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THE 1971 MIDYEAR REVIEW OF THE ECONOMY

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

FIRST SESSION

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THE 1971 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, JULY 7, 1971

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

The committee met, pursuant to call, at 2 p.m., in room G-308, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Javits, Miller, and Pearson; and Representatives Griffiths and Blackburn.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Courtenay M. Slater, economist; and Lucy A. Falcone, research economist.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today the Joint Economic Committee begins its midyear review of the economy. A midyear assessment of the state of the economy and of the possible need for policy changes always an important responsibility of this committee. This year, there are several reasons why a midyear review is especially timely and important.

First, the policies so far adopted do not appear adequate to restore healthy growth and reduce unemployment. Growth of real output is falling far below the hopes expressed by the administration at the beginning of the year, and far below the rate needed to restore full employment.

Second, progress in restoring price stability has been so painfully slow as to be almost imperceptible.

Third, monetary stimulus has not produced the hoped-for response. Interest rates have recently begun to rise despite the unusually rapid growth of the money supply.

Fourth, in the face of continued high unemployment, continued inflation, and rising interest rates, the administration has just within the past week indicated that it has no intention of adopting new policies. Furthermore, recent statements by administration spokesmen have cast doubt on the commitment of this administration to the goal of full employment.

These statements by administration spokesmen are both puzzling and disturbing. One can only hope that the administration has been misinterpreted. Surely, with the 2d quarter GNP figures not yet available, it is too early to be certain that no new policy measures are needed. And surely, the suggestion that full employment in peacetime is an unattainable "myth" was not meant to be taken as an indication that the present administration has abandoned the long-standing bipartisan goal of full employment.

I hope that testimony by the administration during this set of hearings will clear up any misunderstanding. Tomorrow we will hear testimony from the Council of Economic Advisers. We continue to hope that the Secretary of the Treasury will also be able to testify. I regard it as of the utmost importance that during these hearings it become abundantly clear that this government has a total bipartisan commitment to the restoration of full employment with price stability and a willingness to adopt the policies necessary to achieve this goal.

Today the committee is both pleased and honored to welcome as our leadoff witness the distinguished senior Senator from Montana and majority leader of the Senate, Senator Mansfield. The Congress as well as the executive branch bears great responsibility for the proper execution of economic policy. Senator Mansfield, I know you are greatly concerned about the present economic situation and anxious to foster cooperation between Congress and the executive branch in developing policies to restore full employment and price stability. We are very happy you could meet with us this afternoon. So please go right ahead in your own way.

STATEMENT OF HON. MIKE MANSFIELD, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator MANSFIELD. Mr. Chairman and members of the committee, in accepting your kind invitation to testify, it should be made very clear that I do so not as an economist. I appear before you rather as a Senator who has responsibilities and worries; one who is deeply concerned about the present state of our economy and about the apparent lack of adequate and effective policies designed to meet this critical situation.

As a Nation, we have just celebrated our 195th anniversary. It is an appropriate time, I suggest, to look at our economic posture in terms of immediate needs and long-range effects; in terms of those who suffer today because remedies were not pursued last year and the year before. We do this in the hopes that by next year or the year after, we can return to an economy of full employment and prosperity.

The task will not be easy. The signs are by no means optimistic. Just yesterday it was disclosed that the Federal deficit for last fiscal year, which ended 7 days ago, will exceed $23.3 billion. It was reported as well that the national debt scored its biggest increase in 26 years—a whopping $26 billion.

Deficit spending is now the accepted economic practice of both Republican and Democratic Administrations. Where should we spend this deficit? Where will the best stimulus to the economy come to cut down on the high unemployment? As a noneconomist, I wonder if the Government is not spending its $26 billion in the wrong places. There might very well be a more productive place to spend—where the long term investment in this country could be improved and a more significant short term economic stimulus could be achieved. More in human development and less in hardware accumulation would be a good start. We do not fully fund the programs for education, manpower training, and pollution but find the rationale to increase military obligations in the coming year by over $5 billion from last year.

However, I must admit that there are some signals—though faint at best—which give us reason for some encouragement. Housing figures, for instance, show improvement. But of all the economic sectors bogged down by this economy, it is housing that has fallen among the furthest. And I am not so certain that this positive sign will long survive. Witness yesterday's announcement that some prime interest rates will be raised to 6 percent. Housing investment gains would easily be choked off by soaring interest rates.

As for unemployment, the monthly figure announced by the administration last Friday showed an adjusted rate of 5.6 percent. On the surface, this is a decrease over the preceding month's figure, but the Labor Department stated nevertheless that there were 1.1 million more unemployed Americans in June than the preceding month. The increase is due in great part to the influx of college-age students seeking employment. It is a sad fact that in June 1971, 1.1 million more Americans wanted to work and couldn't find work than in May 1971. The total number of Americans out of work today is 5.5 or 5.6 million. It was 4.4 million just last month.

In truth, there are 800,000 Americans classified as completely discouraged from seeking employment. In truth, there are 400,000 Vietnam veterans unable to find work on their return home. In truth, the adverse economic statistics have been with us too long. In a very graphic way, they have told the story of the American economy day after day after day. They are alarming statistics. To repeat, 5.5 or 5.6 million Americans are out of work today.

Scores of cities are categorized as having substantial unemployment. Hundreds of so-called labor areas have reached the critical level. Hundreds of labor areas have been identified as persistently critical—having severe unemployment for a year or more. In Seattle, Wash., the situation is well known. But what about Marion, S.C., and Manchester, Ga., and Alexandria, La., and Butte, Mont., and all the rest? Albuquerque, Charleston, and Johnstown, Pa., may have moved off the most critical list last month. But they were quickly replaced by St. Louis—America's 10th greatest city.

And what about the effect of economic policies as they have been applied to individual labor groups? Unemployment among teenagers was 17.3 percent last month; among blacks, 9.4 percent. What about the effect on those major labor areas where significant unemployment has more than tripled in the last 2 years?

Then there is the question of inflation. For too long, inflation has continued at an unbearable level. For too long, the rosey and optimistic predictions have been converted into gloomy and pessimistic facts. In the month of May the fact was that prices went up by more than one-half of 1 percent. The annual rate for that month was about 7.2 percent. That is the rate of inflation. This is anything but price stability. Combined with critical unemployment, adverse inflation has given us the worst of both worlds—able-bodied Americans unable to find work and facing at the same time ever-increasing bills at the grocery store. This is the case today. It has been the case for too long.

We all share some responsibility. Democrats and Republicans alike. For too long the various ups and downs of the economy have played havoc with large numbers of Americans, their families, and their future plans. I do think it unfortunate that there has been conflict or confusion and sometimes seeming duplicity from the various quarters.

As I said at the outset, I am not an economist, but I am troubled when what seems to be recommended by the Federal Reserve is rejected out-of-hand by the Treasury with the Council of Economic Advisers resting uncertainly somewhere in between.

I do think that our once firm goal of full employment should still be sought. It should not be dismissed or replaced with a less rigid standard of partial employment. In short, high unemployment is intolerable and unacceptable in our land. What the American people have had to endure these past months is too great a price to pay for restoring stability to prices. Such stability does not seem to be in sight.

Again, the most tragic and ironic aspect of this economic situation today is that despite the increase in the number of the unemployed, there has been no substantial progress in the fight against inflation. We have paid and paid dearly with the jobs of over 5 million Americans or more for a price stability which up to now has been a most elusive objective.

It is an economic situation where there is much room for burden-sharing. It has granted the President twice wage, price, and rent authority for the next 2 years. It is presumably on the basis of such authority that policies advocated by the Chairman of the Federal Reserve could be implemented. Congress, as well, enacted last year the selective credit control authority designed to assist those segments of the economy most in need.

On the jobs front, Congress is also doing its share. On this score, I was most disappointed that the accelerated public works measure was vetoed last week. It was with this proposal that Congress sought to move quickly in establishing building programs that would in turn mean jobs for countless numbers of Americans. At the same time, I was pleased that the Emergency Employment Act was at long last embraced by the administration. By providing at least 150,000 jobs almost immediately, it is certain that this measure initiated by Congress can help alleviate the ravages of unemployment and at the same time provide the type of public services that are in such vital need.

It should be pointed out that those suffering in the wake of unemployment today are by no means limited to the workers at the bottom of the labor market. It has been the unemployed engineer, the skilled worker, and the general laborer from whom I have been hearing as well. And the problem is not limited to just one sick corporation or enterprise. It is nationwide and affects us all. Indeed, I am concerned about an attitude that urges the spending or guaranteeing of hundreds of millions of dollars to save particular companies or railroads in the name of safeguarding the economy while refusing to initiate measures aimed at taking the unemployed off the welfare rolls immediately.

As one economic reporter put it last week: fresh and vigorous initiatives are imperative to pull the Nation out of its economic quicksand. It is suggested that the initiatives have been lacking or so obscured by divisiveness among the administration experts that all we are getting is more of the same—more unemployment and more inflation. What is happening in turn, I fear, is that disillusionment and frustration are taking their toll among the American people. What has been experienced with regard to the issue of Vietnam is being transferred now to the issue of the economy. It is frustration fed by promises and followed only by a plague of failures and fatigue. An inflation of predictions will not make up the $15 billion differences between the projected $1,065 billion GNP of the administration and the more realistic $1,050 billion GNP figure projected by most economists. Do not misunderstand me. What is happening to the economy today is in part, at least, an outgrowth of what happened years and years ago, under Democratic administrations.

As for future steps, I would hope that at long last a sound wage and price program would be instituted. I have said so many times in the past. I was frankly pleased with today's news that the President is knocking heads, I am speaking figuratively here, together in the steel industry. I hope all efforts in this direction are stepped up. But all in all, in viewing the economic landscape from my perspective, I find very little to celebrate as this Nation enters its 196th year. The few encouraging signs today have not grown into a basis for optimism. Your leadership, Mr. Chairman, and the leadership of this committee have served the people well by persisting in its demand for more aggressive economic policies. I would encourage your continued efforts.

It will be efforts such as these that ultimately will assure a strong economy. In the end, a strong economy is essential to the future of America. After all, it is the only tool we have in facing our domestic needs in the years ahead. What we will do to educate our children, to clean the air we breathe and the water we drink, to care for the aged and the infirm will depend largely on the state of the economy. Only if that state is strong and healthy can we be a better America. And if we are going to be strong in safeguarding the best interests of this country from abroad, then I want to say, ladies and gentlemen, we have to be just as strong in safeguarding the economy at home.

Thank you.

Chairman PROXMIRE. Thank you very much, Senator Mansfield, for a very vigorous and effective statement.

Senator Mansfield, it occurs to me that one big economic fact that frankly I didn't mention in my opening statement, and you refer to briefly in your statement, but I think it is a very big economic fact in the minds of many Americans, and in the mind of business and others, as we look forward to this coming year, is that the Vietnam war is now being wound down. We all hope and pray it will be over in 6 months, 9 months, or a year, and it may very well be over. As the war is being wound down and the people are discharged from the military, and more rapidly than they have been in the past, as defense contracts may be reduced, we are going to have resources that will be freed, we are going to have people who will be seeking additional jobs. We went through the same kind of a situation, as you recall so well, after World War II. In fact, it was far more dramatic and a far bigger reduction than almost everybody expected. Many predicted we would have a serious recession or depression after World War II and it didn't materialize. The situation, of course, was quite different. There were many pent-up demands. But there are some pent-up demands now, and savings are very high now.

