaster for this Nation to depart from this long held basic economic policy which is competition.

Senator JAVITS. Well, Mr. McLaren, my time is up, but I give you the examples of Germany and Japan as being the nations which are forging ahead in trade and economics very much faster than we, and with not nearly the standard that you have set. I also would like to note that I am not urging an absence of competition. I am only urging some new concept of the antitrust laws based upon the public interest and not only on competition which I think is too simplistic.

Thank you very much, Mr. Chairman.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. Gentlemen, I think both of your statements are helpful, and I certainly welcome them.

Mr. McLaren, I was delighted to hear you ad lib after you finished your statement on your opposition to the Williams amendment to the one bank holding company bill. This is, it seems to me, a complete cave in to the conglomerates especially with the grandfather clause of March 23, 1969, and it means that conglomerate are effectively taken out from under the bank holding company legislation. So I am delighted you have taken the strong position here, and I intend to make a fight on the floor. I made a fight, a losing fight, in the committee to knock out the Williams amendment so I will make another fight on the floor. You are right about the grandfather date. You and the Federal Reserve both said it would be a mistake to extend it beyond June 30, 1968, and I agree.

I am somewhat puzzled in view of the nature of your response to Senator Javits' last question. I am puzzled on your statement because you come up with a whole series of recommendations in your prepared statement which seem to me to be more motherhood and apple pie and not very helpful really in fighting inflation.

You say you are opposed to this collusive fee setting by pharmacists and real estate agents, and the Justice Department Criminal Division is going to go after the Mafia in the event they are responsible for inflation. You want us to critically examine free trade laws which are a State responsibility. We don't have the same kind of fair trade laws, at least on a Federal basis, as I understand it, there is not much that we can do about that.

On trade barriers, you compromise your position, in response to Senator Javits, and I appreciate that compromise and I think it is realistic, but once again I can't see that we are going to rely, at least increasingly, on foreign trade to overcome inflation and then you end up with your final brave position politically coming out squarely for consumer protection.

So I just don't see that this adds up to much of a program for fighting inflation by the chief antitrust officer of our Government.

Mr. McLAREN. Senator, I think the best answer that I can make to you is that based on our economic analysis, as best we can tell, the worst is behind us and it would be a mistake now to take rather drastic action which could be highly expensive and could lose the yardage we gained.

I think that is the best answer I can make on that.

Senator PROXMIRE. If you take the statement that Mr. Budge gave us, that I thought was quite alarming, maybe I misinterpreted it, Chairman Budge pointed out the volume of securities registered with the Commission in this conglomerate area increased from $880 million in 1966 to $11.2 billion, in other words, it increased almost twelvefold in 2 years, and while there are economic conditions now that temporarily seem to be halting this concentration it seems to me we are getting a tremendous increase in concentration through conglomerate route.

Doesn't this really suggest that we are going to have to crack down very hard on concentration if we are going to preserve this competition which you see, rightly, I think, is the long-range answer to inflation.

Mr. McLAREN. Well, Senator, I don't think that that takes into account what has happened since the first half of 1969. I grant you that when the administration changed, and we looked at what we were faced with in early 1969, the merger movement was going like a prairie fire. But I think that the strong stand that we have taken against conglomerate mergers of the major size, and the trend toward more mergers and defensive mergers being generated by the takeover mergers, and the giants merging with one another, we have very effectively put a brake on that. Then, you have had changes in the money market and in the stock market, and Congress has acted in the field of taxation of interest payments on debentures, and that has had its effect. I think that we are in a lot better shape than we were.

Senator PROXMIRE. I think that is true, and I think you have done a good job in many respects.

I simply wanted to make sure that you are not going to let up and you recognize some of this improvement has been for economic reasons, you just said that——

Mr. McLAREN. Yes, sir.

Senator PROXMIRE (continuing). And not for reasons of public policy.

Mr. Budge, I am very concerned about your statement when you discuss the disclosure provisions of the SEC Act which, I understand, is really the heart of much of the reason for your Commission, designed to inform the public on the financial conditions of corporations dealing in securities, and you mentioned the disclosure problem in context of merger activities in conglomerates and so forth.

It seems to me—and you point out that you are going to extend disclosure requirements with respect to registration forms.

The test of the pudding is in the eating and I would like to pick up the Lockheed case as an example. The SEC's disclosure regulations, in my view the SEC first dragged its feet over a year on my request for an investigation of the suppression of the C–5A cost overrun information. Second, after much urging on my part, the SEC finally concluded the staff investigation a few weeks ago.

Now as I read the staff study I see very serious failure of disclosure on Lockheed's part. Yet the SEC said there was no evidence of legal violation despite the fact there had been suppression of information while Lockheed was selling $125 million worth of debentures in the

market, and the company knew it, but the public didn't know it, didn't know about these enormous overruns; they were available to people in the Pentagon, and to procurement officials, but they were not generally available to the people who, in good faith, bought those debentures.

It seems to me that the SEC's conclusions are inconsistent with the staff study.

Could you comment on this, and also tell us whether in addition to the staff study, which has been released, there were staff recommendations and, if so, can you provide us with those recommendations?

Mr. BUDGE. So far as I know, Senator, the complete text of the staff report to the Commission was delivered to your committee.

Senator PROXMIRE. Were there staff recommendations?

Mr. BUDGE. Yes.

(The following letter of clarification was subsequently supplied for the record by Mr. Budge:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C.

Hon. WILLIAM PROXMIRE,
U.S. Senate, Washington, D.C.

DEAR SENATOR PROXMIRE: As you will recall from our conversation after my appearance before the Joint Economic Committee on July 10, 1970, I explained that I had inadvertently misspoken in response to your question concerning the inclusion of staff recommendations in the investigative report relating to Lockheed Aircraft Corporation.

As Mr. Pollack's testimony indicated, staff recommendations were made during the Commission's consideration of the investigative report.

With respect to the question of insider trading discussed in Volume II of that report, the staff concluded that there were no actionable violations of the federal securities laws. With respect to the general disclosure question discussed in Volume I of the report, various recommendations and views of the staff were considered by the Commission as to possible courses of action. As you know, the Commission determined to order public proceedings pursuant to the Securities Exchange Act of 1934 so that these disclosure matters could be further explored.

I am also writing to Chairman Patman with a request that my testimony be corrected in this respect.

Sincerely,

HAMER H. BUDGE, *Chairman.*

Senator PROXMIRE. There were no others.

Well, didn't the SEC let Lockheed off the hook in its recent decision to postpone the public hearings on the disclosure issue?

Mr. BUDGE. That was a judgment which was reached by the presiding officer. The Commission has not participated in that in any way. It was the Commission's design that the hearings open promptly, they were opened promptly, and the first submission, as we understood, was to be the staff report. We found that an objection was made that there was confidential material in that report which should not be in it, at least a consideration of whether it should be in the public domain and that matter is now being resolved by the hearing officer. The Commission has taken no part in it.

Senator PROXMIRE. If it is not in the public domain I would hope the hearing officer would at least or you would disclose the reasons why this is not made public because it would seem to me here is an area where the burden of the proof is very strongly on those who would conceal from the public this kind of information.

It has nothing to do with national security, obviously. Yet it does have a lot to do with confidence and faith in our security markets

Mr. BUDGE. Well, as one example, Senator, it is my understanding that there are income tax returns of individuals, which were examined as the Commission was investigating, to see whether or not there had been violations of the insider trading statutes and the rules of the Commission.

Senator PROXMIRE. I wouldn't expect you to reveal the contents of those, of course, but——

Mr. BUDGE. That is one area which is being considered.

Senator PROXMIRE. I understand that, but it would seem to me that kind of information which is not disclosed wouldn't prevent you from presenting the evidence that was possible to reveal without compromising that kind of privacy.

Mr. BUDGE. Well, I am sure the standard that you enunciated there will be observed.

Senator PROXMIRE. Does the SEC collect data on the profits of corporations dealing in securities? For instance, do you separate profits of divisions within comglomerates?

Mr. BUDGE. Our chief accountant, Mr. Andrew Barr, is here, and I will defer to him, Senator, if I may, to answer that. I am not positive.

Senator PROXMIRE. Mr. Barr?

Mr. BARR. I am not sure of your question, Senator.

Senator PROXMIRE. My question is, Do you, when a conglomerate files its reports, have to break down the profits that it makes on the basis of its various subsidiary corporations or can they file a report, simply an overall report?

Mr. BARR. A consolidated statement.

Senator PROXMIRE. A consolidated statement is all they have to file.

Mr. BARR. Well, in some cases a parent company statement must be filed but that is not the common situation.

Senator PROXMIRE. Do you collect data on that?

Mr. BARR. No, sir.

Senator PROXMIRE. Do you collect data that separates profits of government sales from profits of commercial sales at all?

Mr. BARR. There is a disclosure in prospectuses but not to a great extent.

Senator PROXMIRE. Do you collect data on profits of defense contractors?

Mr. BARR. No, sir.

Senator PROXMIRE. You are not required to under the law?

Mr. BARR. No, sir.

Senator PROXMIRE. And you feel you have no responsibility for doing it?

Mr. BARR. I don't think we have. It is a separate transaction.

Senator PROXMIRE. I have a few other issues I will defer. My time is up.

Chairman PATMAN. Thank you.

Mr. Widnall?

Representative WIDNALL. Thank you. I certainly want to add to the welcome which has been given to you by other Members of the Congress, and I appreciate your good testimony.

Mr. Budge, a former colleague, I am certainly glad to see you back again, as a witness or on any occasion, in the Halls of Congress.

Mr. McLaren, you indicated that some types of conglomerate mergers are procompetitive and some are anticompetitive. Could you discuss that a little more so that people could better gage what types of merger they could safely enter into?

Mr. McLaren. Well, basically, and this is something that we really are promoting, as I have indicated in my main statement, we have quite a number of industries which the economists classify as concentrated. We would be delighted to see diversified companies, whether they identify themselves as conglomerates or otherwise, make what we have called foothold or toehold acquisitions in the concentrated industries or enter de novo, make an entry in one level and expand in other levels, and in this way tend to deconcentrate some of these markets.

We think this is a practical concept because economic studies show that, in relation to costs, prices and profits are somewhat higher in the concentrated industries than they are in the unconcentrated industries.

Representative Widnall. Is there any practical way in which companies could know in advance or have some advance inkling of what might be considered a merger that is satisfactory to the U.S. Government?

Mr. McLaren. The Department of Justice put out in mid-1968 a set of merger guidelines, including a section on conglomerate mergers. Since this administration has been in office, both the Attorney General and I have made a number of talks on the subject of conglomerate mergers and what we are concerned with, and areas where we are not. If a company or a pair of companies are in doubt, they can come in either to the FTC or to the Justice Department and find out whether we will sue if they go ahead, and we will tell them.

Representative Widnall. Do you give that opinion in advance?

Mr. McLaren. Well, we call it a business review procedure. We are not allowed to give opinions, but we do have a business review procedure, where they present a proposed course of conduct, and we indicate whether or not we will sue on it, and we do that regularly.

Representative Widnall. Do you think that the existing law is sufficient to deal with most of the problems of reciprocity or do you think substantial reciprocity should be a per se violation of the Sherman Act wholly apart from merger considerations?

Mr. McLaren. I think that substantial reciprocity in a systematic fashion by an important factor in an industry is a violation of section 1 of the Sherman Act. We have brought, I think, five or six cases on the subject of reciprocity, charging violations of section 1 and section 2, and in each case the companies have—no, in all but one case, the companies have accepted consent decrees in which they are taking strong court orders against the practice.

I think we have sufficient law.

Representative Widnall. I don't think that directly answered my question, which was, Do you think substantial reciprocity should be a per se violation of the Sherman Act wholly apart from merger considerations?

Mr. McLaren. I don't think it is necessary to make it a per se violation. If smaller companies are engaging in a certain amount of reci-

procity, I don't think that that is going to result necessarily in unreasonable restraints of trade. I think that when you get a major industry, a company which perhaps gets into the hundreds of millions of dollars of trade, tied up in systematic reciprocity, I think this is a sufficient drag on the economy that should be outlawed under the Sherman Act and I think we have the tools to go after it. I don't really think that it is necessary to make it a per se violation.

Representative WIDNALL. Chairman Budge, recently the Accounting Principles Board has been considering a number of changes in the accounting treatment for companies which choose to merge. Has the Securities and Exchange Commission taken a neutral position toward the changes embodied in this Board's exposure draft or has it taken action, either in support of or opposed to the changes?

Mr. BUDGE. I would say, Mr. Widnall, that the Commission is most desirous of reaching a resolution of this problem. They have been working on it for a long time with the accounting profession for which the Accounting Principles Board is the spokesman.

The Commission, I think, is not wedded to any particular solution. We simply hope that the accounting profession can reach some unanimity within itself which will result in a resolution of the problem. There have been suggestions that the 3-to-1 ratio be reduced to 9-to-1. The Commission has not actually considered that on its merits.

Representative WIDNALL. The conglomerate report of the FTC staff recommends that the responsibility for framing of reporting requirements be taken from the exclusive domain of the SEC and shared with the FTC. What is your reaction to that suggestion?

Mr. BUDGE. So far as I know every work product which we have is available to the Federal Trade Commission, and they have a different purpose in some of the collection of information than we would have, and for those purposes I would say, I don't feel we have any objection to the Federal Trade Commission getting any data which it needs for its purposes which, of course, are different in many areas than the purposes for which we collect the data.

Representative WIDNALL. Mr. McLauren, you have mentioned the fact that list prices in many industries overstate the real prices that are offered through discounts and special terms. In your opinion, has there been an increase in the discounts and special terms that have been offered recently?

Mr. MCLAREN. I really have no empirical data to go on, Congressman Widnall. I was basing my statement on this survey that had been made by a financial writer for the New York Times and was reported in last Sunday's Times, that there were increasing discounts in a number of industries, and it began to look like perhaps the inflationary rise is being punctured somewhat. That is what I had reference to.