What do you feel we should do in view of the certainty that we are going to be discharging hundreds of thousands of people from the Armed Forces over the next few months and every likelihood that the war will be wound down and perhaps ended in the next 12 months?

Senator MANSFIELD. Well, Mr. Chairman, first let me say that it is difficult to accept the words of those who advocate 3.6 to 4 percent as a livable level of unemployment in this country. What ought to be done is to use the tools provided in the laws which the Congress passed; the law, for instance, passed a year or so ago having to do with regulating credit and interest rates in certain depressed sectors, the law which was renewed just a few weeks ago, renewed to give the President standby wage-price and rent controls. I think we ought not to veto the legislation which has been vetoed this year and last. We ought to recognize the fact that by trying to wait out a long term objective without taking any steps will only extend the rate of unemployment, up it, and at the same time increase the instability which marks the economic situation in this country.

We have wasted $130 billion in carrying on a war in Southeast Asia, a tragic war, a mistaken war and a war in an area which is not vital nor essential to the security of the United States.

We will pay twice that much before we are through and then we will double that amount because the costs of the war in Vietnam are going into the next century just as the costs of the Spanish-American War and to a limited extent the Civil War and to a still more limited extent the War of 1812 have come into this century.

All this money which we have spent, wasted—it is getting to be a popular term, they even apply it to human beings—could have been spent so much better at home in taking care of the needs of our people, in controlling some of the difficulties which confront us, like pollution and the like, in stopping the devisiveness which has come out of the war, and in bringing us together, so that together we could work for the common good and in that way make this a stronger and a better and a more liveable country for all of us.

In this war I don't think we are making any preparations to take care of the men discharged from Vietnam. They are coming home unhonored and unsung in many respects. They are thrown into the labor market. I gave you the figures which indicated that their rate of unemployment is very much above the average and it is in contrast to other wars where despite all of the gloomy prophesies and depressions did not occur unless they were of a limited nature. Unemployment certainly didn't reach the 6.2 level or 5,500,000 level, so I would think that what we ought to do is to face up to the present, get away from projections which we have been hearing about for the past 2½ years and do something for the young and the returning veteran and in that way help to build up our country and to bring our people together.

Chairman PROXMIRE. Thank you. I would like to before I get into the details of what we do, I would like to ask you more specifically, you mentioned in passing that you felt that even a rate of, as I understand you to say, 3½ percent to 4-percent unemployment was too high, and you wouldn't accept it. As you know, Secretary Connally, speaking for the administration, says a 4-percent rate of unemployment is a myth, we can't achieve it except in wartime. He claimed we haven't achieved it in the past.

At any rate, you contend that we can reduce unemployment to what level, say 3 percent, and we can do that consistent with stable prices, and if necessary in order to do it I take it from your statement that you would advocate wage and price controls; is that correct?

Senator MANSFIELD. Yes, sir; indeed for a limited period, because I think something has to be done to stop this spiraling. It doesn't do the unions any good to get a sizable increase in wages if inflation is going to overtake that increase. It certainly doesn't do those who are living on retirement or annuities any good if inflation is out of control. I realize, of course, that it is impossible to reach zero unemployment, but in general I would agree with the figure which you gave, Mr. Chairman, but express the hope that it could be reduced still further. However, how, I do not know, except on the basis of the actions initiated by the Congress, which are now the law and which the President can use at his discretion.

Something will have to be done. Otherwise we are going to be faced with this anomaly of a decreased percentage in unemployment to 5.6 percent as announced a few days ago, but an actual increase in actuality in the number of unemployed to somewhere between 5.5 and 5.6 million.

It appears to me that despite all of this doubletalk coming out that the trend in both fields is upward and it is quite paradoxical to find such a situation existing in that context.

Chairman PROXMIRE. Now, regardless of the figure we take, whether we take a 3-percent unemployment figure or 4 or even 4½ or 5, it is hard for me to see any stimulus which the administration is putting into effect in the economy. The Secretary of Treasury keeps talking about a stimulative fiscal policy. Have you heard of the administration suggesting a policy, have they offered the Congress or leadership in the Senate and House anything since last February that would indicate that they want to stimulate the economy? You did speak about how they finally accepted the public service employment bill which is a very limited effort in this direction, and commendable, but except for 150,000 job proposal can you think of anything else that they have done?

Senator MANSFIELD. Frankly, no. I understand that the administration has an economic game plan. It was supposed to stretch over a period of time. Two and a half years is a long time with no let up in sight. And conditions have reached such a stage that people are becoming more and more worried and according to some of the polls which I have noted the economy has become the No. 1 question in the minds of many of our people superseding the Vietnamese war which I think is the No. 1 question and should be until it is settled. In my opinion many of our troubles are tied directly and indirectly to what has been happening in Vietnam, in the case of expenditures, in the case of losses and in the case of problems, which certainly have been encouraged from there and which will leave their marks on our people for decades to come. The costs will be paid by the rest of the people in the next century, as I have indicated. So I would hope that we could work together, the Democratic majority, if I can put it in political terms, with the Republican administration.

As I tried to say earlier, I have my responsibilities as a Member of Congress, as does every member of this committee, and as a citizen I have my worries, as I think most citizens in this country do, and what I would like to see is the administration and the Congress working together cooperatively in tandem to the end that we could do everything possible for the common good. As far as political effects were concerned, they should be secondary because if the country is in good shape we will all benefit, if the country is in bad shape we will all suffer, Democrats and Republicans alike.

Chairman PROXMIRE. My time is up. Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman. Thank you, Senator.

I want to say for my own part I am gratified and flattered being a Republican invited to the Democratic kickoff for the presidential race of next year.

Senator MANSFIELD. Would the gentleman yield?

Representative BLACKBURN. I would be happy to yield.

Senator MANSFIELD. I noticed a statement that I was going to mention but discretion is sometimes the better part of valor, U.P. dispatch No. 7 from Washington under the heading "Economy," "Democrats open fire today on President Nixon's decision to stand pat on the policies he hopes will restore momentum to the economy by the time the presidential campaign opens next summer."

It kind of disturbs me because I am not appearing here in a political context. I happen to be a Senator from the State of Montana as well as the majority leader, and I happen to feel that what we face is not a Democratic problem or Republican problem but a national problem, and I want to repeat again as far as I am concerned I would hope that our political sensibility would not rise to the surface but that the national good would always be in the forefront.

Chairman PROXMIRE. Would you yield? As chairman of the committee I take full responsibility for having invited the majority leader to appear and I would point out to the distinguished Congressman that we have a dilemma on the committee. We listened to the spokesman for the administration and we should. We are very anxious to get Secretary Connally: We hope he can appear, we expect him to appear later in the month. We, of course, are having the chairman of the council of economic advisers representing the President's view, and we think for balance it is deisrable and necessary to have at least one spokesman for the majority party and we make no apologies that we have done that. Our spokesman happens to be Senator Mansfield although he has decided that he will present this as he says as much as he can and not in a partisan way but from the standpoint of, as he sees it, as a Senator from Montana.

Representative BLACKBURN. Let me ask the Senator this question. Senator, I have read your statement, I have heard your statement, and I find that you emphasize the number of Americans who are out of work. Of course, there are more Americans working today than ever before in the history of the country. Isn't that true?

Senator MANSFIELD. That is true.

Representative BLACKBURN. So, since we are dealing with a much larger population, the numbers in the absolute themselves are not as significant. In other words, 5½ million people unemployed 20 years ago would have been far greater or far worse a problem than it is today because we are dealing with a much larger population.

Senator MANSFIELD. That is true. You have to divide the number into the whole to get the percentage. But 5.5 or 5.6 million Americans out of work seeking work to me is an abominable figure.

Representative BLACKBURN. Don't we also have to take in account the seasonal factors of the college graduates who are just coming out of school just now entering the labor market? I know for myself and I think it is true for most young people, that when they graduate from college it takes them some time to find a job that they like and many times they work at three or four different jobs for several years until they finally find the one occupation with which they are satisfied for the rest of their life. This is all part of the mobility of our society; isn't that true?

Senator MANSFIELD. That is true.

Representative BLACKBURN. And there is always going to be some mobility of people who are seeking a better job than what they had before?

Senator MANSFIELD. Oh, yes; we are a society which moves on wheels and what happens this year has happened in years gone by, and I tried to say, I think before you came in, Congressman, that the difficulty lies not with this administration but lies with previous Democratic administrations as well, so if we are going to put out any blame I think we have enough to put out all the way around.

Representative BLACKBURN. Well, the point I am trying to make is that we are going through an unsettling period right now in which we are trying to windup a war. We have discharged 700,000 or 800,000 young men who were formerly in the military.

Senator MANSFIELD. Pretty close to a million.

Representative BLACKBURN. We have seen some of our major defense industries cutback. The aerospace industry in particular is undergoing rather serious cutbacks, and I believe your statement pointed out that the engineers are among the group who are suffering the most right now from unemployment. Well, this is a deplorable situation but the alternative of going to war or keeping a war going to keep people employed is certainly not acceptable. So, don't you think that the disruption that we are undergoing now is one of the normal prices that our society has paid in the past and will pay in the future whenever it winds down a military engagement and tries to return to a more civilian oriented economy?

Senator MANSFIELD. No, Mr. Congressman, I don't because that wasn't the case after the Second War, it wasn't the case after Korea, it need not be the case now. I cannot accept a 6.2 percent, or if you want to put it another way, 5.6 percent, which amounts to 5.5 million people out of work. I cannot accept a 7.2 percent inflation rate based on last month's figures, as being something we should accept, shrug off and consider normal. To me it is very abnormal and I think it is up to us to take care of it and if we don't I think we will pay a price.

Representative BLACKBURN. Don't you think we should consider figures not solely on the basis of 1 month but perhaps on the basis of quarterly figures. The rate of inflation for this year, the last figure I saw for the whole year, taking into account last month was well, was something like 4.1-percent Consumer Price Index increase. That is the annual rate of increase. Don't you think that is a great improvement over the 6.7-percent rate of increase that we faced in 1968?

Senator MANSFIELD. I didn't know that we faced a 6.7-percent increase in 1968, but I will take your word for it.

Representative BLACKBURN. There were several periods there when we did face the rate of inflation.

Senator MANSFIELD. On a monthly basis or quarterly?

Representative BLACKBURN. For the year it was about 6.4, I believe, but I don't have the figures in front of me.

Senator MANSFIELD. Speaking of these figures which you just gave, I believe that last year the rate was about 5.2 percent, so if you have it down to 4.8 I would say that is a sizable gain in that area.

Representative BLACKBURN. So we are making progress in our fight?

Senator MANSFIELD. Not enough.

Representative BLACKBURN. Against inflation.

Senator MANSFIELD. Not enough.

Representative BLACKBURN. Well, sir, are you suggesting the imposition of wage and price controls with the vast bureaucracy, with the estimated expense of $2½ to $3 billion to establish the bureaucracy to really fix wage and price controls, as an alternative to our present method?