Representative WIDNALL. That was the point of my question, whether or not there is evidence inflation may be abating by a faster rate than is indicated by prices.

Mr. MCLAREN. I hope that may be so, but I don't have anything more to go on than what I have said, Congressman.

Representative WIDNALL. You have also mentioned the fact that foreign competition is an especially important factor in restraining inflationary behavior in concentrated industries. Does this indicate

that firms in concentrated industries may not really exercise substantial market power due to competition from firms around?

Mr. McLAREN. I think that is a real possibility in certain industries, and as I interpolated in my prepared statement, I think this is another study that we should make to see just what effect imports have had on some of these price levels, if any.

I don't know exactly how that study would be run. We would have to put the economists on it, and I suppose they would have to take into account price levels and volume of imports.

Representative WIDNALL. I have time for just one more short question. Is perhaps one explanation of your fiindings that prices have risen less in concentrated industries than would have been expected during the recent inflationary period been that they experienced substantial price competition from foreigners?

Mr. McLAREN. I would think, and I have to speculate now, I would think that might very well be an explanation in some industries. I don't think it could be the explanation of the whole trend. There are so many industries involved which were subjected to statistical analysis, and I don't think that would explain the whole thing. But I think we should know what effect it does have, and in what industries.

Representative WIDNALL. Thank you. My time is up.

Chairman PATMAN. Yes.

Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. McLaren, in your prepared statement you say, "but it does mean that, in my view, this is a very unpropitious time to be erecting rigid new barriers to imports."

Who has been suggesting that we erect rigid new barriers to imports?

Mr. McLAREN. There have been any number of articles written in the business magazines, in the newspapers. I think there has been a certain amount of testimony before congressional committees, and there is real concern, I know, that we may be moving toward further trade barriers and away from the policy of free trade that we have had over the last 30 years or more.

Senator MILLER. You are not referring to any particular legislation that has been introduced here in the Congress, are you?

Mr. McLAREN. No, except as I suppose the legislation and the publicity on certain negotiations have generated some of these articles and speculation about a real trend in that direction.

Senator MILLER. For example, now, I introduced a bill which relates to meat imports. It provides for continuation of meat imports, it provides for increases in meat imports based upon a percentage of our increased domestic consumption. I understand other legislation similar to that has been introduced. You are not referring to that as rigid new barriers, are you?

Mr. McLAREN. I had no particular legislation in mind on that, Senator, and I would simply say that I would hope that any kind of protection that is found to be needed would go down the line of tariffs, so that as prices increase we can get increased supply and not just have people paying higher and higher meat prices because——

Chairman PATMAN. Senator, would you yield briefly, please, sir?

Senator MILLER. Yes.

Chairman PATMAN. Mr. Weinberger is with us now, he was delayed, he was detained, and he couldn't help it and we are glad to have you, Mr. Weinberger, but since we have started I wonder if it would be satisfactory for you to place your prepared statement in the record at this point and be available for the answering of questions?

Mr. WEINBERGER. Surely.

Chairman PATMAN. Many members have seen your prepared statement, I know I have myself, and some members have already interrogated witnesses about your statement.

STATEMENT OF HON. CASPAR W. WEINBERGER, CHAIRMAN, FEDERAL TRADE COMMISSION

Mr. WEINBERGER. Yes, Mr. Chairman, that would be completely satisfactory. I should apologize and explain to the committee what detained me. At the time I accepted your invitation and made all arrangements to be here I did not have other responsibilities, and as of yesterday afternoon I learned some of those involved attendance at the Cabinet meeting which is going on now. I left as soon as I could so I wouldn't detain the committee any longer. But I would be delighted to have the prepared statement put in the record and try to answer any questions you may have.

Chairman PATMAN. Thank you, sir.

(The prepared statement of Mr. Weinberger follows:)

PREPARED STATEMENT OF HON. CASPAR W. WEINBERGER

Mr. Chairman and members of the Committee, I welcome this opportunity to appear before you on behalf of the entire Commission to discuss with you, at your request, monopoly and concentration problems.

Although the programs of many Federal agencies are involved in the fight to eliminate the causes of inflation, clearly one of the most important elements in this fight is the antitrust efforts to increase the competitive efficiency of markets. Today I would like to concentrate on the Federal Trade Commission's part in this program.

The persistent inflationary pressure of the post-war period, particularly in recent years, has focused attention on the role of antitrust and trade regulation policy in reducing the upward spiral in prices and wages caused by inefficiencies in product and labor markets—so-called structural inflation. In an economy committed to high levels of employment, such inefficiencies must inevitably become major bottlenecks to achieving price stability.

The assumption of our free enterprise market economy is that adjustments to changes in supply and demand are achieved through individual decisions of firms that rival one another to make sales. This market activity translates changing supply and demand conditions into price movements. Those industries faced with increasing demand or costs should experience price increases for their products, while those industries faced with declining demand or costs should react with price decreases. For the economy as a whole, one can visualize an orchestration of price increases and price declines which would tend to offset each other and thereby produce a stable overall price level for the economy.

That this model of competitive equilibrium has not been fully achieved, is due in part to the high degree of concentration and other structural characteristics such as barriers to entry which exist in some markets. In these oligopolistic markets it is said that firms tend to recognize their mutual interdependence in pricing, and fear of retaliation causes the few firms in the market not to cut prices when industry demand falls or when costs decline. This, of course, results in inflationary pressure for the economy as a whole since the price increases of industries experiencing increasing costs are not offset by price declines of oligopolistic industries. It should be emphasized that too often analysts of inflation look only at those industry experiencing price increases while, in fact, the indus-

tries that contribute most to inflation may well be those who prices do not fall or do not fall far enough.

There seems to me to be two major anticompetitive conditions that present obstacles in achieving price stability, and I would like to review with you the Commission's efforts to combat these trends. The areas I will cover are: (1) existing concentrated industries; and (2) the merger movement, and the trend toward concentration, particularly in consumer goods industries.

I. Concentrated Industries

Effective competition is the rule rather than the exception in the American economy. In most markets, competition serves as a self-regulating mechanism which prevents noncompetitive, interdependent pricing. However, market structure, particularly in a few key industries, apparently allows leading firms in these industries to exercise a significant degree of *discretionary* power in setting prices, that is, discretion not controlled by ordinary market considerations. It is the exercise of this discretionary power in concentrated industries which poses a serious problem for price stability.

There is some empirical data showing that prices, profitability, innovation and other aspects of industrial performance are related to the structural characteristics of markets, and particularly the level of concentration in these markets. Level of concentration is customarily measured in terms of so-called concentration ratios, usually expressed as the percentage of industry production accounted for by the 4, 8 or 20 largest producers. Applying this measure to manufacturing industries as a group, about one-third of total production is in concentrated oligopolies where four firms account for more than 50 percent of industry production.

We are concerned about this condition because, as I have indicated, when concentration is high, companies tend to develop communities of interest. One of these interests is to avoid those strategies most likely to lead to retaliation. Price cutting is usually the first such practice to be eliminated. Whether done collusively or not, the plain fact is that decreases in demand need not be met in these concentrated industries by reducing prices, but rather can be absorbed by cutting production and employment. While this path can of course be pursued by any company, it is obviously easier if there are only 3 or 4 real competitors to consider.

Another significant effect of concentration is in the area of employer-employee relationships. In the periodic wage negotiations between key industries and powerful labor unions, the ability of the industries to carry higher wage costs is the primary factor determining wage demands. The unions usually look at industry profit rates as the crucial indicator of this ability and studies, which statistically relate the level of market concentration to the effectiveness of competition, show that when four firms in an industry control more than about 40 or 50 percent of production, profits tend to be significantly higher. As a result, bargaining in these concentrated industries seems to be no more than negotiations over a division of profits between management and labor. However, these profit-inspired wage settlements have far wider implications.

Wage settlements in excess of productivity set inflationary wage trends for the rest of the economy. Moreover, price increases which, in turn, are designed to reestablish target rates of return in concentrated industries follow the wage settlements, and add more fuel to the inflation fires.

II. The Merger Movement

In light of all of the above aspects we are, of course, concerned over the major postwar wave of mergers which begain in the mid-1950's and accelerated sharply in the late 1960's to become one of the largest merger movements in the nation's history. Since mergers historically have been an important source of concentration, there is concern that this movement could create new oligopolies or at least transform loosely oligopolistic industries into those which are tightly oligopolistic.

Last fall the Commission published its first phase of its study of this recent merger movement. Data in this report show that the merger movement of the last several years has been centralizing and consolidating corporate control in an unprecedented fashion among relatively few vast corporations.

In 1968 the merger movement reached such magnitude that in a single year nearly 10 percent of all independent manufacturing corporations having more

than $10 million in assets were acquired. The merger movement has had a particular influence on these medium-sized and large corporations which as a group account for nearly 90 percent of manufacturing assets and net income. Between 1967 and 1969 the merger drain was so heavy that for the first time the number of such companies has not grown despite a rate of growth of the economy that would have projected a substantial increase in the number of such firms.

There is now some real evidence that this trend has slowed down markedly, probably for a variety of reasons, one of which certainly is the poor performance of the stock market.

The immediate impact of the merger activity in manufacturing was to increase the overall concentration of industrial assets among a relatively few large corporations. Specifically, the share of manufacturing assets held by the 100 largest corporations in 1968 was greater than that held by the 200 largest in 1950, and the share of assets controlled by the 200 largest of 1968 equalled that held by the 1,000 largest in 1941.

The effect of this merger movement on pricing, profits and efficiency is more difficult to measure. We do not know yet, for example, whether in conglomerated industries firms engage in the kind of mutual forebearance of competition which discourages price cuts and may result in inflationary price increases. We do know that a substantial percentage of the companies acquired by the largest corporations held leading positions, and nearly all were profitable companies. Less profitable companies were usually acquired by small firms. It appears that few of the acquisitions by large companies have been of the toehold type, i.e., acquisitions of companies that needed to be revitalized and expanded in order to challenge the market position of dominant firms.

A few of the large mergers were horizontal, but many involved companies in related product areas, and there is some evidence that those industrial areas that had the greatest merger activity also experienced increases in concentration. It was also found that industries dominated by the 200 largest manufacturing corporations experienced concentration increases.

It must be noted however, as I have said, that the number of mergers and concentration resulting from mergers has slowed appreciably in recent months. How much of this is due to the stock market is not fully known yet. In any event, we now have a breathing spell in which to evaluate what has happened in recent years.

III. The Commission's Program

With respect to each of these problems—concentration and the merger movement—the Commission has evolved what we consider to be an effective program.

In concentrated industries, the Commission has approved a series of in-depth studies. Six industries have been selected for initial investigation: steel, automobile, drug, electrical machinery, energy, and chemical industries. Studies will be initiated and carried out, to the extent resources permit, of structure and conduct, as well as performance variables such as profits, innovation and new investment.

In addition to these in-depth studies, the Commission is now endeavoring to improve its *Quarterly Financial Report* program so as to assess more effectively competitive trends. The improvements in the program will focus particular attention on making performance data on concentrated industries generally available. Access to adequate industry data on an industry by industry basis has become increasingly difficult in recent years as conglomerate firms have begun to account for increasing shares of production in most industries.

It should be understood, however, that neither our studies of concentrated industries nor our improved reporting systems are being undertaken as interesting academic exercises by our Bureau of Economics. At this beginning stage of our studies, however, it would be neither useful nor appropriate for me to attempt to articulate a possible enforcement policy which could evolve from these studies.

Although there is a lack of firm legal precedent for attacking oligopolistic pricing practices, I believe the real problem is the absence of hard data and evidence. Despite decades of intense concern with pricing under oligopoly, we actually know very little about the patterns of price leadership, price rigidity, market-share stability, non-price promotions, and other market phenomenon which can be used as a basis for either invoking established doctrines of conspiracy or articulating new theories of collusive or quasi-collusive agreement. We propose to develop these data from our studies.

But in addition to the existing concentration in key basic industries, which will be the subject of our special study, there is evidence of a disturbing trend toward concentration in consumer goods industries. This trend has occurred since World War II. With respect to this increase in concentration in consumer goods industries, over the last five years the Commission has taken a major step in reducing the anticompetitive concentration trend in such industries (many of which involve necessities) by issuing both complaints and merger enforcement guidelines covering food products, textile products, food retailing, and department stores.

The Commission's Bureau of Economics in the last several years has devoted a large share of its resources to analyzing structure and performance problems in consumer goods industries. Next year the Commission will be conducting an extensive examination of the breakfast cereal industry which will seek to determine, among other things, whether and to what extent the public may be denied the benefits of vigorous competition because of the structure of the industry, the conduct of industry members, or the interplay of the two. We hope the study may determine whether product promotion and brand proliferation leads to any problems.

In an attempt to keep abreast of developments in the widespread merger movement the Commission has focused its merger investigations on acquisitions of large companies holding important positions in relatively concentrated industries. Besides developing individual cases the Commission has issued enforcement guidelines based on extensive legal-economic analyses of a number of merger-prone industries. I have already mentioned some of the consumer product areas in which guides have been promulgated. In an effort to extend this very successful enforcement instrument—the promulgation of guidelines—to conglomerate mergers the Commission's staff is now working on the second phase of its extensive merger investigation looking in depth at what happens after, and as a result of, conglomerate mergers.

Last year the Commission took another new step in merger enforcement by initiating a premerger notification program which requires any corporation with assets of $250 million or more to provide detailed information on all acquisitions involving assets of $10 million or more. The purpose of this requirement is to permit the Commission to assess quickly the probable anticompetitive consequences of the proposed merger.

The focus of my testimony on existing concentration and trends in that direction should not in any way detract from the importance of the broad range of other antitrust activities of the FTC. The Commission devotes a large share of its resources to investigations of specific price conspiracies and predatory practices.

These practices often have substantial adverse effects on consumer prices. For example during the period of the tetracycline (a widely used antibiotic) conspiracy, 100 capsules cost $30.60. After antitrust action in 1962, the cost of 100 capsules dropped to $4.25. Total alleged damages in suits filed by overcharged users totalled hundreds of millions of dollars and, so far, users have been awarded damages of more than $100 million.

Available price data for the baking industry show the effects of a bread price conspiracy in that industry. Consumers in the State of Washington paid 15 to 20 percent more for bread, resulting in total costs to consumers amounting to several million dollars a year until the conspiracy was broken up by FTC legal action in 1964.

In addition to its antitrust activities, the Commission is a consumer protection agency. Although some see little connection between this and antitrust, I consider the areas to be closely related. What is antitrust if not a tool to provide consumers with a system that will give them the products and services they need at the lowest possible prices? The elimination of deceptive acts and practices makes it possible for competition to concentrate on price and quality. Truthful information about products is essential to effective competition. Any acts or practices that withhold information from consumers or tell purchasers untruths, blunt the force of competition and the efficiency of markets.

With this in mind, the Commission has recently proposed trade regulation rules which are designed to provide vital information to consumers. For example, one rule would require manufacturers of light bulbs to disclose—in addition to wattage which is presently revealed—the bulb's designated life expectancy in hours and its initial light out-put in lumens. Another proposed rule would require clothing manufacturers to label their good permanently with proper

washing and cleaning instructions. Still another requires that retail gasoline pumps be posted with the gasoline octane rating.

Recognizing the vital importance of consumer education, the Commission has also undertaken a stepped-up program of consumer education.

Finally, I believe if we are to do more than simply describe and study the anticompetitive trends in our economy, a completely revitalized Commission, capable of vigorous and prompt action and performing with a high degree of professionalism is required. In the last several months, as a result of the unified effort of the entire Commission, I believe that significant changes have taken place. It is my hope, as I near my time to leave the Commission, that through the recently announced reorganization of the Commission—which among other innovations has established a strong Office of Policy Planning and Evaluation—the Federal Trade Commission will fulfill the historic and vital assignment given to it by the Congress.

Chairman PATMAN. You may proceed.

Senator MILLER. Thank you.

Well, Mr. McLaren, I am a little curious about your favoring the tariff approach because it seems to me that those tariffs could result in increased prices of the imported items which would be contrary to consumer interests, if that is what you seem to be directing your suggestion toward.

Mr. MCLAREN. What I am saying is that if we are going to do something, I think that tariffs are preferable. I think——

Senator MILLER. I know you said that, but my point is——

Mr. MCLAREN. Nothing would suit me better.

Senator MILLER. Well, you say nothing would suit you, you don't want any action at all.

Mr. MCLAREN. I think that by and large it is self-defeating to erect barriers to international trade.

Let me point out a couple of considerations. Suppose you have two or three major companies that really dominate a U.S. industry. If we are really devoted to maintaining competition, which is supposedly the job of the Antitrust Division, and if these companies have very high market shares, particularly when one of them has perhaps a 50 or 60 percent market share of the domestic industry, we should be thinking about monopolization charges, and possibly dissolution. I don't think that is necessary if imports can come in so that you are talking about a world market and not just a protected national market.

I think that the use of section 2 of the Sherman Act to bring monopolization charges is going to be necessary. If we let just a handful or less of very large companies dominate an industry, we are not going to have effective competition.

Senator MILLER. I appreciate your elaborating upon that because now I would understand your statement to really read "but it does mean that in my view this is a very unpropitious time to be erecting rigid new barriers to imports in the case of heavily concentrated industries." If I have understood your statement that is about what you mean.

So if we are looking at possible quota legislation, and we find a problem because of what some people would term execessive imports—for example, that imports are taking over the entire increase in domestic consumption instead of only a fair share of it—we have to refine this according to whether or not we are talking about competition with the U.S. concentrated industries or those which are not concentrated.

Mr. McLAREN. Well, I wouldn't confine it, respectfully, sir, to just the concentrated industries.

I think that competition basically assists in the best allocation of our resources, and I think that no less an executive than the president of United States Steel said not long ago we must concentrate on producing and doing the things we do best. If we can bring in from abroad things that can be given to the American people at low prices, then we should concentrate our energies and our resources in producing things where we can do a better job.

Senator MILLER. Well, that is a good statement of economic theory, and I don't think anybody is going to argue about that whether it is enunciated by you or somebody from private industry or me.

But it seems to me there is something that has been left out of the discussion right now and that is I think we had better look at the nature of the exporting country or the exporting businesses.

Mr. McLAREN. I agree with that.

Senator MILLER. I would think if you are dealing with a country which is subsidizing exports or with some exports coming in from a concentrated cartel in another country, that might be a little different and that ought to be a factor in our consideration, don't you think?

Mr. McLAREN. I don't deny that at all. And I have said that I think that we shouldn't have to be a victim to nations that won't accept our products in return.

They can't expect to have an open door here——

Senator MILLER. That is right.

Mr. McLAREN (continuing). And a closed door abroad. I recognize that, and I have said that we shouldn't accept dumping, and if they are subsidizing dumping over here we shouldn't stand still for it. But I think it is very important that we avoid a great flood, and I am afraid if one industry gets relief, another is going to demand it and another, until we get a great flood of protectionist legislation. This is my concern.

Senator MILLER. Well, my only point to you would be that I think we ought to look at the flood and pick the pieces out of the flood. I can't go running for cover just because somebody says "well, if you are going to do justice for this person or this industry or these types of commodities, therefore everybody else is going to run in."

We are supposed to be looking at everything over here on Capitol Hill. I know some people talk about getting the camel's nose under the tent, but quite frankly, if the camel's nose ought to be under the tent, put it under there. That doesn't mean the whole camel ought to get under there. I just deplore some of the, what I regard as a little unnecessary, scare talk about protectionist legislation, when there is a one-sided approach to it without recognizing what some of our trading partners have been doing about their own protection, and their exclusion from their markets of our goods.

I would like to ask one other question, and that is how many cases do you have now, current cases, involving conglomerate mergers?

Mr. McLAREN. Five, I believe, that are now pending.

Senator MILLER. What are those? Do you know off hand?

Mr. McLAREN. We filed six and settled one. We filed one against Ling-Temco-Vought on the Jones & Laughlin Steel acquisition; we filed one against ITT involving its acquisition of Canteen Corp.; a

second one against ITT involving Grinnell Corp.; the third one against ITT involving its acquisition of Hartford Fire Insurance Co. Then we filed one against Goodyear and Northwest Industries, and we filed fairly recently one against Wachovia Bank and, I think, American Finance Corp.

Senator MILLER. Would it be asking you too much to provide for the record, with the chairman's permission, a statement of guidelines used in determining action in those cases?

Mr. McLAREN. I think we can furnish copies of the complaints which pretty well set out the considerations.

Senator MILLER. I don't mean that. I mean the guidelines used in reaching a decision on whether to file a complaint.

Mr. McLAREN. Well, I don't think we have written down any guidelines.

Senator MILLER. But could you give us something?

Mr. McLAREN. Yes, I think we could draw up the considerations. In effect, what you are asking, I think, is for a trial brief on five or six cases.

Senator MILLER. Well, sir, I am not really asking for that. I am asking though for some policy guidelines—for example, the concentration problem, something along line—which you might develop in a page or two. I don't want a long brief or anything but I would like a statement of policy guidelines which you would say were followed in deciding on these cases. I think it would be very helpful to the committee, and I for one would appreciate it.

Chairman PATMAN. Are you willing to file that, Mr. McLaren?

Mr. McLAREN. I know that the prior administration spent about 4 years getting up the guidelines that were published in 1968 and I know it is a difficult thing to try to lay out all the considerations. We will certainly make an effort to get something to you.

Senator MILLER. Thank you very much.

Chairman PATMAN. Without objection it is so ordered. It may be inserted at this point in the record.

(The following information was subsequently supplied for the record by Mr. McLaren:)

SUMMARIES OF BASIC ALLEGATIONS OF THE COMPLAINTS IN SIX CONGLOMERATE MERGER CASES

(1) *United States* v. *Ling-Temco-Vought, Inc., Jones & Laughlin Steel Corporation*, and *Jones & Laughlin Industries, Inc.*, Civil Action No. 69-438, W.D. Pa. This case has been settled by a consent decree requiring substantial divestiture.

LTV is the 14th largest industrial corporation in the United States. The 1967 revenues of all companies controlled by LTV at the end of 1968 (exclusive of J & L Steel) totalled about $1.9 billion

J & L Steel is the 6th largest steel producer in the United States, with 1968 sales of over $1 billion and assets of over $1.5 billion. J & L Steel accounts for 5 to 10% of the nation's production of the steel products which it manufactures.

J & L Industries is a subsidiary of LTV. Formed in 1969, it now holds more than 80% of J & L Steel's common stock.

The complaint charged that, before LTV acquired J & L Steel, it was a potential competitor in various product lines in which J & L Steel is a substantial factor, including various segments of the steel industry. Similarly, J & L Steel was a potential competitor in various product lines in which LTV is engaged, such a copper and aluminum wire and cable.

The complaint further alleged that both LTV and J & L Steel were potential competitors in such industries as high alloy steels, primary aluminum, building materials, machine tools, and industrial automation processes.

The suit also charged that the acquisition of J & L Steel by LTV significantly increased the ability of the combined company to engage in reciprocal dealing—i.e., to utilize purchasing power to sell its products and services to the detriment of competition.

The complaint also alleged that LTV's acquisition of J & L Steel would increase concentration and encourage further concentration by merger. As a result, the number of firms capable of entering concentrated markets and possessing the capability and incentive for competitive innovation would be reduced; barriers to entry in concentrated markets would be increased; and vigorous competition may be diminished by increasing the actual and potential customer-supplier relationships among leading firms in concentrated markets.

(2) *United States* v. *Northwest Industries, Inc. and The B. F. Goodrich Company*, Civil Action No. 69–C–1102, N.D. Ill. This suit is pending in the United States District Court, Northern District of Illinois, in Chicago.

Northwest, a widely diversified holding company, ranks among the nation's 130 largest industrial corporations in sales and among 55 largest in assets, with revenues of $701 million and assets of $1.3 billion.

Goodrich, in 1967, was the nation's 83rd largest industrial corporation in sales and the 86th largest in assets. In 1968, Goodrich assets totalled about $1 billion and revenues reached about $1.1 billion.

The complaint alleges that the merger may eliminate actual and potential competition between Northwest and Goodrich and substantially enhance the power of the merged firm and its suppliers to benefit from reciprocity in the sale and purchase of products and services. The merger would eliminate competition between the firms in the sale of caustic soda in the inland waterway market served by the Mississippi and Ohio Rivers, and also eliminate the likelihood of competition in the sale of muriatic acid in the same territory.

Potential competition between the firms would also be eliminated in the highly concentrated petrochemical resin and hexachloro-pentadiene markets, the markets for plastics and plastic products, and footwear.

On July 11, 1969, the Court denied the Government's application for a preliminary injunction in this case, but entered a comprehensive "hold-separate" order.

(3) *United States* v. *International Telephone & Telegraph Corporation and Canteen Corporation*, Civil Action No. 69–C–924, N.D. Ill. This suit is pending in the United States District Court, Northern District of Illinois, in Chicago.

ITT is the nation's 12th largest firm, with 1967 revenues of $3.6 billion. It is a rapidly growing company, with much of its recent growth resulting from mergers and acquisitions. ITT annually purchases in excess of $550 million of goods from various domestic suppliers, and its actual and potential suppliers employ about one-third of the nation's industrial labor force.

Canteen, with 1968 revenues of $322 million, is one of the few nationwide vending organizations and a leader among companies providing dining services for industrial plants.

The complaint alleges that competitors of Canteen may be foreclosed from competing for the vending and employee feeding requirements of actual or potential suppliers to ITT, as well as the requirements of industrial organizations owned by ITT and its subsidiaries.

(4) *United States* v. *International Telephone & Telegraph Corporation and The Hartford Fire Insurance Co.*, Civil Action No. 13320, D. Conn. This suit is pending in the United States District Court, District of Connecticut, in New Haven.

Hartford is a leading writer of property and liability insurance and ranks 4th among the nation's property and liability insurance companies. In 1968 it had premium receipts of $968 million, net income of $53.3 million, and consolidated assets of $1.89 billion.

ITT also engages in the life insurance business, reaching a nationwide level of $1 billion. It is also a large purchaser of insurance.

The complaint alleges that actual and potential competition between the two firms will be diminished and that the merger will foreclose competitors of Hartford from competing for the insurance purchases of ITT and ITT's customers, increase the power of ITT and Hartford to benefit from reciprocity effect in selling insurance, and trigger other mergers by companies seeking to protect themselves from the impact of this acquisition or to obtain similar competitive advantages.

On October 21, 1969, the Court denied the Government's application for a preliminary injunction in this case, but entered a comprehensive "hold-separate" order.

(5) *United States* v. *International Telephone & Telegraph Corporation and Grinnell Corporation*, Civil Action No. 13319, D. Conn. This suit is pending in the United States District Court, District of Connecticut, in New Haven.

Grinnell is the 268th largest industrial corporation in the United States, with 1968 sales of $341 million, net income of $14 million, and assets of $184 million. Grinnell is the largest manufacturer and installer of automatic sprinkler fire protection systems in the United States. It is also a leading manufacturer of plumbing and piping hardware.

The complaint alleges that the merger will entrench Grinnell's already leading position in several concentrated markets, including the manufacture and installation of automatic sprinkler systems.

The complaint also alleges that the power of ITT and Grinnell to employ reciprocity and benefit from reciprocity effect will be substantially increased and the markets for Grinnell's competitors will be correspondingly foreclosed. Thus, the merger will raise barriers to entry, discourage smaller firms from competition in those markets, and trigger other mergers by competitors of Grinnell seeking to protect themselves from the impact of this acquisition.

The acquisition of both Grinnell and Hartford will enable ITT to utilize and benefit from its insurance business in promoting and increasing the sale and installation of Grinnell automatic sprinkler systems.