Senator MANSFIELD. Yes; on a temporary basis to see if we can't halt inflation.

Representative BLACKBURN. How can we temporarily spend $2½ billion?

Senator MANSFIELD. It wouldn't cost $2½ billion for a 6-month tryout period. You know that.

Representative BLACKBURN. How are we going to just get the data on the millions of prices and wages and wage scales and commission methods of payment in this country just to set up a data bank with all of this vast store of information. It would require somewhere between 6 months and a year just to get the information accumulated, much less to implement the wage and price controls.

Senator MANSFIELD. Well, I think we have a Bureau of Labor Statistics, we have lots of Government agencies, we have lots of bureaucrats who are working in this, and I think the Chief of State of this Nation before he went into the Navy in the Second World War had a good deal of experience in the field of wage and price controls.

Representative BLACKBURN. Well, as I recall some testimony before my committee, the Banking Committee in the House, there was an estimate it would take something like 100,000 full-time employees and possibly several hundred additional part-time employees to really implement and make effective wage and price controls. Are you saying these estimates are unrealistic?

Senator MANSFIELD. No; because I don't know the source and it is the first time I have heard the figures.

Representative BLACKBURN. Don't you think we should consider this sort of evidence or at least gather evidence on this fact before we start advocating the imposition of such drastic measures on our economy?

Senator MANSFIELD. I couldn't agree more, Congressman.

Representative BLACKBURN. I have no further questions.

Chairman PROXMIRE. Mrs. Griffiths.

Senator JAVITS. Would Mrs. Griffiths yield to me and I will yield her my time?

Representative GRIFFITHS. Yes, sir.

Senator JAVITS. I am due on the floor, as the majority leader knows, for the conquest of cancer bill, which I am managing with Senator Kennedy, and I just wanted to say to the majority leader that I came out of respect, in deference to him. I think it is very constructive that as the leader of his party, he should testify, and I think this is a critical subject, it is probably the most critical after Vietnam. I thoroughly agree with Senator Mansfield about it being the bone in the throat of America.

I would like to make one suggestion, Mr. Chairman. I think we should have either from the majority leader or from the chairman of this committee a presentation of a program which can be juxtaposed to the administration's program. I think that this would be very helpful and very constructive.

I appreciate the majority leader with his traditional modesty. He said he is a noneconomist and he presented one major idea. We could invoke the possibility of wage and price controls. But I do think that there ought to be a point-by-point program submitted which we could, in connection with our impending report, lay beside the administration proposals. I hope very much that he would give that and our chairman would give that every consideration.

Chairman PROXMIRE. May I say to the Senator from New York he is always very constructive. I think this is a most useful suggestion. Frankly, when we invited Senator Mansfield to appear we didn't specify that was particularly what we wanted. Many witnesses will appear and indicate courses of action which they espouse.

I have a statement here from Speaker Carl Albert, for example, of the House, who, I think, has some detailed proposals here. The majority of the committee will certainly propose alternatives and I think this is a very helpful suggestion.

Senator MANSFIELD. Could I interpolate this? May I say it is a good suggestion, too, and just as I have advocated for years there ought to be a greater degree of cooperation between the administration and the Congress in the field of foreign policy, so I think the same thing should be applied domestically and I would hope that the experts within the administration would get together with the experts chairing and the ranking members of the various committees most interested in the economy—Labor, Public Welfare, this Joint Committee, Banking and Currency, and the like—and see if together we could not work out something which would place the national good ahead of party profit.

Senator JAVITS. Thank you very much, Mrs. Griffiths; it was very gracious of you.

Representative GRIFFITHS. Thank you. I would like to say I appear here, too, because of deference in gratitude to you for your kindness. One of the points, I think, that really should be made is where is the unemployment. I noticed your figures and I come, you know, from the bomb burned city of Detroit and we have unemployment in the inner city that runs as high as 65 percent of young men between the ages of 16 and 24.

It seems to me that it presents a danger and a cost that really are not made clear when you read mere statistics of 5 or 6 percent unemployment rate nationwide. So that we need to do something direct exactly toward those areas, those danger points.

Another thing that I think might be emphasized is the problem now with trade. For the first time in our lifetimes we are facing almost a deficit in our trade balance. It seems to me that both political parties should be tremendously interested and should move toward checking the record to find out what is causing this. This is something we cannot afford, either. As you have said, there is plenty of blame for all of us but there is plenty of work for all of us and some of these things should be worked out before it is too late for the whole country.

Senator MANSFIELD. May I say I agree with you completely. You mentioned some of the high unemployment rates in Michigan. I was astounded to hear the 65 percent figure which is extraordinary. In my own State of Montana the unemployment rate has usually been higher than the national average and now it must be around 12 or 13 percent, maybe 14 percent because of the fact that the miners and the smelters in the copper industry went out on strike last Thusday. So the seasonal work which compensates in the summer will not be able to take up the slack this time and I cannot emphasize too much the fact that we have to work together. This is not a Republican problem, it is not a Democratic problem, it is a national problem, and if we do not get busy on it, I think we are going to pay a terrific price.

This country cannot afford another depression let alone a recession because we will not be able to pull out of it this time like we did in the thirties. People were hungry then, they did not have much, they were striving to better themselves, there were not so many people here. But here I find an article in The New York Times this morning by a Leonard Silk, an economic writer of some note, and he refers to a study made by Prof. Robert Eisner of Northwestern University, and Professor Eisner puts it this way and I quote:

> The list of war costs read like a catalog of evils and sufferings in the American economy. The war has caused inflation, the war has caused high taxes, the war has contributed to the housing shortage, the war has drained resources in the areas of education, transportation, housing and all of the services of government from police protection to postal delivery.

Add to that the rise of new problems, the aggravation of old ones; add to that the casualties, and I think this country faces a most difficult period and I cannot emphasize, and I hope this committee will forgive me if I reiterate and reiterate, I cannot emphasize too much the fact that what we are in is not a Republican recession or a Democratic recession, both parties had much to do with bringing us where we are today. We are facing a national situation which calls for the best which all of us can produce because if we do not, as Congress-woman Griffiths has said, the results will be something which we will regret, not only to our dying day but perhaps to the dying days of our children and grandchildren as well.

Representative GRIFFITHS. Thank you.

Chairman PROXMIRE. Senator Miller.

Senator MILLER. May I say to my distinguished leader that after some of the talk I have heard about the depression and recession and the suggestion that housing development gains would easily be choked off by soaring interest rates, I am beginning to wonder what the stock market is going to do tomorrow morning.

Senator MANSFIELD. Probably go up some more.

Senator MILLER. Well, first, the Senator has said there is much room for burden sharing and indeed there is; but I do believe in fairness. I should say I think the general tone of his statement, and I know the sincerity with which it is given, seems to emphasize the burden on the Executive rather than on the Congress.

Senator MANSFIELD. That is correct.

Senator MILLER. Now, if that is so, then it would seem to me that fairness would require us to explore some of the shortcomings of the Congress. I do not see anything in here except in a blank reference to what the Congress has done with respect to granting the President wage and price and rent authority and selective credit control authority, both of which measures I voted for. But if the Senator feels so strongly about it why does he not as majority leader, see to it those in control of the Congress mandate those?

Senator MANSFIELD. Well, now, the Senator is taking a lot of freedom when he attributes the authority to a person who just happens to be a Majority leader to do the things which he advocates. I voted for the same legislation which the Senator did and I think as a matter of fact, the vote was unanimous in the Senate on both pieces of legislation, including wage-price and rent controls, which was renewed just several weeks ago, but I do not believe that you were here, Senator Miller, when I said what we ought to do—maybe you were—what we ought to do is to work in tandem with the administration and get their ideas.

I do not know what their game plan is, to tell you the truth. I can recall of no proposals which they have sent to the Congress asking that we work together to try and work ourselves out of the difficulties in which we find ourselves. I mentioned the piece of legislation I did to indicate that in my opinion, the Congress has done as much as it could up to this time, that we are eager, willing, and want to hear from the President and his advisers with legislative proposals which they think will be beneficial. But to repeat, I do not know what the administration game plan is, it is just a term I have seen in the newspapers, but how you would define it, how you would explain it, I am at a loss to say.

Senator MILLER. Well, I do not know whether there has been a piece of paper issued saying this is the administration game plan but I think the Joint Economic Committee for one, has received some rather good outlines of what the administration has in mind at least, certainly as far as their targets and objectives are concerned. What I think, and, of course, I thoroughly agree with the Senator, that this should be a bipartisan sharing of the burdens and coming up with the necessary actions, but unfortunately, that laudatory approach does not always find itself reflected in what is done out on the Senate and House floors. But it seems to me that if there is concern that there should be wage and price controls, if that concern is strong enough, all the Congress has to do is legislate.

Senator MANSFIELD. Congress has legislated standby wage and price controls and the President has indicated he does not intend to use it, just as President Johnson before him said he did not intend to use it.

Senator MILLER. If the Congress feels strongly enough about the matter all they have to do is mandate it and they have not seen fit to do so. As the Senator knows, they attempted to do that over in the House and it was defeated by a very wide margin.

We can talk about wage and price controls, and I am not throwing them out of the window as a possible solution to this. I hope we never have to get to it. But I also think to a degree it is a last resort proposition and if things are getting better, even though they may not be getting better as fast as we would like, I would hope that we would not mandate wage and price controls at this time.

Senator MANSFIELD. May I say, if the Senator will allow me, that the legislation passed calls for voluntary wage and price controls to be under the supervision of the President whenever he wanted to put it in operation. He has indicated he does not desire to do so and will not do so.

Senator MILLER. I must emphasize if we want to see them actually done and we do not want to have to worry about whether the President wants to do it or not, all we have to do is mandate them in legislation passed by the Congress. We have that power.

Senator MANSFIELD. Yes, but the Senator knows that would be an impossibility to take action of that nature.

Senator MILLER. Well, I do not know that it would be an impossibility. I am sure the President would carry out the law passed by the Congress if we mandated wage and price controls.

Now, the Senator quoted from some comment that fresh and vigorous initiatives are imperative and that is a very fine cliché, but I think the Senator from New York had a very good point when he suggested what ought to be done would be to have the leadership come up with some of these fresh and vigorous initiatives spelled out in specifics so that we can take a look at them and preferably try to handle them on a bipartisan basis. After all, we are members of the separate independent branch of the Government, and I might say to my friend from Montana if he wants to get a mandatory selective credit control authority going, I will be pleased to vote for it because I feel very strongly on that point, even though the executive branch does not want it.

Senator MANSFIELD. Why does the Senator not introduce legislation to that effect if he likes it so well?

Senator MILLER. Well, I did not say I liked it so well. But I would be pleased to vote for it. If the Senator feels as strongly as he does, apparently, by referring to it in his statement, I will be happy to cosponsor it with him.

It is true, and this Senator knows, there is not a soul in the Congress on either side of the aisle who looks on 6 percent unemployment as normal. We all deplore it and we want to do something about it. But do you not think that fairness demands that we recognize that when the defense and space contracts are cut by billions of dollars, when you have upwards of a million men taken out by the reduction in the Armed Forces, that we cannot have our cake and eat it too. We cannot expect to get by without some unemployment and that the problem is not whether we have unemployment because that is inevitable when we have those actions taken by the Congress. The problem is how to make the transition as short as possible. Is that not the real problem?