On October 21, 1969, the Court denied the Government's application for a preliminary injunction in this case, but entered a comprehensive "hold-separate" order.

(6) *United States* v. *The Wachovia Corporation and American Credit Corporation*, Civil Action No. 2656, W.D. No. Car. This suit is pending in the United States District Court, Western District of North Carolina, in Charlotte.

Wachovia, with deposits of $1.3 billion, is the largest commercial bank in North Carolina and the 39th largest bank in the nation.

American is a major non-bank financial institution, with 90 offices in North Carolina and offices in 12 other southeastern states. Its total assets are $400 million. Through its subsidiaries, American is engaged in consumer lending, sales financing, factoring and commercial financing, leasing, and property and casualty insurance.

The complaint alleges that Wachovia and American compete in retail automobile financing, and that Wachovia is a potential competitor in consumer lending and factoring. Actual and potential competition in these areas would be eliminated by the merger.

The complaint further alleges that American competes with non-bank financial institutions which borrow extensively from banks, and that the merger of American and Wachovia may give American a competitive advantage.

The complaint also charges that the merger is likely to create significant opportunity for tying or tying effects. Customers needing commercial and industrial loans are also actual or potential customers for factoring and leasing services. Retail businesses which borrow from banks often arrange for consumer financing for their customers.

Finally, the complaint aleges that the merger may trigger additional mergers between banks and other financial institutions, thereby increasing concentration and barriers to entry in various financial markets and reducing the number of firms with the capability and incentive for competitive innovation in providing various types of financial services.

On June 4, 1970, the Court denied the Government's application for a preliminary injunction in this case, but entered a comprehensive "hold-separate" order.

Chairman PATMAN. Senator Jordan?

Senator JORDAN. First, let me add my voice of commendation to each of you for your fine statements to the deliberations of this committee. They are first rate, and I shall proceed first to interrogate my old friend of long standing, Chairman Budge.

Mr. Chairman, some people say that the stock market overreacts to changes, economic changes, in the Nation. What do you think about it? How can we account for the wide range of a drop of from a third to 40 percent in most of the securities in a situation where the other economic factors may not warrant such a fluctuation?

Mr. BUDGE. I think you are absolutely correct, Senator. The stock market does tend to overreact and to over anticipate what the future might bring. I think that has been the history of investment decisions made by-individuals which are reflected in the stock market.

Senator JORDAN. You mentioned in your prepared statement about the tremendous increase in volume in the past several years. What, in your opinion, is a saturation point in volume on the stock exchanges? I think within the past year or 2 they have had to have trading holidays in order to catch up with the work in the back rooms. Is this what we should anticipate in the future, and is this a good way to handle trading in securities?

Mr. BUDGE. Well, I am sure that the tremendous increase in the volume came as a complete surprise to the people in the industry.

I recall the prediction in 1965, at that time the trading on the New York Stock Exchange averaged 6 million shares, the prediction that by the year 1975 they could expect to be trading 10 million shares. Well, it was only 3 years later when they were averaging nearly 13 million and, of course, one day hit 21 million. The industry was simply not geared up for that kind of volume.

Then, in anticipation of a continuation of that kind of volume the industry did gear up to handle considerably more volume than it is now handling.

We use as sort of a guideline at the Commission under current conditions a total share volume on the combined volume on the New York Stock Exchange and the American Stock Exchange of 22 million shares a day as being a volume of shares which can efficiently be handled by those two exchanges and by the securities firms whose input goes into the exchanges.

Senator JORDAN. What do you predict, are we going to have a proliferation of exchanges or will it be possible to improve the efficiency in the back rooms to overcome the load down there, looking to the future?

Mr. BUDGE. Well, we think a lot of steps are being taken to improve the efficiency of the exchanges.

The Commission, of course, would like to see a continuation of the auction markets that essentially is an agency operation rather than the other markets where you may get into essentially a dealer operation.

The markets at the present time, I think, are essentially very healthy. There has been a drift in the last 2 years particularly to the third market. The third market now represents about 7.2 percent of the trading in listed securities. That is quite an increase during the last 2 years; a steady increase.

Senator JORDAN. You mentioned the fact that trading in the past several years has gone to bigger volume by fewer people; that is, it is more institutionalized than it was in the old days when the stock exchange was an auction market where people met to trade in their securities.

You suggest that this trend may have deepseated and, perhaps, ominous effects. To what were you referring when you used the word "ominous"?

Mr. BUDGE. I think, Senator, to change the nature of the markets from a meeting place where scores, even hundreds of transactions are

handled in smaller amounts to a market where there are a few large transactions would be a very serious and a very detrimental change to our trading markets.

The Commission now has, in response to a direction given it by the Congress, a study which will be completed in the late fall, which we hope will give us the exact answers as to just what effect this institutional trading is having on our markets and some of the related questions as to just what effect the institutional trading is having on the portfolio companies themselves. Certainly there is a tremendous effect. There has to be.

A few years ago if we had had a trade of 50,000 shares of one issuer on the New York Stock Exchange it would have been front page news. I noted the other day there was 1 day when there were over 80 block trades in excess of 10,000 shares, and one of those trades accounted for 500,000 shares of one issuer, something unheard of just a few years ago, and that news was way back in the financial part of the paper and not highlighted at all.

But there has been a very real, a very fundamental, change in the trading practices.

Senator JORDAN. Yesterday we had a very able witness, Mr. Regan, of New York, and he told us that there had been quite a change in their institution in the past several months, that individual buyers from the heartland of America were coming into the market with greater volume than they had heretofore, and even ahead of the institutional buyers. Have you observed that?

Mr. BUDGE. I have not. I am not sure just to what area he refers as the heartland. I assume that would be in, perhaps in, the Middle West geographically.

Senator JORDAN. Middle West, away from the East.

Mr. BUDGE. I think perhaps the trading pattern has been just the opposite on the two coasts. I would be happy to explore that further within the Commission and submit a statement.

Senator JORDAN. I wish you would.

Mr. BUDGE. Submit a statement for the record?

Senator JORDAN. I wish you would.

(The following information was subsequently supplied for the record by Mr. Budge:)

RECENT STOCK TRADING PATTERNS AMONG INDIVIDUAL INVESTORS

Donald Regan testified earlier in these hearings that individual investors who are clients of Merrill Lynch were net buyers of common stocks all during the first five months of this year. Moreover, during May—the worst month in terms of price attrition—this trend became even more pronounced. Based on reports from Merrill Lynch offices across the country, they were able to conclude that it was "heartland America" that was doing most of the buying. By "heartland America" he meant places like Little Rock, Houston and Albuquerque. At the same time, the amount of brokerage done by their offices in the big seaboard cities was falling off.

During this period, nonmembers of the New York and American Stock Exchanges—institutions as well as individuals—were sellers on balance according to the daily transactions data compiled by those exchanges. Hence, since the monthly transactions data for noninsured private pension plans, investment companies and insurance companies (both life and property and liability companies), included elsewhere in this record, show that these large institutional investor groups were buyers on balance through May, it is obvious that transactions of all individuals as a group netted to a sales position throughout this period.

However, this does not necessarily mean that Mr. Regan's observations regarding the investment posture of individual investors of his firm residing in various sections of the country is necessarily invalid when applied to the entire investor population residing in these geographic areas. In fact, the results of an informal poll of some two dozen other brokerage houses—ranging from several other nationwide wirehouses to medium and moderately small-sized regional firms—tend to confirm at least part of Mr. Regan's testimony; i.e., individuals who are clients of these firms are buying on balance in the mid-west, less so in the West but still appear to be selling on the East coast.

To place this pattern in perspective, it should be pointed out that virtually one-half of the volume of transactions attributable to individual investors on the New York Stock Exchange during the first six months of 1969 originated in brokerage offices located in New York State according to the 1969 Public Transactions Study for that Exchange. The large wirehouses, such as Merrill Lynch, have their offices spread across the entire United States and consequently their business is not as geographically concentrated as is the business of the New York Stock Exchange.

Moreover, it should also be mentioned that trading as distinct from long-term investment among individual investors appears to be the most concentrated in New York State. In this context, the 1970 Census of Shareholders conducted by the NYSE shows that residents of that state now own ten percent of all corporate stock outstanding, compared to their fifty percent share of New York Stock Exchange trading volume.

Senator JORDAN. What risk does an investor take when he leaves his securities with his broker?

Mr. BUDGE. Well, I think he is at complete risk if the broker becomes insolvent except as he becomes a creditor.

Senator JORDAN. So when you are talking about, as you did in reply to Senator Javits and others, providing some insurance to protect investors, this was one of the points you had in mind, that very risk that he would take.

Mr. BUDGE. Yes. I might say Mr. Regan's firm on any given day holds other people's property in the form of securities and money in the neighborhood of $18 billion, just that one firm.

Senator JORDAN. Well, when we are overhauling the statute don't you think we should take a look at the Securities and Exchange Act of 1934, wherein brokers and dealers are required to meet minimum standards, and you say that every firm maintains a minimum net capital of $5,000. Is that a misprint?

Mr. BUDGE. No, sir; and that is a relatively new requirement. Of course, there are a great many brokers, broker-dealers, who actually operate in a way where the public is not really at risk.

For example, a small broker-dealer who handles primarily mutual funds where the remittance is made directly to the company, usually in the form of a check made out to the underwriter, the net capital in that case of $5,000 is probably ample.

It certainly wouldn't be ample for a firm of any real size that is doing business with the public, and I think, Senator, that actually there needs to be a revisitation by industry and by the Commission into this entire capital area. I think that the types of capital particularly which have been used in these firms has not been of the character which we would wish on an optimum basis, and I feel that the industry and the Commission are conducting that reexamination at the present time, looking to the overall capitalization for an improvement in the firms and improvement in the requirements under the law and under the rules of the Commission.

Senator JORDAN. Thank you. My time is up.

Chairman PATMAN. Thank you, sir.
Senator Percy?
Senator PERCY. Thank you, Mr. Chairman.
Mr. Weinberger, you have had an easy time of it this morning so I will start with you.
Mr. WEINBERGER. All right, sir.
Senator PERCY. I would like to say, however, that I was delighted at the appointment that was made that you have accepted. I think you are leaving a tremendously important post. You have accomplished a great deal in the restructuring of the FTC as it was badly in need of it. The reward for doing a good job, I suppose, is to go on and do another tough job and there is certainly an indication that great strength is going to stay in the new Office of Management and Budget.
Mr. WEINBERGER. Thank you, sir.
Senator PERCY. You talked in your prepared statement and Senator Javits commented before he had to leave on the necessity for consumer protection.
Mr. WEINBERGER. Yes.
Senator PERCY. We all realize the need for this and the Congress is grappling with the problem.
I just came from Europe yesterday, and I met with students and teachers representing a great many people who have been suddenly notified that though in some cases they arrived a few days ago on a package tour, the money of the company has run out, and they are going to have to return to the United States or be on their own. If ever I have talked to angry young people, sore at the establishment, with all this pious talk about consumer protection, there they are. With a once-in-a-lifetime experience awaiting them in Europe, they have to go back because they are dead broke, and the Ambassadors don't know what to do with them. What are we going to do about it so we can protect them in the future? Would this require bonding? What kind of legislation can we write, how can we plug this kind of a gaping loophole?
Mr. WEINBERGER. Well, Senator, you certainly put your finger on an extremely visible and very serious problem, very likely one in the field of deceptive and false advertising. And I would assume, although I did not see the ads and obviously should not prejudge anyone whose case may come before the Commission, but I would assume there would have been some advertising holding out the clear possibility of completing the trip in the event the necessary number of dollars were paid, and very obviously that was not done in the case you just put.
It is a little late with that kind of situation to bring a false advertising proceeding, a cease-and-desist order, against a company which is probably already in bankruptcy.
I think that the suggestion you made in your question of requiring bonding under circumstances of this kind might be a very good one.
The Commission has not looked into this specific problem, although I would certainly think it is safe to assume in view of the complaints we have had that we would at the very least have a staff investigation to find out what did cause this situation. In all likelihood it was an undercapitalized company, and if it was one that never had any intention or any financial ability of completing its obligation, then a very serious fraudulent case has been made out.

I would think just on the basis of the limited knowledge I have of that situation, that a prebonding requirement would certainly help prevent people holding themselves out to be able to complete trips when they are not, in fact, able to do so.

Senator PERCY. I would welcome any suggestions for legislation from the FTC or from Mr. McLaren's division. I am certain that Senator Proxmire, who is very vigilent in these areas of consumer protection, would be interested in taking a look at it with me.

Mr. WEINBERGER. We will certainly, as a special order of business, request our general counsel's office and the Consumer Protection Division to suggest some form of remedy in this kind of situation, and if the Commission approves it we would be glad to end it up.

Senator PERCY. I have assigned it to a group who feel strongly about it, my summer interns. They have attacked this problem with vigilence.

Do you agree, Mr. Weinberger, with the statement made in the prepared statement by Mr. McLaren that this is a very unpropitious time to be erecting rigid trade barriers to imports?

Mr. WEINBERGER. I think anyone would agree with a statement that opposes rigid trade barriers; yes. I think that there may very well be some situations—Mr. McLaren specifically extempted dumping, and I had a little experience in my private practice with a couple of dumping cases involving foreign steel imports—where we would perhaps want to strengthen the barrier against dumped goods.

I can conceive of many situations of that kind.

As a general principle, however, I think the more international trade we can promote the better, and I am sure Mr. McLaren's concern is that if you erect a rigid trade barrier you will meet with retaliation which will in the long run have a bad effect on increasing international trade.

Senator PERCY. To my esteemed colleague, Senator Miller, who comes from the same area of the country where we have some of the same concerns, I would say that I am mainly concerned about the fact that in the Senate 75 Senators are cosponsors of quota bills. I can't think of anything that is more rigid that a quota. A tariff at least enables someone to cut their costs or price offer or something like that, but a quota is absolute.

It is restrictive, and you never know what the cost to the consumer is. You can't trace it through. So I would hope that Congress would restrain itself now, and I hope the administration will stand firm on a long-term policy of protecting the consumer in a consumer's economy not just the producer. These rigid absolute quotas are a terrible thing which, I think detract immensly from the problems of fighting inflation. If we start to pass quota legislation I don't know where you would stop. Every executive secretary of every trade association in Washington would have to get a particular quota on his particular product—strawberries or whatever it may be—and you will never end this process.

I would like to ask Mr. Budge about the airlines. We have seen a great liquidity problem with the railroads—not just one but there are four or five that I am concerned about.

Looking down the road, will the airlines be in the same position a year or so from now? Are they facing the same kind of economic squeeze that the railroads have been?

Mr. Budge. Senator, as I view the situation with regard to liquidity, I feel that it is a selective thing. Now whether the airlines are going to be in the same position that has confronted the railroads I would have to look at that specifically.

Of course, this matter of liquidity is nothing new. I have what I think are some very graphic figures here that show the ratios of liquidity starting back in 1948 and up to the present time, and you can see a very gradual erosion starting with the ratio at 2.06 in 1948, and 2.19 in 1949, and a gradual reduction down to a figure of 1.63, which is the situation today.

I think these figures are a very quick picture of the liquidity situation historically. I would be happy to furnish them for the record.

(The following information was subsequently supplied for the record by Mr. Budge:)

TABLE 1.—LIQUIDITY RATIOS OF U.S. CORPORATIONS, END OF YEAR, 1961–69

Industry	December								
	1961	1962	1963	1964	1965	1966	1967	1968	1969
QUICK RATIO [1]									
All corporations [2]	0.38	0.37	0.35	0.33	0.29	0.25	0.24	0.23	0.19
Manufacturing [3]	.50	.48	.47	.42	.38	.30	.28	.28	.21
Mining	.68	.65	.61	.58	.55	.44	.41	.36	.35
Retail trade	.33	.30	.28	.28	.24	.22	.22	.20	.18
Wholesale trade	.23	.24	.22	.21	.19	.18	.18	.18	.15
Service	.38	.35	.35	.34	.32	.32	.29	.27	.24
Electric utilities	.32	.35	.30	.32	.26	.24	.18	.17	.14
Gas utilities	.31	.32	.25	.26	.25	.21	.18	.14	.15
Water utilities	.36	.27	.26	.27	.24	.23	.22	.31	.27
Railroads	.68	.70	.74	.69	.63	.55	.45	.39	.33
Nonrail transportation	.46	.45	.43	.42	.42	.42	.40	.40	.32
Finance	.27	.24	.24	.21	.19	.18	.17	.16	.15
Communications	.56	.62	.54	.49	.33	.31	.28	.21	.14
Agriculture, construction, and other	.26	.28	.25	.25	.23	.23	.22	.26	.2[illegible]
CURRENT RATIO [4]									
All corporations [2]	1.96	1.91	1.87	1.84	1.79	1.74	1.75	1.72	1.64
Manufacturing [3]	2.50	2.44	2.38	2.35	2.28	2.17	2.21	2.15	2.02
Mining	1.93	1.98	1.93	1.83	1.74	1.57	1.61	1.51	1.52
Retail trade	2.22	2.17	2.09	1.99	1.94	1.88	1.83	1.77	1.71
Wholesale trade	1.88	1.94	1.88	1.83	1.72	1.68	1.72	1.77	1.68
Service	1.28	1.23	1.21	1.21	1.17	1.19	1.22	1.25	1.22
Electric utilities	.95	.99	.93	1.03	.93	.96	.88	.80	.72
Gas utilities	1.09	1.01	.97	1.05	1.02	.89	.88	.83	.84
Water utilities	.84	.80	.85	.88	.74	.72	.75	.89	.85
Railroads	1.27	1.29	1.30	1.27	1.25	1.17	1.13	1.03	.97
Nonrail transportation	1.32	1.38	1.33	1.27	1.32	1.36	1.35	1.30	1.20
Finance	1.55	1.48	1.49	1.46	1.46	1.43	1.42	1.40	1.37
Communications	1.22	1.32	1.20	1.35	1.07	1.07	1.11	.97	.82
Agriculture, construction, and other	1.54	1.52	1.45	1.43	1.39	1.42	1.44	1.44	1.38

[1] Cash and U.S. Government securities divided by total current liabilities.
[2] Excludes banks, savings and loan associations, insurance companies, and investment companies.
[3] Based on benchmark derived from Statistics of Income (IRS) and differs from Quarterly Financial Report for Manufacturing Corporations.
[4] Total current assets divided by total current liabilities.

Source: Office of Policy Research, Securities and Exchange Commission.

TABLE 2.—LIQUIDITY RATIOS OF U.S. CORPORATIONS, QUARTERLY, DEC. 31, 1968, THROUGH MAR. 31, 1970

Industry	December 1968	March 1969	June 1969	September 1969	December 1969	March 1970
QUICK RATIO[1]						
All corporations[2]	0.23	0.22	0.21	0.20	0.19	0.18
Manufacturing[3]	.28	.26	.24	.22	.21	.20
Mining	.36	.36	.35	.35	.35	.35
Retail trade	.20	.20	.20	.18	.18	.18
Wholesale trade	.18	.17	.17	.16	.15	.15
Service	.27	.26	.25	.24	.24	.21
Electric utilities	.17	.19	.16	.16	.14	.15
Gas utilities	.14	.20	.18	.15	.15	.17
Water utilities	.31	.33	.29	.27	.27	.29
Railroads	.39	.35	.34	.30	.33	.28
Nonrail transportation	.40	.35	.32	.31	.32	.32
Finance	.16	.15	.15	.15	.15	.14
Communications	.21	.17	.15	.14	.14	.13
Agriculture, construction and other	.26	.25	.23	.22	.22	.21
CURRENT RATIO[4]						
All corporations[2]	1.72	1.72	1.70	1.67	1.64	1.63
Manufacturing[3]	2.15	2.13	2.10	2.06	2.02	1.99
Mining	1.51	1.55	1.56	1.55	1.52	1.48
Retail trade	1.77	1.80	1.78	1.73	1.71	1.73
Wholesale trade	1.77	1.73	1.79	1.69	1.68	1.71
Service	1.25	1.25	1.24	1.24	1.22	1.21
Electric utilities	.80	.82	.78	.74	.72	.75
Gas utilities	.83	.89	.87	.79	.84	.90
Water utilities	.89	.98	.93	.89	.85	.84
Railroads	1.03	.99	.99	.96	.97	.90
Nonrail transportation	1.30	1.28	1.24	1.24	1.20	1.22
Finance	1.40	1.39	1.38	1.37	1.37	1.35
Communications	.97	.92	.89	.89	.82	.78
Agriculture, costruction and other	1.44	1.42	1.41	1.37	1.38	1.36

[1] Cash and U.S. Government securities divided byt ota. curren tliabilities.
[2] Excludes banks, savings and loan associations, insurance companies, and investment companies.
[3] Based on benchmark derived from Statistics of Income (IRS) and differs from Quarterly Financial Report for Manufacturing Corporations.
[4] Total current assets divided by total current liabilities.

Source: Office of Policy Research, Securities and Exchange Commission.

TABLE 3.—FREQUENCY DISTRIBUTION OF RATIOS, TOTAL CURRENT ASSETS TO TOTAL CURRENT LIABILITIES, LARGE DURABLE GOODS MANUFACTURERS,[1] BY MAJOR INDUSTRY

Ratio	Motor vehicles	Other transportation equipment	Electrical machinery	Other machinery	Other fabricated metal products	Primary iron and steel	Primary nonferrous metals	Stone, clay, and glass	Instruments and related products	Other[2]	Total
Mar. 31, 1969:											
5.00 and over			2	2	1	2	2	1	1		11
4.00 to 5.00	1	1	4	3	2	1	1	2	2	1	18
3.50 to 4.00	1	1	5	5	2	2	2	3	1	1	23
3.00 to 3.50	1	1	8	10	2	2	5	3	1		33
2.75 to 3.00	3	1	3	4	1	5	2	2	1	1	23
2.50 to 2.75	1	1	4	4	1	3	4	6	1	3	28
2.25 to 2.50	2	2	3	11	2	6			3	2	31
2.00 to 2.25	2	1	7	9	4	4	2	6	1	2	38
1.75 to 2.00	3	6	9	4	1	3	1	1	1		29
1.50 to 1.75	4	2	5	3	2	1	5	3	2		27
1.00 to 1.50	2	11	4	1	4	2		1		1	26
0.50 to 1.00											
Less than 0.50											
Total	20	27	54	56	22	31	24	28	14	11	287
Mar. 31, 1970:											
5.00 and over	1					1		1	3		6
4.00 to 5.00			5	4		1	1	1	1		13
3.50 to 4.00		2	2	2	2	1	2	5	1		17
3.00 to 3.50	2	1	6	5	2	2	1	3	1	1	24
2.75 to 3.00			4	3	2	4	5				18
2.50 to 2.75	2	2	5	13	2	9	4	7	2	2	48
2.25 to 2.50	2		7	3		2	1	3	4	2	24
2.00 to 2.25	1		9	11	2	4	1	1	1	4	34
1.75 to 2.00	2	4	6	9	2	2	4	2	1	3	35
1.50 to 1.75	4	3	8	4	4	5	2	2	3	2	37
1.00 to 1.50	5	14	7	4	6	2	1	2		2	43
0.50 to 1.00											
Less than 0.50											
Total	19	26	59	58	22	33	22	27	17	16	299

[1] Corporations with total assets of $100,000,000 or more.
[2] Includes furniture and fixtures, lumber and wood products, and miscellaneous manufacturing.

Source: Office of Policy Research, Securities and Exchange Commission.

TABLE 4.—FREQUENCY DISTRIBUTION OF RATIOS, TOTAL CURRENT ASSETS TO TOTAL CURRENT LIABILITIES, LARGE NONDURABLE GOODS MANUFACTURERS,[1] BY MAJOR INDUSTRY

Ratio	Food and kindred products and tobacco	Textile and apparel products	Paper and allied products	Printing and publishing	Chemicals and allied products	Petroleum refining and related products	Rubber, leather, and plastic products	Total
Mar. 31, 1969:								
5.00 and over		1		1	1	1		4
4.00 to 5.00	4	2		1	1			8
3.50 to 4.00	5	4	1	1	6		1	18
3.00 to 3.50	3	3	4	1	4	1	1	17
2.75 to 3.00	5	2	5		9	1	4	26
2.50 to 2.75	4	4	3	4	17		1	33
2.25 to 2.50	6	5	6		11	2	1	31
2.00 to 2.25	12	1	3		7	5	2	30
1.75 to 2.00	10	2	3	3	6	10	2	36
1.50 to 1.75	10	2		1		1	2	16
1.00 to 1.50	3	2	1		3	4		13
0.50 to 1.00	1	1	1			1		4
Less than 0.50								
Total	63	29	27	12	65	26	14	236
Mar. 31, 1970:								
5.00 and over		2			2			4
4.00 to 5.00	2	4		1	2			9
3.50 to 4.00	3	3	1		3	1	1	12
3.00 to 3.50	4	4	5	1	8	1	2	25
2.75 to 3.00	3	3		1	9		1	17
2.50 to 2.75	5	2	6	2	11			26
2.25 to 2.50	7	3	5		7	3	2	27
2.00 to 2.25	12	6	1	2	11	1	2	35
1.75 to 2.00	12	4	4	2	9	7	4	42
1.50 to 1.75	10	2	1	2	3	6	1	25
1.00 to 1.50	10	3	2	2	4	7		28
0.50 to 1.00			1					1
Less than 0.50								
Total	68	36	26	13	69	26	13	251

[1] Corporations with total assets of $100,000,000 or more.

Source: Office of Policy Research Securities and Exchange, Commission.

TABLE 5.—FREQUENCY DISTRIBUTION OF RATIOS, TOTAL CURRENT ASSETS TO TOTAL CURRENT LIABILITIES, MANUFACTURING CORPORATIONS WITH TOTAL ASSETS OF $10,000,000 AND OVER, BY ASSET SIZE GROUP

Ratio	$10 to $25 million	$25 to $50 million	$50 to $100 million	$100 to $250 million	$250 to $1,000 million	$1,000 million and over	Total
Mar. 31, 1969:							
5.00 and over	50	27	11	11	4		103
4.00 to 5.00	62	41	17	17	9	1	147
3.50 to 4.00	39	25	25	25	15	1	130
3.00 to 3.50	49	44	36	24	21	5	179
2.75 to 3.00	29	15	13	24	20	6	107
2.50 to 2.75	44	25	34	27	28	6	164
2.25 to 2.50	45	35	28	31	23	8	170
2.00 to 2.25	53	23	19	25	21	22	163
1.75 to 2.00	49	35	23	19	29	18	173
1.50 to 1.75	41	35	18	21	13	9	137
1.00 to 1.50	51	29	20	17	12	10	139
0.50 to 1.00	11	4		3	1		19
Less than 0.50	2		1				3
Total	525	338	245	244	196	86	1,634
Mar. 31, 1970:							
5.00 and over	39	21	21	7	3		91
4.00 to 5.00	48	23	23	18	5		117
3.50 to 4.00	37	17	22	10	13		99
3.00 to 3.50	49	40	35	25	21	6	176
2.75 to 3.00	33	24	17	14	21	3	112
2.50 to 2.75	40	19	28	34	30	11	162
2.25 to 2.50	50	31	29	24	20	8	162
2.00 to 2.25	42	34	33	27	31	10	177
1.75 to 2.00	59	42	21	25	24	28	199
1.50 to 1.75	68	48	31	29	16	17	209
1.00 to 1.50	75	51	27	31	23	18	225
0.50 to 1.00	9	5	3		1		18
Less than 0.50	5						5
Total	554	355	290	244	208	101	1,752

Source: Office of Policy Research, Securities and Exchange Commission.