Senator MANSFIELD. Well, that is true and I would agree that this Administration has reduced our Armed Forces by something close to 1 million men, somewhere between 900,000 and a million, and what you say about the unemployment in the aerospace industry is correct, also; but I think you ought to go back a little bit further and point out how profligate we were with our resources in giving contracts to some of the aerospace manufacturers, how many billions of dollars we have wasted in exotic weapons and machinery of various kinds, and how much those losses totaled up to, and you might get part of the answer there because we really went hog wild in years gone by in spending so much money in this area and, as a matter of fact, getting so little in the way of results.

Senator MILLER. And so we are reaping the rewards.

Senator MANSFIELD. In part.

Senator MILLER. And we should expect to reap the rewards.

Senator MANSFIELD. Not——

Senator MILLER. That is not the problem. The problem is what do you do about it to keep that transition as short as possible so that we will be able to get the unemployment which we have got to expect with those activities, to get that unemployment rate down.

Senator MANSFIELD. Well, we have been withdrawing on a phased basis from Vietnam for almost 2½ years, in the meantime unemployment has gone up, inflation has remained steadily, very likely gone up over that 2-year period, and I do not see any measures being recommended by the Administration to cope with this except the so-called "economic game plan" about which I know nothing and I only refer to it because I see it mentioned so often in the newspapers. And the Senator from Iowa evidently does not understand what the game plan is, either, because he says he has never seen such a diagram.

Senator MILLER. I do not mean that I do not understand it. I think that the game plan has become sort of a cliche too. I do not think that there will be any attempt by anyone to put down an a sheet of paper and call it the administration game plan, but I do think that some guidelines have been given and they were given early this year before our Joint Economic Committee which satisfied many of us that the objectives sounded pretty good, but I recounted before Arthur Burns the objectives and I said, now, Mr. Burns, these objectives are fine but they depend upon a number of assumptions, an assumption that things on the domestic scene will be reasonably stable, the assumption that the things on the international scene will be reasonably stable, including our balance of trade, the assumption that those in control of the Congress will keep pretty well within the administration's budget, full employment budget spending limits, and several other things, and I said, do you think we will be lucky if all of those assumptions work out? And he said, I think you will be very lucky. So, I think the objectives have been spelled out but the uncertainties, at least some of them, rest over on Capitol Hill.

Senator MANSFIELD. Nobody is arguing with you about that.

Senator MILLER. And so it is easy to criticize but I think what we need is constructive criticism which will be specific in what ought to be done.

The Senator from New York has come up with the challenge and the majority leader has indicated that the challenge will be met.

Senator MANSFIELD. Just a moment. Not by me but by those who know what they are talking about, like the members of this committee on both sides, the Committee on Labor and Public Welfare, the Committee on Banking and Currency, and I want to see the chairmen and the ranking members and the Democratic members of those committees, I would like to see them get together with their, let us say, counterparts in the Administration so that the question of politics would not come in but that the common good, the national good would be first and foremost.

Now, I do not go on assumptions because I am not an economist, I am an ordinary guy you see in the street, who knows that unemployment is high and the numbers are going up, if not the percentage, who knows that inflation has not been under control and who knows that his money can be stretched so far and it can only buy so much and that the retiree and the persons living on annuities and social security, that they are squeezed and they are being given no relief, so what can we do together, not by throwing the ball back and forth, what can we do together to help the Nation as a whole, and what will we do together instead of just talking about it?

Senator MILLER. The Senator from Montana is more than just the ordinary person. We are all ordinary people in our reactions which you have just described. But in addition to that we are extraordinary people because we have the responsibility to do something about it.

Senator MANSFIELD. Not extraordinary, if I may interrupt, lucky people, because none of us would have gotten elected to the jobs we now hold if we did not have a lot of luck, a lot of friends and a lot of good fortune, but with the job does go responsibilities and we have got to face up to those responsibilities as best we can, but I would hope instead of them being Democratic responsibiliites or Republican responsibilities, once in a while we would get together and try and forget the politics of the situation and do something for the common good.

Senator MILLER. Well, I thoroughly subscribe to that, Senator, and you know it, and I think that it might be helpful not only to have the committees that you refer to and the chairmen and the ranking members but also I am sure that the minority leader would join with the majority leader so we might get a bipartisan congressional approach to some of these deeply serious problems that we have, and I would hope further that there would be a little restraint on the part of some-people, and I am referring to some on both sides of the aisle, to try to restrain from negative criticism and come up with positive constructive approaches to follow this bipartisan burden-sharing that you have referred to, and I am sure the Senator from Montana knows that he can count on me to do all I can to back him up in that respect.

Senator MANSFIELD. I appreciate that. It is easy to criticize, it is easy to praise too, if praise is deserved, and I would hope that out of these hearings will come something which will do us all some lasting good because we just cannot keep on at this rate of unemployment. I do not care whether you use percentages or total numbers, we just cannot keep on at this rate of inflation, because the days of luck which this country has enjoyed for so many decades may be coming to an end and we have to recognize that our resources are not unlimited, we have to recognize that we have problems here at home, we have to do what we can to face up to them rather than to avoid them, and it is going to take some sacrifice, it is going to take some harsh legislation perhaps, but if you are going to do something for the people, and you mean it, then I think you had better do it because we are the people, too.

Senator MILLER. Thank you, Senator, and thank you, Mr. Chairman.

Chairman PROXMIRE. Senator Mansfield, you have been challenged twice by both Senator Miller and by Senator Javits to come forward with a program. I think you have done that. In fact, I think you have said more in eight pages than the witnesses who appear here ordinarily do, and said more constructively.

You advocate, as I understand it, a temporary wage-price control program which would be very far-reaching and have real impact, and if you apply it, as I understood you to do so, you apply it to interest rates, it would have immediate effect in stimulating housing. If you hold down interest rates automatically you get a great stimulus in housing.

You also, as I understand it, propose that we should proceed with an accelerated public works program that would, as I understand it, provide jobs. That is another part of your positive program, too.

Now, I do not want to be too partisan but I want to call attention to what the Secretary of the Treasury says in his famous press conference that he had just a week or two ago in charting the future for the administration economically. He set out a four-point program. The four points consisted of: No. 1, we are not going to institute a wage-price review board. No. 2, we are not going to impose mandatory wage and price controls. No. 3, we are not going to ask the Congress for any tax relief. No. 4, we are not going to increase fiscal spending.

Senator MANSFIELD. The Senator from Iowa is talking about negativism.

Chairman PROXMIRE. That is right. There are four negatives in a row. I suppose if you had enough negatives together you would get some kind of positive statement.

Let me ask you about a particular reference that you made in your statement, you kind of ad libbed it in, about the President's action with respect to the possible steel strike, negotiations going on between the management of steel and industry and United Steel Workers. The administration seems to me to be playing a peculiar role here. They did call the sides together and appealed to them to make a reasonable settlement that would not be excessively inflationary, that would help us in world trade. What they did not do, what seemed to be sensible, was set any target, did not give any figure, did not provide any wage or price guidelines of any kind at all, just called them together.

Senator MANSFIELD. That is right. I think it was an introductory step and it was a good idea, long overdue, but I do not think that one meeting of that sort is going to bring about a solution to the difficulties which face both labor and management in the steel industry; and I must say the President was right when, as the press reports, he pointed out to them if they do not get together and achieve better methods of production and more productivity, that the end result is going to be a decline in the world markets and in the domestic markets because Japanese steel, West German steel, South African steel, and other kinds of steel will come in. This steel will undersell our products, it will mean more unemployment, more modernization in some aspects by the steel industry itself, and in that respect he did a good job. He placed before them what I consider the economic facts of life. But one meeting is not going to bring about a settlement unless agreement is in the works in the meantime. It is going to take a lot of meetings among a lot of industries. The President is going to have to use his great personal influence and on occasion he is going to have to lock management and labor into a room and tell them to stay there until they come out with a settlement. His emphasis on the needs of the people, his concern for the national aspect of the economy were all good. When I used the term he brought them together and knocked heads, I made it very clear that I was speaking figuratively in using that expression, but he did bring them together, I think, for the first time on this basis and I hope that it results in more and better jaw boning in the months and weeks ahead because there will be other industries which will have a pretty heavy impact on the economy and the welfare of the Nation as a whole, and despite what the Senator from Iowa says, it is not the Congress which should take the initiative but the leadership should come from the President, whoever he may be.

Chairman PROXMIRE. Well, I think that is a very, very generous statement and it may well be right. I hope it is.

Once again, I would emphasize that it is a preliminary meeting and there were no goals specified, either prices or wages, and previous administrations have done that with considerable success.

Let me ask you about this. The administration is making much of the fact that housing starts at the rate of 1.9 million, that is an improvement over 1970 when it was 1½ million, but there has been no further improvement since last December and it is far short of the goal set by the Congress in the 1968 Housing Act, which was 2.6 million housing starts.

Now, if we get 2.6 million housing starts that would be an additional 1½ million jobs. That would go a long, long way toward solving our employment problem plus helping to provide the safe, sanitary homes that we all desire.

One thing that troubles me particularly, is that with the turn around in mortgage rates, even the current production rate of 1.9 million is threatened.

Senator MANSFIELD. Right.

Chairman PROXMIRE. It always bothers me that housing and the building of public facilities is the first to feel the pinch of tight money. Would you have some thoughts about what we should be doing to get more housing?

Senator MANSFIELD. Well, I think that the administration—I do not see how the Congress could without enacting legislation, which I do not think would be proper at this time—to call bankers in to discuss with them this question of interest rates and to point out to them a fact they already know, what its effect is on the economy, and I think there has also got to be a meeting of the minds between the contractors, the construction management people and the workers themselves to the end that they will not price themselves out of jobs. But will be able to develop a longer time period of productivity at a reasonable wage over a longer period of time.

What a lot of people seem to forget when they talk about the high wages that construction workers are paid is that many of them—and this is very true in Montana—work very few days, very few weeks a year, and what they have to do in the meantime is to make out as best they can or take a secondary job. So, those are matters which should be gone into. It is going to take a lot of forebearance and understanding on both sides, on all sides, really, but it has got to be done, because if it is not then in the long run those directly concerned and the rest of us off on the sidelines, so to speak, will be hurt.

Chairman PROXMIRE. I just have one other question I would like to ask and it is a question that troubles me very much as chairman of this committee, and I have talked to other members of the committee and it concerns them a great deal, too.

I read in the paper that the Secretary of the Treasury, John Connally, has been designated as chief economic spokesman for the administration, and I do not know exactly how that designation developed, but that was the press story, and I think undoubtedly, in view of the great weight he carries and his unquestionable ability he may well be their spokesman.

As you know, this committee was set up by the Employment Act of 1946 and was set up for the purpose of helping Congress to determine the economic policy in cutting across all kinds of lines which affect other standing committees. Now it is very difficult for us to arrive, however, at an economic policy if the chief economic spokesman for the administration will not appear before us.

Would you not say that the chief spokesman for any administration, Democratic or Republican, should find time to appear before our committee to tell us what the economic policies of the administration are?