TABLE 6.—FREQUENCY DISTRIBUTION OF RATIOS, CASH AND GOVERNMENT SECURITIES TO TOTAL CURRENT LIABILITIES, LARGE DURABLE GOODS MANUFACTURERS,[1] BY MAJOR INDUSTRY

Ratio	Motor vehicles	Other transportation equipment	Electrical machinery	Other machinery	Other fabricated metal products	Primary iron and steel	Primary nonferrous metals	Stone, clay, and glass	Instruments and related products	Other[2]	Total
Mar. 31 1969:											
0.60 and over	4		7	2		3	5	6	3	2	32
0.50 to 0.60		1	4		2	1		2	1		11
0.45 to 0.50				4		1	2	1			8
0.40 to 0.45	1	1						2	2	1	7
0.35 to 0.40		1	2		2	2	2	3		2	14
0.30 to 0.35		2	4	3		1	5	5			20
0.25 to 0.30			4	5		5	1	2		1	18
0.20 to 0.25		1	6	2	3	7					19
0.15 to 0.20	2	2	5	13	3	6	3	3	2	1	40
0.10 to 0.15	9	5	7	12	7	3	3	3	4	2	55
Less than 0.10	4	14	15	15	5	2	3	1	2	2	63
Total	20	27	54	56	22	31	24	28	14	11	287
Mar. 31 1970:											
0.60 and over	1		2			1	2	2	2		10
0.50 to 0.60			2	1			2	1			6
0.45 to 0.50	1	1	2		1	1	1		2		9
0.40 to 0.45			1	1	1	2		1	1		7
0.35 to 0.40			1	2			2	3			8
0.30 to 0.35			4	2	1		3	4	2		16
0.25 to 0.30	1		1	3		5	3	3	2	2	20
0.20 to 0.25	1	2	3	3	2	5	2	1	1	1	21
0.15 to 0.20	5	2	13	7	4	8	2	5	1	3	50
0.10 to 0.15	3	4	9	16	4	6		5	2		52
Less than 0.10	7	17	21	23	9	5	5	2	4	7	100
Total	19	26	59	58	22	33	22	27	17	16	299

[1] Corporations with total assets of $100,000,000 or more.
[2] Includes furniture and fixtures, lumber and wood products, and miscellaneous manufacturing.

Source: Office of Policy Research, Securities and Exchange Commission.

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TABLE 7.—FREQUENCY DISTRIBUTION OF RATIOS, CASH AND GOVERNMENT SECURITIES TO TOTAL CURRENT LIABILITIES, LARGE NONDURABLE GOODS MANUFACTURERS,[1] BY MAJOR INDUSTRY

Ratio	Food and kindred products and tobacco	Textile and apparel products	Paper and allied products	Printing and publishing	Chemicals and allied products	Petroleum refining and related products	Rubber, leather, and plastic products	Total
Mar. 31, 1969:								
0.60 and over	7	1	4	4	11	4		31
0.50 to 0.60	3		1	1	3	1		9
0.45 to 0.50	1	1	1	1	4			8
0.40 to 0.45	3		1		4	1		9
0.35 to 0.40	2				6	1		9
0.30 to 0.35	1		3	1	6	5		16
0.25 to 0.30	5	1	1		3	2	1	13
0.20 to 0.25	7	3	4	2	3	6	1	26
0.15 to 0.20	7	2	5	1	13	2	1	31
0.10 to 0.15	11	10	3	2	10	2	3	41
Less than 0.10	16	11	4		2	2	8	43
Total	63	29	27	12	65	26	14	236
Mar. 31, 1970:								
0.60 and over	4	1	3	1	11	3		23
0.50 to 0.60	1		1		2			4
0.45 to 0.50	1	1		1	3			6
0.40 to 0.45	2				4	1		7
0.35 to 0.40	2		2	2	2	1		9
0.30 to 0.35	1	1	1	1	6	4		14
0.25 to 0.30	4		1		7	2	2	16
0.20 to 0.25	8	2	1		4	4		19
0.15 to 0.20	15	3	5	3	6	6	1	39
0.10 to 0.15	12	13	5	3	16	2	6	57
Less than 0.10	18	15	7	2	8	3	4	57
Total	68	36	26	13	69	26	13	251

[1] Corporations with total assets of $100,000,000 or more.

Source: Office of Policy Research, Securities and Exchange Commission.

TABLE 8.—LIQUIDITY RATIOS OF MANUFACTURING CORPORATIONS, BY INDUSTRY GROUP, DEC. 31, 1968, AND, MAR. 31, 1970

Industry group	Quick ratio		Current ratio	
	Dec. 31, 1968	Mar. 31, 1970	Dec. 31, 1968	Mar. 31, 1970
All manufacturing	0.28	0.21	2.14	1.99
Durable goods industries	.28	.19	2.11	1.94
Motor vehicles and equipment	.30	.25	1.88	1.80
Aircraft and parts	.07	.09	1.40	1.41
Electrical machinery	.21	.14	2.17	1.92
Other machinery	.35	.18	2.43	2.14
Other fabricated metal products	.26	.19	2.22	2.01
Primary iron and steel	.53	.27	2.28	2.04
Primary nonferrous metals	.34	.24	2.46	2.27
Stone, clay, and glass products	.49	.28	2.48	2.14
Furniture and fixtures	.38	.27	2.49	2.48
Lumber and wood products	.31	.21	2.20	1.99
Instruments and related products	.37	.29	2.50	2.43
Miscellaneous manufacturing	.29	.19	2.26	2.19
Nondurable goods industries	.29	.24	2.19	2.07
Food and kindred products	.27	.20	2.08	1.96
Tobacco	.16	.14	3.11	2.66
Textile mill products	.23	.19	2.42	2.38
Apparel products	.16	.16	1.85	1.98
Paper and allied products	.34	.20	2.36	1.99
Printing and publishing	.35	.37	2.20	2.19
Chemicals	.30	.20	2.40	2.18
Drugs	.59	.46	2.57	2.42
Petroleum refining	.31	.30	1.94	1.84
Rubber and plastics products	.18	.14	2.12	2.02
Leather and leather products	.22	.18	2.56	2.40

Sources: Office of Policy Research, Securities and exchange Commission, June 1970.

TABLE 9.—LIQUIDITY RATIOS OF MANUFACTURING CORPORATIONS, BY ASSET SIZE GROUP, QUARTERLY, DEC. 31, 1968, THROUGH MAR. 31, 1970

Asset size group	Dec. 31, 1968	Mar. 31, 1969	June 30, 1969	Sept. 30, 1969	Dec. 31, 1969	Mar. 31, 1970
Quick ratio:						
All manufacturing	0.28	0.27	0.25	0.23	0.23	0.21
Under $1,000,000	.34	.33	.31	.33	.31	.31
$1 to $5,000,000	.31	.28	.27	.26	.26	.24
$5 to $10,000,000	.31	.30	.27	.25	.25	.21
$10 to $25,000,000	.30	.29	.28	.25	.24	.22
$25 to $50,000,000	.30	.30	.27	.27	.27	.22
$50 to $100,000,000	.27	.27	.26	.24	.23	.23
$100 to $250,000,000	.28	.26	.23	.22	.21	.19
$250 to $1,000,000,000	.27	.25	.24	.21	.21	.19
$1,000,000,000 and over	.27	.27	.24	.20	.21	.19
Current ratio:						
All manufacturing	2.14	2.12	2.09	2.06	2.01	1.99
Under $1,000,000	1.86	1.88	1.87	1.86	1.83	1.88
$1 to $5,000,000	2.15	2.15	2.08	2.07	2.05	2.03
$5 to $10,000,000	2.34	2.35	2.23	2.17	2.15	2.14
$10 to $25,000,000	2.24	2.35	2.32	2.27	2.21	2.20
$25 to $50,000,000	2.46	2.47	2.39	2.33	2.29	2.20
$50 to $100,000,000	2.39	2.35	2.37	2.34	2.29	2.32
$100 to $250,000,000	2.51	2.41	2.40	2.33	2.27	2.26
$250 to $1,000,000,000	2.28	2.30	2.31	2.26	2.20	1.81
$1,000,000,000 and over	1.95	1.93	1.90	1.87	1.82	1.81

Source: Office of Policy Research, Securities and Exchange Commission, June 1970.

TABLE 10.—LIQUIDITY RATIOS AND PROFIT RATES, SELECTED LARGE RAILROAD CORPORATIONS, RANKED BY QUICK RATIO IN 1ST QUARTER 1970

Name of company	Quick ratio [1]		Current ratio		1969 percent return on equity [2]
	1st quarter 1970	1st quarter 1968	1st quarter 1970	1st quarter 1968	
Chicago, Milwaukee, St. Paul & Pacific	0.07	0.32	0.75	1.03	[3]—1.5
Penn Central	.09	.09	.76	.82	—4.8
Chicago & Northwestern	.09	.11	.77	.75	—4.4
Baltimore & Ohio	.14	.17	.76	.90	3.0
Chicago, Rock Island & Pacific	.17	.17	.86	.84	[3]—3.5
Illinois Central	.21	.36	1.25	1.04	4.4
Chesapeake & Ohio	.24	.37	.88	.98	5.4
Missouri Pacific	.26	.52	.93	1.05	4.1
Southern Railway	.26	.45	.94	1.11	[3]5.8
Southern Pacific	.29	.53	.75	.98	5.2
Union Pacific	.32	.91	.79	1.61	6.0
Seaboard Coast Line	.32	.16	1.01	.98	5.0
Norfolk & Western	.38	.52	.90	1.09	6.9
Burlington Northern	.39	.58	1.03	1.39	[3].9
St. Louis-San Francisco Railway	.46	.40	1.07	.88	6.5
Louisville & Nashville	.46	.48	1.07	1.20	6.0
Atchison, Topeka & Santa Fe	.48	.68	1.11	1.46	4.0
Denver & Rio Grande	1.04	.95	1.64	1.60	6.5
Gulf Mobile & Ohio	1.22	1.02	1.92	1.85	6.0
Averages for the industry	.28	.40	.90	1.07	(4)

1 Cash and "temporary cash investments" to total current liabilities.
2 Net profit after taxes as percent of stockholders' equity.
3 Data from Moodys.
4 Not available.

Sources: Quarterly and annual reports to ICC, except as noted. Office of Policy Research, Securities and Exchange Commission.

TABLE 11.—LIQUIDITY RATIOS AND PROFIT RATES, SELECTED LARGE AIRLINE COMPANIES, RANKED BY QUICK RATIO IN 1ST QUARTER 1970

Name of company	Quick ratio [1]		Current ratio		1969 percent return on equity [2]
	1st quarter 1970	1st quarter 1968	1st quarter 1970	1st quarter 1968	
National Airlines	0.06	0.11	0.52	0.90	[3] 6.3
Braniff Airways	.14	.05	1.11	.91	7.1
United Airlines	.16	.88	1.15	1.90	8.1
Northwest Airlines	.23	.34	.98	1.35	12.1
American Airlines	.24	.57	1.21	1.56	9.5
Continental Airlines	.26	.44	.85	1.29	3.3
Pan American World Airways	.31	.21	1.43	1.33	−5.6
Trans-World Airlines	.33	.27	1.19	1.23	5.5
Eastern Air Lines	.46	.18	1.31	1.20	−.1
Delta Airlines	.55	.31	1.48	1.37	[3] 16.2
Western Air Lines	.66	.74	1.36	1.72	−15.4

[1] Cash and "temporary investments" divided by total current liabilities.
[2] Profit after taxes as a percent of stockholders' equity.
[3] Data are for 9 months ending Mar. 31, 1970, and have been converted to an annual rate.

Sources: Asset and liabilities data are based on quarterly reports to CAB. Earnings data are from Moody's Manuals. Office of Policy Research, Securities and Exchange Commission.

Senator PERCY. Specifically, aren't the airlines subject to the same economic forces the railroads have been? The railroads have exceedingly high purchase costs for new equipment, rigid trade union policies which are forcing up prices, rigid regulation by government. Again yesterday the airlines were denied a rate increase which is being held up. This is the same pattern that the railroads have had. They are regulated to protect against monopolistic conditions that may have existed years ago but today under the present competitive conditions really do not exist. Yet they cannot adjust themselves to the economic conditions.

Are you taking a look at airlines to see what policy changes might be necessary to prevent the airlines from getting into the same position that the railroads are in?

Mr. BUDGE. I think certainly the airlines are capital candidates for this difficulty because of their commitments for equipment which, I understand, are tremendous. I am not sure that the Commission really had a role in attempting to cure this situation, but I shall certainly take a closer look at the airlines situation and see if there is something which we can suggest.

I am sure for the reasons that you indicate, and because of the equipment contracts which the airlines have, that they are very likely candidates to be in this same condition.

Senator PERCY. Mr. McLaren, I would like to say to my fellow Chicagoan how proud I have been of the very vigilant job you have done of pursuing some of the best friends I have had in industry. But I suppose if they are good friends they will understand you are doing it as a public servant because you believe it is necessary, and if they have not breached any laws they have nothing to be concerned about.

I was a little concerned about the food industry, particularly the breakfast food industry. We have got some fine Chicago companies in that field and I felt they were tremendously competitive. I think you will find they are the kind of men you will find exceedingly helpful in providing every bit of analytical work to help prove to you that there isn't any kind of collusion in that industry which harms the consumer.

I would like to ask you about price and wage controls. You have taken a strong position against them. I believe deeply that they would be unworkable today. Also to what degree do price and wage controls depend upon public support? In other words, is it possible for us to even hire enough public servants or bureaucrats or whatever you call them to really control wages and prices if 200 million people don't want to observe such controls or don't feel that the national emergency is such as in the middle of World War II. Even then we had black and gray markets. Today do you think the public would really support price and wage controls?

Mr. McLaren. I think you have put your finger on a very important aspect of the thing and I put that down as really one of the tremendous costs of the black marketing that would spring up.