Senator MANSFIELD. Well, it would be preferable if they did.

Speaking of John Connally, Secretary Connally, he is a very strong man. When Secretary Connally appears before a committee you always know where he stands. Secretary Connally at the same time is not an unreasonable man. He has had plenty of experience in politics both at the State and national level. He is a man of exceptional ability, in my opinion, and I do not know whether or not he is the chief economic spokesman for the administration, but if he and Arthur Burns could get together I think it would be an outstanding team because I have a high regard for the Chairman of the Federal Reserve System, Dr. Burns, and I have a high regard for Secretary Connally as well.

However, I do not know in view of the lineup which you have mentioned, Mr. Chairman, where that leaves the Council of Economic Advisers. I suppose still back in the shadows.

Chairman PROXMIRE. Apparently they are, although I have great faith in Paul McCracken. I think he is a fine counselor, a very able economist. We disagree with him on policy but I cannot fault him on ability or dedication to his work.

Here is the problem we have on this committee and I think that it should be discussed publicly, I think it is best to discuss it publicly, I do not know any other effective solution. We are having difficulties in getting Secretary Connally to appear. No. 2, the Secretary of Labor has refused to meet with us to discuss the unemployment rate and, of course, the press conference which the Bureau of Labor Statistics used to hold on the unemployment rate has been canceled, they no longer will do that.

We have had difficulty getting the Secretary of Defense. The Secretary of Defense has consistently refused to appear before this committee to discuss economic policies and the impact of the defense program, which is probably the most significant of the direct effects that the Federal Government has on the economy.

So these are real problems for us and I ask you this publicly because you are our leader and you do have great concern for the Congress and dignity and force of the Senate and the great responsibility we have under the Constitution to determine policy. But it is very difficult to do so when the administration will not cooperate by sending their principal spokesmen before us so we can develop a policy as we should in public hearings.

Senator MANSFIELD. Well, Mr. Chairman, I think they should come before any congressional committee when requested to do so, if for no other reason than to get the opposite point of view, if there is an opposite point of view, but I think in all fairness it should be said that these men are very busy. If they are not very busy at home they are undertaking responsibilties abroad. They also have to appear before other committees, as the chairman well knows, and they have been appearing before Ways and Means, Appropriations, Foreign Relations, Armed Services, and the like, so that they do not have the time they should have really, to appear before——

Chairman PROXMIRE. Let me interrupt at this point to say that is all true, of course, and I am perfectly willing to hold a hearing Saturday; we have held Sunday hearings of another committee which I chaired, any time, nights, weekends, at any time, but just twice a year we think we ought to have the spokesman, economic spokesman for the administration before the Joint Economic Committee and at least once in 4 years we ought to have the Secretary of Defense appear before us. He has not appeared before us ever.

Senator MANSFIELD. I think this is a reasonable request and that is one way perhaps which a meeting of the minds could be arrived at and this spirit of cooperation and partnership working in tandem could be put into effect, and in that respect it is a reasonable suggestion which the chairman of this committee has made, and I know from personal knowledge, that he would be prepared to meet with any of them at any time on any day, even including Sunday. He has held many Saturday meetings, to my knowledge, here. He is, if I may say so publicly, a glutton for work. I do not envy but I admire your stamina in more ways than one, and I think it would be a good idea if they would come down. But the chairman knows there is no way he can force them down, but if they would come voluntarily perhaps it would be a benefit to both the administration and the Congress and more important, to the Nation as a whole.

Chairman PROXMIRE. Well, as one glutton to another, I know you do more work than I do.

At any rate, let me thank you very, very much, Mr. Leader, for an excellent statement and for fine responsiveness to our questions.

Senator MANSFIELD. Thank you.

Chairman PROXMIRE. I ask unanimous consent that the prepared statement of the Honorable Carl Albert, Speaker of the House of Representatives, be included in the record at this point.

(The prepared statement of Representative Albert follows:)

PREPARED STATEMENT OF HON. CARL ALBERT, SPEAKER, HOUSE OF REPRESENTATIVES

Mr. Chairman, thank you for giving me the opportunity to present my views on the state of the economy in conjunction with the Joint Economic Committee's annual Mid-Year Review.

It is clear from the first six months' performance that we are still mired in the depths of the economic slump which characterized all of 1970, officially labeled a recession year by the National Bureau of Economic Research. Faced with a prolongation of the unprecedented simultaneous recession and inflation plaguing the nation, I find it incredible that the Nixon Administration has announced that it is sticking to its original "game plan." That strategy is now clearly unfolding and appears to have two essential ingredients, to wit: (1) ignore the facts, and (2) attempt to pump up the economy with pep talks. This negativism flies in the face of the imperative to act, to do something to get the country on the road to economic recovery.

Where are we in mid-1971? The consumer price index for May, the last month measured, was up 0.6 percent at a 7.2 percent annual rate, and the wholesale price index was up 0.3 percent the same month. The inflation rate reflected by the GNP deflator was 5.6 percent annually during the first quarter, and it would be a surprise indeed if the second quarter shows any improvement.

The most distressing aspect of the prolonged economic slump is the persistence of high unemployment. The second-quarter average of six percent of the labor force was up from the two prior quarters, and the 6.2 percent joblessness in May equaled the 9-year high set last December. Five and a half million Americans were out of work in June, up 1.1 million from May, and alarmingly the average duration of unemployment continues to stretch out until it now has reached a modern high of 12.7 weeks. There are 580,000 who have been unemployed 27 weeks or more and 375,000 veterans who cannot find work, while the unemployment rate for minorities and youth, particularly in the inner cities, has reached crisis levels. There are now 53 major labor areas suffering substantial unemployment, and 704 smaller labor markets characterized by substantial or persistent joblessness.

The Nixon recession has worked hardship on untold numbers of Americans. Approximately 1.1 million more individuals fell below the poverty line in 1970 after ten consecutive years of intensive and successful efforts to reduce the number of poor. More than 25.5 million Americans are now in this category. Further, a record high of 14.4 million Americans were forced to rely on welfare assistance in March, and 20 percent of the increase for the month was attributed to prolonged unemployment.

The blight recognizes no class limitations. Engineers, technicians, and scientists are hunting for work in record numbers, and college graduates are finding 26 percent fewer job opportunities than they did in 1970, itself a poor year.

There are other signals warning that all is not well. American businessmen have cut back on previously announced capital spending plans for 1971, and now project only a 2.7 percent increase in spending over last year, the smallest increase in a decade. American industry is still operating at less than 75 percent of capacity, and consumer spending remains on the cautious side, with abnormally high levels of deposits in savings accounts indicating a lack of confidence in the future of the economy. Further, it is clear that interest rates have bottomed out and are starting to move back up toward 1970's disastrous highs, with this week's increase in the prime rate to 6 percent portending future problems.

In the face of this bleak outlook, the Administration's inactivity is difficult to fathom. Benign neglect is the wrong policy at this time, and Pollyanna-ish predictions of future improvements are obviously not buoying up the economy. Rosy forecasts from the White House have not prevented the stock market from going into a steady decline over recent weeks, nor have they convinced the American people, who everyday are confronted with rising prices and increasing numbers of their neighbors out of work. A majority of Americans recently questioned by pollsters believe that this nation is still in recession, and they are the ones who bear the brunt of do-nothing economic policies.

It is time for the Administration to drop its obstinate resistance to any form of incomes policy. The President has overcome his repugnance to using the persuasive powers of his office, but he has not gone nearly far enough. If across-the-board controls on wages and prices are anathema to him, he should at least establish a wage-price review board as recommended by his own chief advisors as a minimal first step. The tragic plight of millions of Americans under the twin yoke of recession and inflation can no longer be subordinated to the myth of the inviolability of free enterprise.

I am pleased at the President's conversion to the principle of public-service employment as one antidote to the scourge of joblessness, and I deeply regret his recent veto of the accelerated public works bill. Government initiatives are obviously the key to economic recovery, and we cannot afford the luxury of partisan politics at this critical juncture. Business as usual can no longer be the byword if the American people are not to lose faith in their own future within our system. We are not dealing with abstractions but with the welfare of our fellow-citizens and the quality of life in this nation for years to come.

I appreciate having the opportunity to share my views with the committee and applaud your leadership in attempting to move the country forward.

Chairman PROXMIRE. The committee will stand in recess until tomorrow afternoon at 2 o'clock when Paul McCracken and the Council of Economic Advisers will appear in room 1202.

(Whereupon, at 3:15 p.m., the committee was recessed, to reconvene at 2 p.m., Thursday, July 8, 1971.)

THE 1971 MIDYEAR REVIEW OF THE ECONOMY

THURSDAY, JULY 8, 1971

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

The committee met, pursuant to notice, at 2 p.m., in room G-308, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

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

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Richard F. Kaufman and Courtenay M. Slater, economists; Jerry J. Jasinowski, research economist; George D. Krumbhaar, Jr., minority counsel; Walter B. Laessig and Leslie J. Bander, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

This afternoon, we are continuing our midyear review of the economy. Our witnesses are Mr. Paul McCracken, Chairman, and Mr. Herbert Stein, member, Council of Economic Advisers. As I said in announcing these hearings, it seems to me that the present economic situation can only be described as dismal. We have just learned that the Federal deficit for the fiscal year just ended will probably exceed $23 billion. This deficit was due entirely to the shortfall in tax receipts. Tax receipts were about $25 billion below what they would have been in a full employment economy. Thus, had the economy been at full employment, the budget would have shown a small surplus.

This budget deficit is one measure of how far the economy has fallen below the level at which it could be operating. The $7 or $8 billion by which State and local government tax receipts have fallen below the full employment level in the past year is another. The approximately $65 billion gap between actual and potential GNP during the first half of 1971 is still another. And, of course, the 5½ million persons out of work and the continued rapid rise in the price indexes are still other, and more obvious, measures of the situation.

In the face of these facts, and in the face of early reports that GNP probably increased no more than $20 billion in the second quarter—and most of this was simply inflation—everyone was startled and concerned last week when the Secretary of the Treasury stated emphatically that no new policy actions were contemplated.

This does not seem to me to be a time to close the door on new initiatives. It seems rather a time to search vigorously for new ideas; to examine carefully possible new policies for stimulating real economic growth without aggravating inflation. Certainly, it seems to me to be a time for a vigorous and comprehensive incomes policy.

Yesterday, the Senate majority leader, Mike Mansfield, testified before us. He stressed repeatedly the need for a bipartisan approach to economic policy. He made clear his willingness to cooperate with the administration in working out new policies to reduce unemployment and to control inflation. I share this willingness, and I think I can speak for all the members of this committee when I state that we hope, through these midyear hearings, to conduct a constructive, objective evaluation of the present economic situation and of possible new policies.

Mr. McCracken, your testimony before this committee has always been informative. We have learned to count on you for responsible and undoctrinaire advice. Of course, we have not always agreed with your conclusions. No doubt we will again uncover some disagreements today. So I want to stress again that our purpose this afternoon is a constructive public exploration of the policy alternatives presently available to us.

Mr. McCracken, you have a very fine prepared statement. I've had a chance to read it, you handle it in your own way. If you abbreviate it in any part, it will be printed in full and the tables at the end will be printed in full in the record.