I think in all-out wartime, as we had in World War II, where people saw the need and were completely behind the war effort, that was one thing. I have a serious question that wage and price controls at this time would be palatable, and considering all the costs, and considering the fact that economists do indicate that we have pretty well seen the thing run its course, and we are, so to speak, about to get some of the benefits of this program of self-restraint that we have been on, I think it would be a terrible mistake at this stage and under these conditions to start on controls.

Senator Percy. Mr. Chairman, if I could just make one final comment, which you might disagree with me on, I happen to believe that there is so much psychology involved in this whole area that the more we talk about the possibility of price and wage controls the more it is going to add to inflation.

Every speech that is given by anyone saying let's have price and wage controls is an indicator and signal to unions to get wages up faster than the controls can be put in and industry to raise prices so they can get in under the wire, and 200 million people can't be outwitted by Government bureaucrats. We have proved it in the Department of Agriculture. There isn't a dirt farmer for 30 years who has not been able to outwit all the computers and all the bureaucrats just trying to rigidly control six crops.

If we tried to control and regulate millions of wages, individual wage rates and of hundreds of thousands of individual prices without any of the public really behind it, I don't think it would ever work, and I really think we ought to stop talking about it.

I hope we are over the hill and seeing some light at the end of the tunnel on inflation now. But the more we keep talking about it the worse it is going to be to try to control inflation against this psychological barrier.

Thank you, Mr. Chairman, very much.

Senator Proxmire (presiding). Well, thank you, Senator Percy. I appreciate your reference to me. I don't know why you think I am for wage and price controls. I have been firmly and emphatically against them repeatedly. I fought them in this committee when people have suggested that we put this suggestion into a report, and I continue to be against them, although I think we ought to consider wage-price guidelines and I think they can be helpful.

I would like to ask you, Mr. Weinberger, I have had a chance to look at your prepared statement. Unfortunatey, I didn't have it in

advance. In your prepared statement you indicate how heavily concentrated industry is becoming, and you base this on a study which your Commission has made.

You say that, "data in this report show that the merger movement of the last several years has been centralizing and consolidating corporate control in an unprecedented fashion among relatively few vast corporations."

You say "the merger movement has had a particular influence on these medium sized and large corporations," and so forth. Then you go on to point out that the share of manufacturing assets held by the 100 largest corporations in 1968 was greater than that held by the 200 largest in 1950, and that you have a peculiar situation in which the number of firms, middle sized and large firms, actually hasn't been growing for the last couple of years. And then you also point out the acquisitions have not been of the small firms that are failing but have been firms that apparently are prosperous and simply concentrating together.

On the basis of that, in your prepared statement you say, and I quote:

> Wage settlements in excess of productivity set inflationary wage trends for the rest of the economy. Moreover, price increases which, in turn, are designed to reestablish target rates of return in concentrated industries follow the wage settlements, and add more fuel to the inflation fires.

Your conclusion appears to be that where you have this concentration of union power and of economic power on the part of corporations that you have an inflationary situation.

Now, I don't know whether—I know you have met Mr. McLaren, I don't know whether—you read his prepared statement this morning but he said the study made by the Department of Justice indicated that the concentrated industries have increased their prices less than the rest of industry. This is something I knew about.

Frankly, while the study was made by a Wisconsin man and it must be therefore of the very best, and I am sure it was the best that could be made under the circumstances, I wonder if we can rely on that kind of a study unless you make a much more profound analysis of whether or not the situation is such because of the capital intensive nature of the concentrated industry, because of the efficiency in the industry, that the prices didn't go up—should have gone up even less than they did go up in the concentrated industry and would have gone up less if you had more competition.

Mr. WEINBERGER. Senator, I think you may be reading more into my prepared statement than is there. I did speak about the degree of concentration and the increased number of mergers, citing a previous study of the Commission. I also said it was possible that under circumstances of this kind where you had oligopolies and you had heavily concentrated areas of industry, it was possible that prices might move, on the basis of something other than supply and demand, without any collusion or without any violation of the law. But I went on to say that at this point we did not have any empirical data that would lead us to conclude that concentration always resulted in inflationary tendencies or anything of the kind.

I don't think Mr. McLaren's prepared statement is in any sense contradictory to that. His prepared statement, as I read it, is to the effect

that their own study, which one of the first I have actually seen in this field, shows that in concentrated industries prices didn't rise as much as in other areas. That is some evidence——

Senator PROXMIRE. Some evidence but it certainly isn't conclusive evidence, and I think maybe Mr. McLaren would agree it is not conclusive evidence that concentration by itself is not an inflationary factor.

Mr. McLAREN. We can't guarantee that concentration or less concentration is the why of it, and I suggested there is another possibility, that imports may provide additional competition, but that is a factor we haven't traced into the study.

Senator PROXMIRE. They may. But what is wrong when you have a situation where excess demand appears to be out of the economy, at least that is what Mr. Burns says and that is what Mr. McCracken and others say, we don't have a problem of too much money chasing too few goods now, but we do have a problem of wage demands that greatly exceed productivity, and we have a concentration of power on the part of the corporations so that rather than resist the wage demands they concede them, and then they make it up by increasing prices, which prices are increased across the board with no competitive discipline involved.

Under these circumstances why wouldn't the present situation suggest that we should have some effort on the part of government to determine what would be a fair wage increase, as little inflationary as possible, and try to persuade unions to conform to that and try to persuade business not to increase their prices unless they can justify that increase on the basis of cost data.

Mr. McLAREN. Well, I am not an economist, Senator. But I do think what you are suggesting is something like the productivity tests that the economists have prepared, and I think that there is a lot to be said for that.

Senator PROXMIRE. Well, it is something like it. But if you just prepare a productivity test which the President suggested in this economic speech you are a historian, you talk about what has happened in the past, and maybe it will be of substance for a doctoral dissertation for somebody a few years from now. But in terms of acting, and acting promptly, to hold back prices or roll back prices in the near term it is not going to be very helpful.

Mr. McLAREN. Well, my own feeling, Senator, is that, and I am sure you know, labor relations are not under the antitrust laws, they are under their own set of labor-management relations.

Senator PROXMIRE. Yes.

Mr. McLAREN. And I think that is appropriate.

Senator PROXMIRE. I agree.

Mr. McLAREN. They shouldn't be under the antitrust laws. But I do feel that our labor legislation is, depending on which statute you talk about, 30 to 40 years old. We might very well reassess our situation, and speaking from the viewpoint of the public, personally I think there is something very wrong about the Congress having to step in and pass a special statute to settle a railroad labor dispute. I think there is something wrong about a handful of people being able to tie up the whole harbor of New York City, of a relatively small union tying up all trucking in Chicago. I think that in the interests of the public we need to study the situation further.

I don't think it is right for labor, I don't think it is right for business, and I think it is very, very wrong for the public.

Senator PROXMIRE. I think it is good to study it and I think it is good to consider what we might do about it. Frankly, I don't want to break up labor unions and I don't think you do either.

Mr. McLAREN. I don't.

Senator PROXMIRE. Perhaps we should negotiate industrywide if it is going to be effective, and this does divide Members of Congress and philosophically divides many members of the American public. But in the terms of what you do now you are not going to get this kind of structural change in labor unions certainly in the next few months or few years, then what do you do?

One thing you can do is what the Kennedy and Johnson administrations did, which was to provide wage guidelines. They don't work very well when you don't have fiscal and monetary policy working in with guideposts. I think we have that. We have a situation where we have slack in the economy, we have 4.7 million out of work, we are operating at far below the optimum capacity, and what we need is some way of restraining wage-push, cost-push inflation, and this seems to me to be one way of moving ahead. The administration seems to have abandoned it.

I would like to ask you, Mr. Weinberger, in your prepared statement you say and I quote:

> There is some empirical data showing that prices, profitability, innovation and other aspects of industrial performance are related to the structural characteristics of markets, and particularly the level of concentration in these markets.

Frankly, I don't understand what this sentence says. Are you saying, for example, that in highly concentrated industries prices are higher or lower; did prices rise faster in inflationary periods or were they lower; profitablity is higher or lower; are the more concentrated industries more innovative or less innovative?

Mr. WEINBERGER. Senator, what I am saying is that there is some data that purports to relate prices indexes and degrees of profitability and degrees of innovation or lack of it to the degree of concentration in that particular industry. I am also saying that we don't have anywhere near enough of this data to use it as an established conclusive fact.

Senator PROXMIRE. Will you provide that data for the record?

Mr. WEINBERGER. Yes.

(The following information was subsequently supplied for the record by Mr. Weinberger:)

FEDERAL TRADE COMMISSION,
Washington, D.C., July 22, 1970.

Hon. WRIGHT PATMAN,
Chairman, Joint Economic Committee, New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: During my testimony before your committee on July 10, 1970. Senator Proxmire asked me to submit for the record whatever information the Commission had available that would demonstrate a relationship between industry structure and various aspects of performance.

In recent years a considerable amount of studies have been undertaken to test statistically this relationship. Most such studies have focused on the level of concentration and its relationship to profits. A summary of these studies was recently prepared by Leonard Weiss for presentation at the American Economic Association Meetings in December 1969. Unfortunately, this study is not yet

in print. However, I am enclosing a draft version in the event you may be interested.

The Federal Trade Commission's Bureau of Economics is actively participating in research designed to examine the key structural factors conditioning industry performance. Recently a staff report entitled "Economic Report on the Influence of Market Structure on the Profit Performance of Food Manufacturing Companies" was published, a copy of which is also enclosed. This report utilized special information developed as a result of a survey of the 1,000 largest manufacturing companies of 1950. The analysis gave special emphasis to the food industry. We are currently in the process of completing an expanded version of this study to cover a broader range of industries.

In addition, a staff study entitled "Structural Determinants of Profit Performance in U.S. Manufacturing, 1947–1967" was recently completed in draft form. This study is now being revised and should be available in the event the Commission dcides to publish it sometime in the fall. It undertook to develop special data on leading firms in all major 2-digit industry classifications for each year since 1947.

In addition to developing measures of concentration it sought to include data on advertising, industry growth, exports and imports. A positive and statistically significant association between concentration and profitability was found, although the strength of the relationship between concentration and profits was less strong than during periods when aggregate demand was weaker. The study is unique in that it undertakes to develop a data source which permits the testing of structure-performance relationships over the business cycle. Heretofore, data employed to test such relationships have been available for only a few, principally census, years.

I hope this material will be useful to the Committee.

With kind personal regards,

Sincerely,

CASPAR W. WEINBERGER,
Chairman.

Enclosures: Econometric Studies of Industrial Concentration, Leonard Weiss. Economic Report on the Influence of Market Structure on the Profit Performance of Food Manufacturing Companies.[1]

Mr. WEINBERGER. It is also true there are data on the other side, specifically in Dr. Stiegler's report, that concentration, as he puts it, is not a major determinant of differences among industries and profitability although it may sometimes be a significant factor.

The simple fact this paragraph is designed to say is that no one knows. I know it is fashionable to decry studies as delaying tactics, but it is really essential to have some data to go on before we make formal recommendations, and so the gist of that paragraph is that there are some data this way, there are some the other. But nobody really knows yet whether concentration has any direct relationship to prices or profitability and, therefore, we are relating to the Congress that we have already begun a study to try to get empirical data of this kind.

Senator PROXMIRE. It seems to me that one element here that is pretty clear is if you don't have the discipline of competition, either for labor unions or for concentrated industry, that one discipline you do have is they are aware, both the unions and the management, they have to rely on public opinion very greatly. The one man who can focus public opinion immediately and promptly on a situation, either an excessive wage demand or an unjustified price increase, is the President of the United States. Now this is one force that we haven't been able to use for the last 4 years or so, since 1966.

I don't mean to criticize President Nixon or President Johnson particularly but it seems to me as a matter of policy this is an instru-

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[1] The enclosures referred to above are on file with the Joint Economic Committee.

ment the country has a right to expect the Chief Executive to use.

Mr. WEINBERGER. Well, it puts quite a burden on any one man, Senator, to determine what is a justified or an unjustified price increase.

Senator PROXMIRE. Well, perhaps, supposing he simply does this: "I have asked the Council of Economic Advisers simply to give me the factual justification, the cost basis for the steel increase we had last year, price increase we had last year, for the oil price increase we had last year, for the automobile price increase we had last year, the biggest we have had in 10 years." They wouldn't give me that, I am not asking the President to turn down——

Mr. WEINBERGER. That is almost word for word in the President's economic message, and that is the new responsibility placed on the Council of Economic Advisers in connection with the alerts.

Senator PROXMIRE. It is not word for word. He talks about gathering information. It is hard to know whether he is focusing on the company of giving us industrial figures or overall figures. I am talking about when a company comes in and makes an announcement to the public, as they do, they are going to increase steel or oil prices a certain amount or automobile prices by a certain amount then we ought to have an investigation promptly by the Council as to what the basis for it is.

Let the public and the Congress judge it if the President doesn't want to. I think he should, but if he doesn't want to at least let us have the facts.

Mr. WEINBERGER. I think the facts will be forthcoming under the economic message. This was one of the goals of the economic message, particularly in connection with the new duties assigned to the Council of Economic Advisers, and in connection with this inflation alert.

Senator PROXMIRE. My time is up.

Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Weinberger, I just have a few questions for you.

Mr. WEINBERGER. Yes, sir.

Representative WIDNALL. Last autumn the Federal Trade Commission released a report on conglomerate mergers, the so-called Mueller report.

Mr. WEINBERGER. Yes, sir.

Representative WIDNALL. At that time Commissioner Jones stated that she had strong misgivings about the report. It was also pointed out that the Commission's release of the report did not indicate agreement with its contents. Does the FTC still maintain this position toward the report?

Mr. WEINBERGER. Yes, sir.

Representative WIDNALL. At the time of the staff report Commissioner Jones also expressed a disappointment that the report did not include any new empirical evidence but instead, in her words "[the] staff is asking the Commission and the public to share its faith in the anticompetitiveness of conglomerate mergers, to substitute that faith for hard data."

Do you anticipate that the second volume of the report will rely more heavily on new empirical evidence than did the first?

Mr. WEINBERGER. That is the whole point of the second phase of it; yes, sir.

Representative WIDNALL. When do you anticipate the release of the conglomerate study, second volume?

Mr. WEINBERGER. I would hate to make a prediction that wouldn't be fulfilled, but it would certainly be my hope it would be forthcoming within a year.

Representative WIDNALL. I understand that one aim of the Mueller report was to examine possible procompetitive effects of mergers. Yet apparently little effort has been addressed to examining such possibilities as the injection of competition into tight knit oligopolies, increasing the firm's and industry's monopoly activity, and the use of cross-subsidization in overcoming barriers in a hard to enter industry.

Will the forthcoming report explore those possibilities more fully?

Mr. WEINBERGER. Yes. This is one of the directions. There was considerable disappointment in the Commission with the first phase report. I think it was expressed to me, although I was not on the Commission, when I came, as being a concern that perhaps the last page of that report had been written first and the rest of it had been assembled to support the last page. I don't know if this is true or not, but this was the worry, and the way it was phrased to me when I joined the Commission, and there was a general feeling among the Commission as a whole that we very much needed a second phase report.

Representative WIDNALL. That is all. I have no further questions.

Senator PROXMIRE. On this inflation alert, Mr. Weinberger, I have the President's speech now. He said, "I instructed the Council of Economic Advisers to prepare periodic inflation alerts."

Presumably that becomes a quarterly or twice a year or something like that.

Mr. WEINBERGER. I don't think that is necessarily required. Periodic, I think under those terms, could mean any time that seemed to them to be warranted under the circumstances.

Senator PROXMIRE. Well, in your view would this mean if the oil industry increases, announced a price increase, that then there would be, this would trigger the action by the Council of Economic Advisers?

Mr. WEINBERGER. I don't think it is excluded by that language.

Senator PROXMIRE. That is the trouble. I want to know when we will get this kind of a report? This vague language is completely unsatisfactory if we are going to find out how it is going to work.

Mr. WEINBERGER. I don't want to qualify my answer by saying that this is outside the purview of the Federal Trade Commission, but let me just suggest that the inflation alert would be issued when, in terms of the message, the circumstances justified or required it. I don't think that the use of the term "periodic" should be taken to mean that they are only going to do it once a year.

Senator PROXMIRE. Then he goes on to say "this will spotlight the significant areas of wage and price increases, and objectively analyze their impact on the price level."

Mr. WEINBERGER. That is what I understood was exactly what you had been talking about a moment ago.

Senator PROXMIRE. No. I have been talking about specific increases in a particular industry or by a particular big company which is a price leader, like United States Steel or Standard Oil of New Jersey, or General Motors or one of the big ones.

Mr. WEINBERGER. It would seem to me that is a possibility if the Council of Economic Advisers felt the circumstances of that hypothetical price rise you are talking about warranted the issuance of an inflation alert.

Senator PROXMIRE. Then it says "The Council won't release it, they will give it to the National Commission on Productivity." The National Commission on Productivity is going to have a meeting sometime in the summer to discuss productivity apparently.

Does that suggest that this is going to be a historical study which will be disclosed some months after these price increases go into effect or in your view would it be, if the price increases are regarded as significant and big, that the National Commission on Productivity would release it promptly, say within a day or two.

Mr. WEINBERGER. I think they have clearly the authority to take that action if, in their discretion, they feel it necessary and justified. I think one of the benefits of this kind of approach is that it does allow a degree of flexibility which the situation may well require in view of the fact that it is very hard to assign to a particular situation a label of being inflationary until a lot of facts are known. I think that is one of the virtues of having an examination of the situation by both the Council of Economic Advisers as well as the Productivity Commission which, I understand, will be announced shortly.

Senator PROXMIRE. I get from your answer then the feeling that this won't be a sharp, quick reaction; that it will be one that they will study, both the Council and the National Commission on Productivity and, therefore, might take several weeks.

Mr. WEINBERGER. Well, my answer was intended to convey the fact that I hoped it wouldn't be a sharp, quick, irresponsible report. I think the degree of study and the degree of examination that would be given would be that which is required by the facts and I don't think they would be interested in rushing into the headlines until they have the facts to support it.

Senator PROXMIRE. I am not talking about that. I agreed with what President Kennedy did in the steel situation in 1962 when he cracked down and succeeded in rolling back steel prices. A lot of people thought it bad and disagreed. I am not talking about that. I am talking about when there is this kind of increase there will be a prompt, within a matter of 48 or 72 hours, a disclosure on the part of the National Commission and the Council of Economic Advisers as to the effect that may have an inflation. That may not be an effort on their part to roll the price back, it may not be an effort on their part to say it was unjustified. Simply a finding of fact of what will be the inflationary consequences of it, and what are the cost elements behind it which result in this price increase.

I don't see how that can be irresponsible, even if it is made very quickly.

Mr. WEINBERGER. We are talking about a hypothetical situation, so it is impossible really for me to guarantee that the Council of Economic Advisers would or would not make such a finding or that the new Productivity Commision would or would not release it within 48 hours or any other given period of time.

My understanding of the procedure established by the President's economic message is that there has been a very, to my mind, sensible

degree of discretion and flexibility and authority given to these two bodies to take the action that seems to them to be required under the given facts of a particular circumstance. I don't think it would be in any sense proper for me to tell you gentlemen that in every case where a price increase or a wage increase is recommended there will be a disclosure of that within 48 hours or 24 or whatever. But there will be the procedure established so that a careful examination can be given to each situation, and whatever action seems to be required under the circumstances of that situation can be taken.

Senator PROXMIRE. All right. Well, then let me just conclude by saying, so far as this question is concerned by saying, I just wish that we could have some assurance that in the event there was a price increase or a wage demand in a major industry that there would be this kind of disclosure. I can't see there is one bit of irresponsibility in disclosing the analysis and conclusions made by this governmental commission.

They are not trying to roll it back necessarily or say it is wrong, at least that is not what I am asking. What I am asking is that they disclose what the effects are and what the cost pressure was, and if it is a major situation that they would consistently do it.

Mr. WEINBERGER. Not being a member of either body I cannot, of course, give you that kind of assurance, but I can give you assurance that the quality and character of the people chosen will be such that I think we will have every reason to place confidence in their decisions.

Senator PROXMIRE. Now, I would like to ask Mr. Budge a little further about the Lockheed situation.

Lockheed officials dumped large blocks of Lockheed stock based on the knowledge of the C–5A overruns. When these officials sold their stock in 1967 it was selling for about $70 a share. It soon began to dip and now it is under $10 a share.

Again as I read the staff report there is serious evidence of insider trading, and yet this issue has been dropped entirely by the SEC. It seems to have washed its hands of it. Why?

Mr. BUDGE. My recollection of the staff report is that the staff report specifically found that there were no violations of the insider trading rules.

Mr. Pollack, Mr. Irving Pollack, who is the Director of our Division of Trading and Markets, which conducted that study is here. I would be happy to have him respond to your specific question.

Senator PROXMIRE. Mr. Pollack?

Mr. POLLACK. Senator, we found that there were no actionable violations in the insider trading because, as the report indicates, we did not find a correlation between the selling and any material significant inside information which the people had at that time. And so based upon the evaluation of the facts which we had developed, we did not feel that there were any actionable violations in that area.

Senator PROXMIRE. Well, isn't it true that the information on the enormous cost overruns which have been so tremendously costly to Lockheed and may very well result in its bankruptcy, and certainly has been the factor, its principal factor, which resulted in the tremendous drop in its stock, was known to these people and was not known to the public, was not known to the people who bought the stock from these officials who sold it at $70 a share?

Mr. POLLACK. I think, Senator, reading of the report will indicate that this was at an early stage of the cost overruns. These people who did dispose of stock had various different positions in the Lockheed enterprise. Many of them had programs of purchasing and selling which formed patterns, which indicated that they had not dumped the stock because of their analysis of the cost overruns as being at that point in time significant in the future of the company.

Senator PROXMIRE. Early in 1967 or before, this was well known to a number of people in the Pentagon, including people who have been closely associated with this staff, Mr. Ernest Fitzgerald, for example, and the president of Lockheed division at Marietta, Ga., who would certainly know if anybody would. Marietta, Ga., is where the C-5A plane is built. He was president of the company, resigned earlier this year; he is one of those who dumped stock several years ago. In fact, he sold the largest block, and the staff report expressed some skepticism about the explanation for his actions.

I wonder if the SEC decided that his resignation constituted sort of a self-discipline on his part and Lockheed's part making it unnecessary for SEC to do anything further. Will you comment on that?

Mr. POLLACK. No; we did not take into account his resignation. The gentleman you referred to, is that Meyer, I don't remember the name but if you give me the name——

Senator PROXMIRE. May.

Mr. POLLACK. May, yes. I think our report indicates in his instance somebody may have a different judgment from the overall one which the staff determined, but weighing all of the facts we felt that this was not an actionable violation which we would move upon.

Senator PROXMIRE. What does an actionable violation require?

Mr. POLLACK. A violation which the staff feels can be supported in some proceeding, whether it be administrative or——

Senator PROXMIRE. I am sure of that. What kind of action would the staff feel would be supported? Give me a hypothetical example.

Mr. POLLACK. If you assumed somebody violated the insider prohibitions against trading, the Commission could bring an injunction against him.

Senator PROXMIRE. What you would have to prove is, he had knowledge of some development in the company that was going to result in a loss that the public didn't have and sold before it was public knowledge; is that what you have to have?

Mr. POLLACK. You would have to show that the information which he had was significant information, which would have given him an advantage over the public at that particular time in determining the overall value of the enterprise as represented by an equity interest, and if you review his particular situation as set forth in the report, you will see he did have, and there is no question he did have, some knowledge, and the question which you have as a reasonable man to judge is: Was he propelled in disposing of his stock at that time by the information he had as to the cost overruns in an enterprise as large as Lockheed?

Now had that occurred at a later time in the cost overruns, Senator, your question might be more easily disposed of and you might then determine, yes, he did have information which would have perhaps

subjected him to an action. But I think what we tried to do in the report, as objectively as possible, was to lay out the facts which we had developed, and the particular situation of each individual giving the explanation which we obtained from them, and such additional documentary data and other information we related to the explanations which they had offered.

Senator PROXMIRE. The Air Force team knew about this, as I understand it, these overruns in 1966 and they began projecting overruns at that time. Certainly the president of the Marietta Division building the plane knew of it. He must have known it before the Air Force team knew.

Under these circumstances it is hard for me to understand why you didn't have an actionable situation.

Mr. POLLACK. I would again refer you back to the report, and what the individual people knew. I have no desire to attempt to argue what other people might conclude from a set of facts which we have, to the best of our ability, objectively stated in the report. If you will recall, Senator, there was some dispute between the Air Force and the people at Lockheed in the early stages as to what the cost overruns might be, and as you would expect people in Lockheed were perhaps somewhat more optimistic in overcoming some of the earlier difficulties that were developing, as the contract proceeded, and perhaps they did not appraise them in the same manner as did some of the people at the Pentagon.

But I think that what you have to do, if you are going to reasonably evaluate any one of these situations, is to do what we did in the report and take each individual case as we did, examine the position which he occupied, the access to the information which he had, place that in the context of the overall operation of the company, and then determine whether or not you feel, as a responsible Government official, that you have enough there to warrant taking some action against him.

And our people concluded, on a review of the evidence, that they had established after an intensive and comprehensive investigation, Senator, that they just did not feel that we had a reasonable basis for proceeding against any one of those people.

Senator PROXMIRE. Was that a staff conclusion, too?

Mr. POLLACK. That was the staff's conclusion; I am speaking now for the staff on the insider trading part of it.

Senator PROXMIRE. One other area, perhaps you had no jurisdiction over. The Air Force conceded, they admitted, that they concealed this information because it would adversely affect, as they put it, the sale of the $125 million of debentures by Lockheed. This, it seems to me, after all, puts yourself in the position of those people who brought those debentures, I looked at the price the other day. It is way below par, something like a third or 40 percent of par, a fantastic loss, and the Air Force knew about this and they said they wanted to conceal it because otherwise Lockheed would have trouble selling these debentures.

I presume the SEC may not have any authority in this area. If not, who does?

Mr. POLLACK. Well, I think that you are referring now to the disclosures in the registration statement where we would have jurisdiction, and that is a separate disclosure problem.

As you will recall, you received two reports. The second report covered——

Senator PROXMIRE. It is one thing you wouldn't have authority over the Air Force's knowledge, you would have it over the company's. You might argue that the company did not agree with the Air Force and, therefore, it is a different situation, but this was the Air Force which said that they were not disclosing this because if they did it would adversely affect the sale of the debentures.

Mr. POLLACK. Well, first, let me say that the Air Force's memorandum which is set forth in the report, as I recall it, indicates what you have already indicated. The company did not acquiesce at that period, as I recall, with the Air Force's full appraisal of the situation, and that the particular official at the Pentagon did not want to get out on a limb in making a statement which might later have proved to be incorrect. But in any event, as to that part that you are now discussing, I am somewhat reluctant to get into that particularly because we are now exploring the area of disclosure in the pending hearings.

The Commission has not determined anything with respect to the other disclosures.

The only point which I was attempting to answer is why the staff had determined in its view that they did not feel that any action was warranted with respect to the individuals recognizing in the one individual case that you mentioned, and we put it in the report, that there was some room for doubt as to the reasons that did propel his selling.

Senator PROXMIRE. Well, gentlemen, I apologize for having detained you so long. You did a fine job, you are all extremely responsive and helpful and these are excellent statements.

I want to announce that on Monday we will have a hearing on credit and money markets with Cyrus Eaton, Otto Eckstein, and Daniel Brill.

The committee will stand in recess until Monday morning at 10 o'clock.

(Whereupon, at 12:40 p.m., the committee was adjourned, to reconvene, at 10 a.m., Monday, July 13, 1970.)

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