STATEMENT OF HON. PAUL W. McCRACKEN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY HERBERT STEIN, MEMBER

Mr. McCRACKEN. Thank you, Mr. Chairman.

We welcome this opportunity to discuss with you the state of the economy at midyear. We hope that the present hearings will help to reduce the uncertainty which exists in the country by highlighting the facts about the economy and the fundamental consensus on policy which is sometimes concealed by the usual debate within Government and among students of economic policy more widely.

For 3 years a basic objective of national policy has been to check the inflation which began about 6 years ago.

It was just about 3 years ago that a bipartisan majority of Congress enacted the Revenue and Expenditure Control Act of 1968, imposing a tax surcharge and a ceiling on expenditures. This was the beginning of the turn in national policy against inflation. At the end of 1968, the Federal Reserve embarked upon a policy of monetary restraint. The present administration carried through the policy of budget restraint which had been begun shortly before it took office. In 1969 it held expenditures down rigorously and worked for an extension of the surcharge.

It also encouraged the Federal Reserve in a course of continued monetary restraint. Since 1969 both fiscal and monetary policy have eased, but the degree of relaxation in both spheres has been limited by continuing concern about inflation.

What can now be said about the outcome of this anti-inflationary effort?

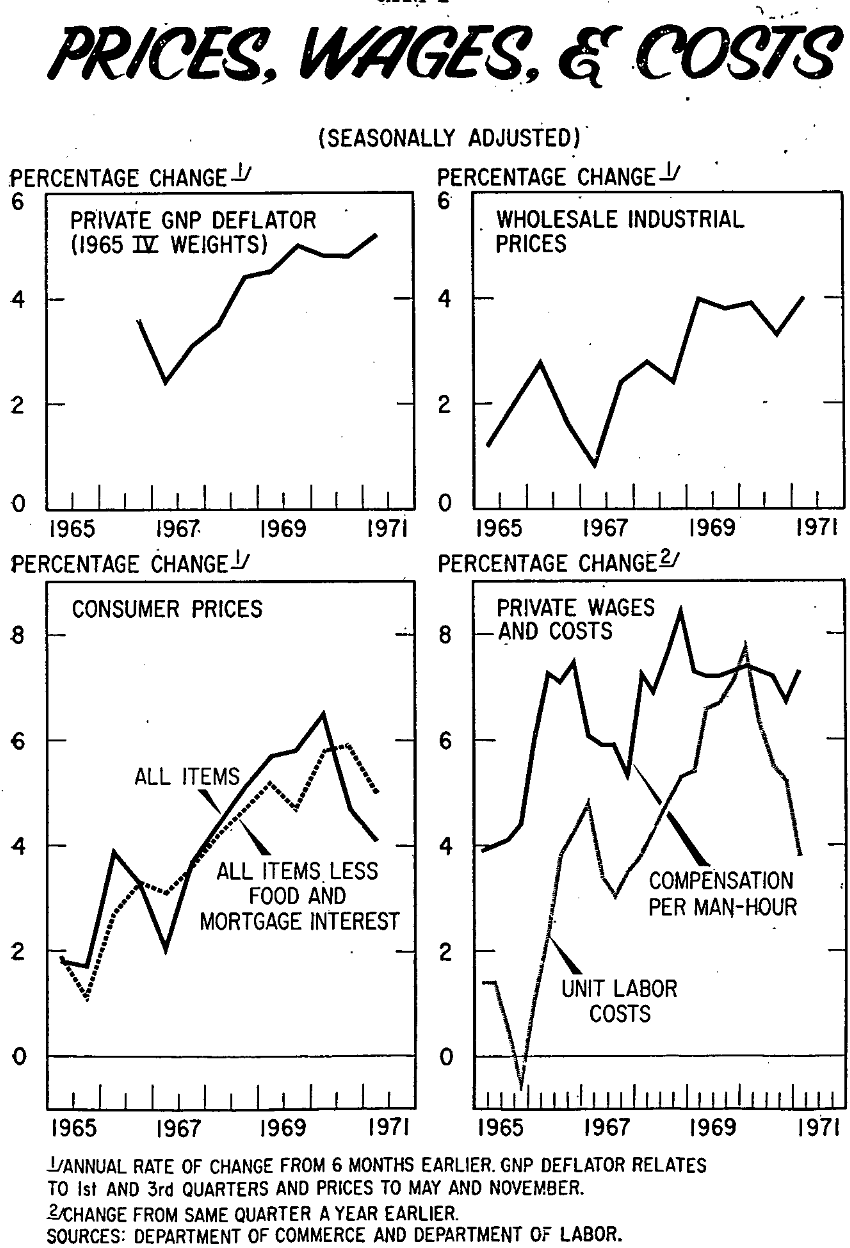
It seems to me that four cardinal facts stand out rather clearly.

Mr. Chairman, I have some charts here which I would like to point out, if I may.

Chart 1 illustrates the extent to which we have seen a deceleration, or at least a cessation, of the trend toward an accelerated rate of inflation. Various measures of the price level are indicated.

(The chart referred to follows:)

CHART 1



Mr. McCRACKEN. This is the rate of increase in the GNP deflator, slightly different from the previous one because of fixed weights.

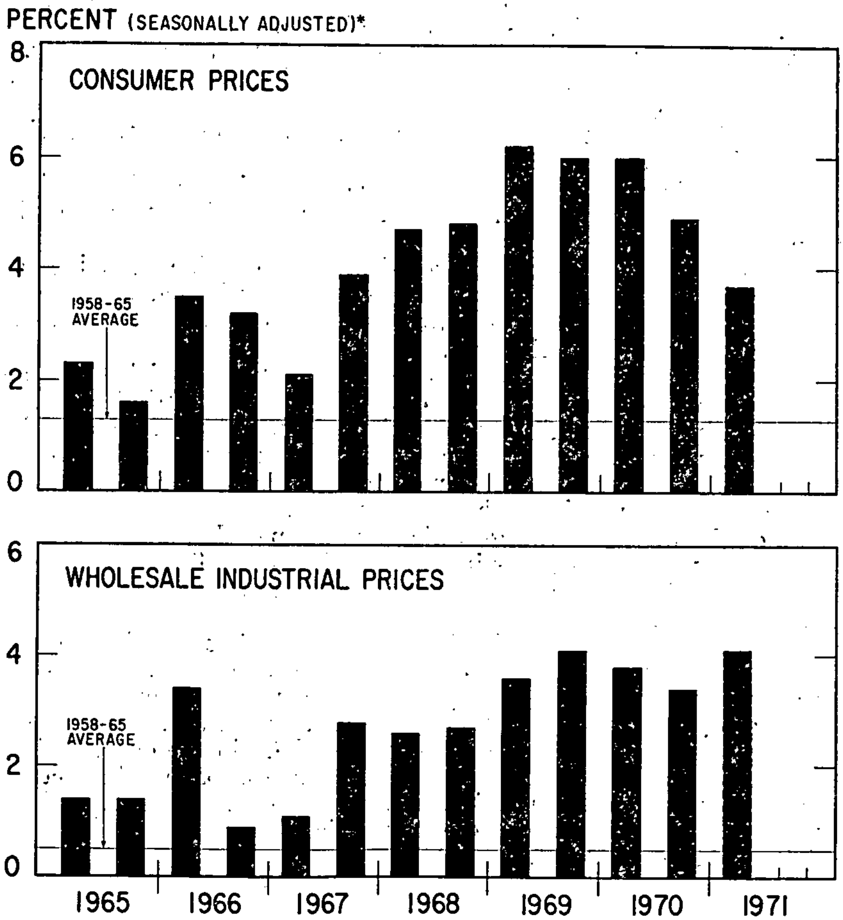
The very rapid acceleration in the rate of inflation has tended to level out. We see a somewhat similar pattern in the wholesale industrial price index. Once again the sharp acceleration through 1967, 1968, and during the early part of 1969 appears to have leveled off at about 4 percent. Finally, we have the Consumer Price Index which shows a deceleration in the rate of inflation since mid-1969.

In chart 2 we see the tendency for the rate of inflation to accelerate from the early part of the period to 5 and 6 percent by the crest in 1969 and 1970. The rate of inflation has now receded; it now seems to be at about 4 percent. So one thing comes out very clearly in both charts. The tendency for acceleration in the rate of inflation which has been going on did come to an end along about 1969, and there has been a recedence in the rate of inflation and the Consumer Price Index.

(The chart referred to follows:)

CHART 2

ANNUAL RATE OF INCREASE IN PRICE INDEXES



*PERCENTAGE CHANGE DURING HALF-YEARS 1965-70 AND DURING JANUARY-MAY 1971 FOR CONSUMER PRICES AND JANUARY – JUNE 1971 FOR WHOLESALE INDUSTRIAL PRICES.

SOURCE: DEPARTMENT OF LABOR.

Mr. McCRACKEN. There was also a recedence in the wholesale price index, the industrial wholesale price index from May 1969 through 1970, though I think it would be more cautious to say——

Chairman PROXMIRE. Mr. McCracken, do you have a chart to show the GNP deflator in the same way?

Mr. McCRACKEN. Yes.

Chairman PROXMIRE. But right there you have consumer prices and wholesale prices. It seems to me the GNP deflator doesn't show quite the same picture, does it? As far as the tailing off of the increase?

Mr. McCRACKEN. This is shown in chart 1 which I showed you. I think that this index and the industrial wholesale price index show somewhat the same thing.

The rapid acceleration in the rate of inflation during this period here seemed to press down and about——

Chairman PROXMIRE. Except the last point on the chart is the highest point on the chart for the GNP deflator. That is not true of the other measures.

Mr. McCRACKEN. Yes; but I would be cautious about putting too much into this. I think about all that we can say is that the rate of increase in the private GNP deflator has been on essentially a plateau.

Chairman PROXMIRE. All right.

Mr. McCRACKEN. There is one other aspect of this which I did not go into in the lower right-hand corner of chart 1, and that is that a somewhat similar, though more erratic, tendency for settlements for wage costs and for the rate of increase in compensation in the private economy to accelerate. These seemed to reach a crest at about a 7-percent rate, perhaps slightly higher than that.

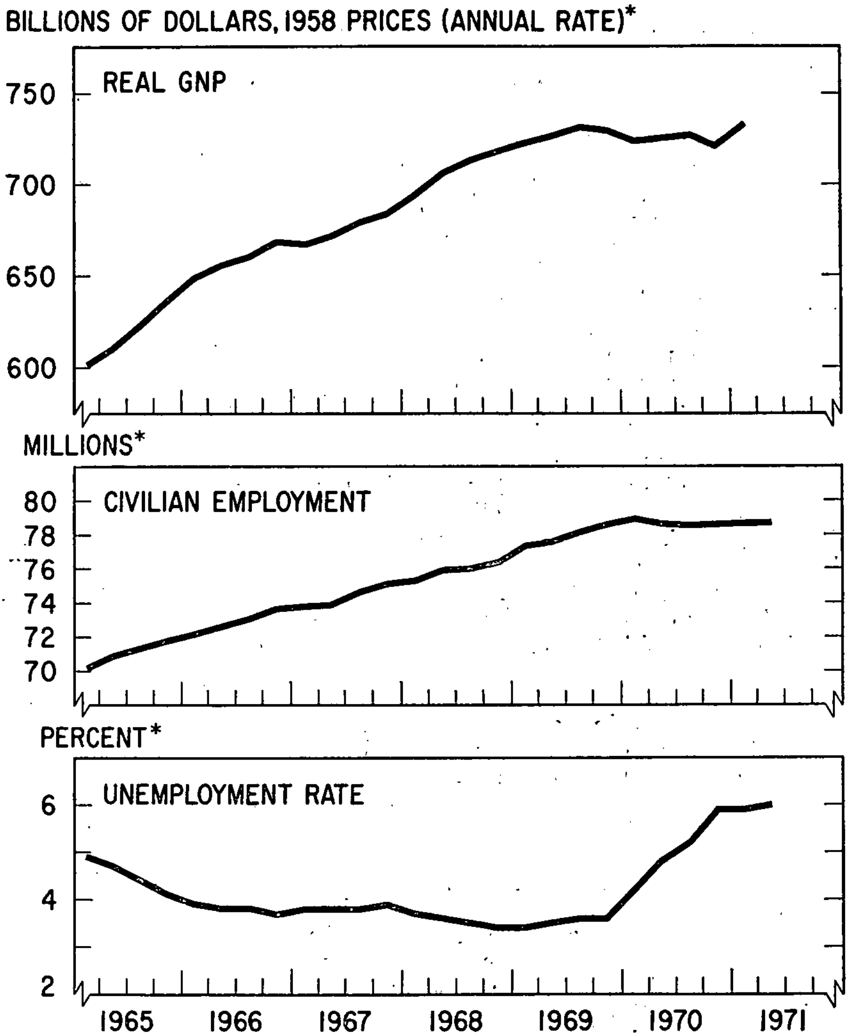
One of the dramatic things which has happened this year is that with the resumption of gains in productivity in the first quarter at a rate even more rapid than normal, we had a rather dramatic decline in labor costs per unit output.

Now, the restrained growth of demand which first ended the acceleration of the inflation and then initiated the reduction also caused a slowdown of output and employment and a rise of unemployment. The deterioration was limited, however, and output and employment have now risen from their lows, as you see here in the chart 3. The recedence of real gross national product in the top panel; the picture for both civilian employment in the middle panel and the unemployment rate in the lower panel are clearly depicted.

(The chart referred to follows:)

CHART 3

OUTPUT, EMPLOYMENT, & UNEMPLOYMENT



*SEASONALLY ADJUSTED.
SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF LABOR.

67-650—71——3

Mr. McCracken. The reduction in output and employment was limited and output and employment have now risen from their lows. The rate of unemployment has flattened out and in June registered a substantial decline. The mildness of the economic slowdown was due, in part at least, to the prompt turn of policy, at the beginning of 1970, in a more expansive direction.

Total output, as measured by the real gross national product, declined about 1 percent from its peak in the third quarter of 1969 to the first quarter of 1970. After a slight rise in the second quarter and a larger one in the third quarter, real output dropped again in the fourth quarter under the impact, of course, of the auto strike.

However, output rebounded in the first quarter of 1971 to exceed its 1969 peak rate and rose further in the second quarter, although we do not yet know by how much. Total employment, seasonally adjusted, declined about one-half of 1 percent from the first quarter of 1970 to its low in the third quarter but has since risen and in the second quarter of 1971 was one-fourth of 1 percent below its peak. The unemployment rate rose to 5.9 percent in November 1970 and hovered in the range 5.8 to 6.2 percent from then until June when, of course, it fell to the rate of 5.6 percent.

In sum, progress has been made against inflation, the slowdown of the economy associated with the start of the antiinflation effort was mild, and it has given way to a rise in economic activity.

Progress against inflation has certainly come more slowly than we hoped and expected. The decline of output and employment, while mild by historical standards, was also more than we had expected. These two facts are, of course, related. That is, given the rise of money GNP, which was much closer to our expectations, the decline of output and employment would have been even smaller than they were if inflation had subsided more promptly.

There are probably several elements in an explanation of the stubbornness of inflation. First, a major factor was the extraordinary strength and duration of the inflationary movement in the period before the excess of demand was significantly reduced. It must be remembered that although policy turned in an anti-inflationary direction in the second half of 1968, it was not until the second half of 1969 that the overall effects on demand became visible. Thus there were about 4 years of demand-stimulated inflation, which generated strong claims for further inflationary price and wage increases which survived the end of the excess demand period itself.

Second, the increased prevalence of 3-year labor contracts has strengthened the tendency for large wage increases to continue to be obtained after initial inflationary stimulus has passed.

Third, the relatively low productivity growth during 1968 and 1969 meant that the disinflationary process began from a condition in which workers had not received the real wage increases they had come to expect whereas profit margins were also exceptionally low. As a consequence the pressure for lower price increases that was exerted by the demand restraining encountered unusually strong resistance on the cost side.

Fourth, the composition of unemployment may have weakened the price and wage restraining force of the slowdown of demand. The unemployment rate for adult men was low, relative to the total, and the geographical distribution of the unemployment was somewhat more uneven than in earlier periods of 6 percent unemployment. This latter phenomenon may have been related to the incidence of defense cutbacks.

The moderateness of the whole slowdown, and the expectation that Government would keep the slowdown moderate, may have delayed the inflation-restraining response.

These and other factors which might be listed, do not, in our opinion, mean that we have entered a new era to which previous experience does not apply. In fact, the general character of the events we are now observing has been noted in the past. For example, the inflation rate did not slow down during the contraction phase of the 1957–58 recession, although that was a relatively sharp recession leading many people then to say that we were in a new, permanently inflationary state. However, the inflation did subside as the economy recovered.

Let us turn now to the prospect before us. Two propositions stand out. The first is that output and employment will continue to rise. The second is that the rate of inflation will not rise, and it is reasonable to expect further deceleration. I believe that these two propositions would be agreed to by most analysts who try to make an explicit forecast of the economy.

There are many ways to reach the conclusion that output and employment will continue to rise. The conventional forecasting technique of adding up categories of demand leads to that conclusion. Housing starts have been rising, housing permits have recently spurted extraordinarily, the supply of funds in savings institutions is large, and the Federal support for housing through the budget is high and rising. All of this points to a further increase in residential construction above the levels already reached.

The expenditures of State and local governments have been rising vigorously, these governments have recently been able to borrow on more favorable terms, they have greatly increased the amount of funds raised in this way, and grants to them from the Federal Government continue to expand.

The Federal Government's own expenditures for goods and services are now starting to rise, after 2 years of decline. Consumers' disposable income has been rising sharply as increased social security benefits have been added to growing incomes earned in production, and this should be increasingly reflected in consumer spending.

Meanwhile, additions to business inventories have been low, and inventory-sales ratios have declined sharply as the rise in sales has outpaced these small increases in stocks. At some point, production schedules must be stepped up further if inventories are to be adequate for this rising sales volume, and this will boost the rate of expansion further.

The behavior of the monetary aggregates also points to further expansion. The money stock narrowly defined increased 7½ percent from June 1970 to June 1971, and at the annual rate of 10½ percent for the past 6 months. The money supply including time deposits rose by 16½ percent for the year and at the rate of 16½ percent, in other words about the same, for the past 6 months. It would be extremely unusual if these rates of monetary expansion were not followed by an increase of money GNP in the next 6 months sufficient to raise production and employment further.

Finally, the index of leading economic indicators has now risen for 7 months in a row. It would be unprecedented for such a long rise in these leading indicators not to be followed by general expansion of the economy.

On the other side of the coin, it is reasonable to expect a further deceleration of inflation. This statement is made cautiously, because the record of economists and others in forecasting the behavior of the price level in recent years has not been inspiring. However, the statement I have just made is a cautious one.

The explanations of the "peculiar" behavior of the price level to which I have already referred are explanations of the failure of the rate of inflation to decline as rapidly as might have been expected. They are not reasons for thinking that the rate of inflation would rise under current and prospective conditions.

There are several cogent reasons for expecting a decline in the rate of inflation in the next year.

First, even though the economy is rising, a good deal of slack will remain in the economy for at least a year.

Second, we can expect a rapid increase of productivity as total output rises. We can see in the lower right hand corner of chart 1 that productivity has increased.

Third, the last of the labor contracts negotiated in 1968 and earlier will soon have been renegotiated and we shall leave behind the time when workers had a strong claim to big settlements to catch up with an amount of inflation that had not been anticipated in their previous contract.

Fourth, the number of workers covered by new settlements and therefore getting the large increases typical of the first year of a 3-year contract will be less in 1972 than in 1971 or 1970.

This combination of conditions should lead to a slower rise of labor costs per unit of output and therefore to a slower rise in prices, which will in turn reduce the rate of wage increases, especially in view of the prevalence of cost-of-living escalator clauses.

The question today is not whether employment and output will be rising and the rate of inflation declining. Every quantitative forecast of which I am aware answers this question affirmatively.

The question is how fast these developments will occur and how far they will go.

More specifically, will the economy rise fast enough to achieve the fundamental goals for the Nation—as, for example, stated in our 1971 Economic Report, namely, "that the rate of unemployment should decline as fast as is consistent with a reasonably steady and durable decline in the rate of inflation?" And operationally, the question has been whether policy should be changed to try to make the economy rise more rapidly.

In our Economic Report, we said that we thought the fundamental goals for unemployment and inflation could be represented by the achievement of an unemployment rate in the 4½ percent zone and a decline of the inflation rate to approach the 3-percent range by around 1972. We also said that we believed those figures could be reached with an expansion of money GNP along a path that would yield $1,065 billion in 1971.

Money GNP so far this year has probably been running below the path we envisaged in January, while inflation has continued higher and the rise of real output and employment have risen less than we had expected. The lag in the increase of money GNP is reflected mainly in the lower-than-expected inventory increase so far this year, which as I have already indicated may portend greater gains in the second half of the year.

Nevertheless, there is a danger that if money GNP were now to rise, or be pushed up, to reach the targets previously put forward, that would revive inflation or at least seriously delay its abatement. This is because to regain the original path from the present apparent starting point of money GNP would require a steeper rise of money GNP than was originally contemplated and because the rate of inflation has been very persistent.

Even if a somewhat reduced target for the rise of money GNP is accepted, questions have been asked about whether existing and prospective policies, added to the private forces in the economy, are likely to be adequate to reach that target. In answering that question, we must recognize that the budget for fiscal 1972 is already much more expansive than the budget that was submitted in January.

Actions taken since January have reduced the prospective fiscal year 1972 revenues by almost $2 billion. Congressional actions on expenditures have increased expected outlays for that year by about $3 billion, and further increases in "uncontrollable" outlays for public assistance, medicaid, veterans benefits and farm price supports will apparently add almost $2 billion to what had been anticipated.

So we have already confronting us a net further expansive fiscal effect of $7 billion beyond that already put forward in the President's budget message, and many actions on appropriations for fiscal year 1972 have not yet been taken.

We should also give weight to the fact, which I have already noted, that the money stock has risen from June 1970 to June 1971 by 7½ percent and the rise during the first half of 1971 has been at the rate of about 10½ percent per year. The effects of this relatively rapid rate of expansion, following, it must be pointed out, an abnormally slow rate of expansion in the latter part of 1970, have yet to express themselves in economic activity.

The rate of monetary expansion in the future will, of course, be determined by the Federal Reserve, and we cannot foretell it. However, if the rate of expansion in the second half of this year were to be half the rate of the first half, the increase from the average of 1970 to the average of 1971 would not be much below 7 percent. Thus, even with a substantial moderation of what most people would regard as an exceptionally high rate of expansion during the first part of this year, we would still have a large year-to-year change in the monetary actions.

Whatever the unemployment rate, we, of course, have unfinished business so long as anyone is searching for work and unable to find a job. In the light of the stance of both fiscal and monetary policy, however, we regard it as probable that money GNP, output, and employment will rise, and unemployment will fall, about as rapidly as is consistent with satisfactory reduction of the inflation rate.

Of course, no one can be absolutely certain of this, and there are risks in any policy that is chosen. The administration's rejection of a policy of yet further economic stimulation reflects the belief that we cannot temporize with the inflation problem with yet more stimulus. Indeed, it is now unlikely that even a very temporary gain on the unemployment front can be obtained by so stimulating the economy that the inflation rate would accelerate.

The system seems to be very sensitive to the expectation of inflation, so that policy moves intended to be expansionary may so generate expectations which raise prices and interest rates and thereby retard rather than advance recovery. This sensitivity to expansionist government policy, which inhibits efforts to restore high employment, is the legacy of many years of inflationary action by the Government.

The decision against further stimulative measures is a difficult one. Nevertheless, the administration believes that its responsibility for the future of the American economy require it to take this course.

We are now seeing how difficult it is to remove from the economy the consequences of the inflation that was allowed to develop after 1965. To permit the inflation to revive, for some short-run and doubtful advantage to ourselves, would be highly irresponsible.

In decisions about the proper course for the domestic economy, and the emphasis that is placed on achieving further progress against inflation, we must also keep in mind our external payments position.

A strong and vigorous domestic economy is, of course, essential for our international position. It is the economies with a strong domestic performance that generally have done well in the international arena——

Mr. Chairman, I am not in very good voice today, and I'm going to ask Mr. Stein to complete the statement.

Chairman PROXMIRE. All right.

Mr. Stein.

Mr. STEIN. It is the economies with a strong, domestic performance that generally have done well in the international arena, and historical evidence is clear that for the United States the surplus in its balance of payments position tends to be positively related to the operating rate of its domestic economy.

Moreover, it is also true that our price performance now is better than that for the industrial world generally. Even so, we cannot ignore the fact that our trade position has not come back strongly from its low in 1968, and in April and May the United States ran a new merchandise import surplus.

There is another important reason for the administration's decision not to recommend tax reductions or expenditure increases at this time. The reason is the long-run consequence for the Federal budget.

Once new expenditures are introduced to give the economy a temporary stimulus, it is hard to get them out.

Therefore, we must realistically expect that further stimulative fiscal action now would leave a permanent or at least long-continuing residue of higher expenditures relative to revenues. This would be added to a budget trend which already shows the costs of present programs for several years beyond fiscal 1972 exceeding the revenue that the existing tax system would yield under conditions of high employment.

The result would be a continuous drain by the Federal Government on the capital supply to finance large Federal deficits, the consequently high interest rates, more difficult financing connditions for housing and for State and local governments, and an inadequate rate of investment in producers' plant and equipment.

For these reasons, the administration does not favor further fiscal actions to pump up the general economy. However, the administration does support actions, through the budget, that will have a large effect on unemployment, per dollar of cost, and relatively small effect on inflation.

It is for this reason that the administration has proposed an enlarged manpower program, now embodied in the manpower special revenue sharing, including provision for increasing manpower funds when the unemployment rate exceeds 4.5 percent.

Also for this reason the President has supported the temporary public service employment bill. H.R. 1, the welfare reform bill, would provide additional public service employment jobs and also training subsidies for private sector jobs. The administration has initiated a Federal program to provide 674,000 temporary summer jobs for teenagers and has enlisted the support of the National Alliance of Businessmen to find 150,000 additional summer jobs.

The suggestion is repeatedly made that our present economic difficulties could be resolved, or at least radically reduced, by something called "income policy." The underlying idea is that if workers and businesses can be kept from raising prices and wages, demand for output can be stimulated and output and employment raised without any inflationary consequences.

Few supporters of "incomes policy" mean comprehensive, mandatory price and wage controls. Congress has given the President authority to impose mandatory price and wage controls, but when faced with the opportunity to do so, the House of Representatives voted overwhelmingly against imposing such controls on its own initiative.

Why this great reluctance to impose mandatory controls? It is because the element of control makes clear that what is involved is forcibly preventing workers, businessmen, lenders, and other individuals from doing what they want to do, which they regard as equitable, and which may, in fact, be equitable by a more objective standard, and which may be in the general economic interest.

Naturally, there is reluctance to adopt measures which have this transparent result.

But still, being determined to find a less difficult solution, many resort to willing the end without willing the means, calling for the results of control without the controls. This is what is meant nowadays by an effective incomes policy—a policy that compels without being compulsory and operates by force of government without legislation.

There is a question whether the end would be desirable even if it could be achieved without compulsion. However, the question is moot, as the lawyers would say, because there is no evidence to suggest that the results can be achieved voluntarily, except very temporarily or in limited sectors of the economy.

No amount of repetition of calls for an effective incomes policy will get around this fact, and neither will the repetition of calls substitute for the study of experience or the attempt to work out detailed, specific standards and procedures. These matters have been the continuing concern of this administration, and particularly of this Council, for 2 and a half years.

We have studied American and foreign experience, we have had a study made by outside experts, we have participated in numerous discussions of the subjects with responsible officials of other governments, at the OECD and elsewhere. The lessons of this experience are clear.

There are countries where voluntary incomes policy seems to have worked for a time. These are small countries, in which the social and economic sectors are highly organized, like Finland and Austria. In such countries representatives of labor, capital, and other claimants on the national income can meet together and bargain over its distribution, each aware of the limits of the total and of a point at which excessive demands become self-defeating.

However, the scope of the bargaining can extend to issues of public policy that also affect the distribution of the national income, such as taxation and social services. However, in large, complex, decentralized societies, where the political and the economic organizations are not congruent, this kind of voluntary agreement to divide up the national income without inflation does not work. I believe that the governments of most of the large countries have cofe to that conclusion.

The reason for the general frustration of efforts at incomes policy can probably be summarized as follows: If the policy is to succeed, it depends on voluntary assent of millions of people to not receiving the increases of prices or wages or other incomes, in money terms, that they could get.

A necessary condition for this voluntary assent is the feeling of the parties that they are fairly treated, or that they are receiving what they regard as their just desserts. However, the sum of what people regard as their just desserts exceeds what the economy is capable of delivering, an unfortunate fact of life, and the attempt to obtain their assent by assuring them all that they will get their just desserts is inflationary.

Thus, wage standards under voluntary incomes policies commonly allow for productivity increases, plus increases to keep pace with past or future changes in the cost of living, plus increases for wages that are absolutely low, or inequitably low relative to some other wages, and increases where necessary to attract labor or raise productivity.

And price standards turn out in practice to be equally complex and difficult to apply in an effective way. Thus comprehensive incomes policy programs have turned out in practice to be ineffectual or with temporary effects that have disappeared in a subsequent wage-price explosion as the suppressed pressures erupted.

Now, the previous discussion as to what is a comprehensive income policy, the attempt to reach a far-reaching restraint, the mechanism of the wage-price review board, or some such device, the term "income policy" has come to be very broadly used, nowadays, to include almost everything except fiscal and monetary policy. This Government, as we said in my testimony earlier this year, has been operating a great many elements of what are commonly called "income policies." By some standards which might be used, it might be said that we have an income policy.

Our discussion here, perhaps at this point, might be related to the more ambitious, gullible and unspecified variance of this devise which we are commonly called upon to embrace whatever is the next step.

Nevertheless, Government intervention in some particular cases may be helpful. These efforts may occur when the Government has a special involvement as purchaser or regulator, when even the parties involved recognize that the increases being obtained exceed reasonable norms, or where there is a clear divergence between the short-run and long-run interests of the parties. The leading case of intervention by this administration has been in the construction industry, where all three of these conditions were present.

A Tripartite Board has been established to pass on wage increases in the construction industry. Increases approved by the Board up to June 30, 1971, were on the average much lower than those commonly obtained before it was established. Average approved increases have been 9.7 percent compared to average actual increases of 15.3 percent in 1970, in the construction industry. Parallel procedures are now being established to restrain other incomes in the construction industry.

And the President has said that the administration will also act in other cases where the appropriate conditions exist.

When this Council first appeared before your committee in February 1969, we said that the country had run out of easy ways to do things. Experience had exhausted the great national asset which is the expectation of reasonable price stability.

The country had run out of the credibility of Presidential guideposts. The slack in the economy and in the budget had been used up. And a deep cynicism about Government policies had been generated.

Even though we pointed these difficulties out 2½ years ago, we did not appreciate how serious their consequences would be. That is water over the dam now, and these conditions are in the process of being corrected.

But the experience leaves behind it a basic lesson. That is how transitory are the gains and how abiding the losses from temporizing with inflation. That lesson underlies the policy of this administration.

At the same time, much of the foundation for orderly and enduring expansion of the economy has been established. The long acceleration in the rate of inflation has been halted, and there is some evidence that the rate has been moving to a lower level. Increases in labor costs per unit of output are now on the average smaller than at any time since 1966, reflecting better productivity gains and a cessation of the tendency for compensation per man-hour to accelerate.

Monetary and fiscal policies are strongly expansive. Much of the effect of these policies, if experience is any guide, has yet to express itself in the economy.

With the cautious inventory policies followed by businesses, rising demand should translate fairly promptly into stepped-up production schedules. These are the building blocks of an improving economic performance in the months ahead.

(The prepared statement of Mr. McCracken follows:)

PREPARED STATEMENT OF HON. PAUL W. MCCRACKEN

We welcome this opportunity to discuss with you the state of the economy at mid-year. We hope that the present hearings will help to reduce the uncertainty which exists in the country by highlighting the facts about the economy and the fundamental consensus on policy which is sometimes concealed by the usual debate within Government and among students of economic policy generally.

I

For three years a basic objective of national policy has been to check the inflation which began about six years ago. Domestically the inflation was creating major economic and social distortions and strains, and it had also produced a serious erosion in our external position as our merchandise trade surplus declined from $7.1 billion at its peak in 1964 to its low of $0.8 billion in 1968.

It was just about three years ago that a bipartisan majority of Congress enacted the Revenue and Expenditure Control Act of 1968, imposing a tax surcharge and a ceiling on expenditures. This was the beginning of the turn in national policy against inflation. At the end of 1968 the Federal Reserve embarked upon a policy of monetary restraint. The present Administration carried through the policy of budgetary restraint which had been begun shortly before it took office. In 1969 it held expenditures down rigorously and worked for extension of the surcharge. It also encouraged the Federal Reserve in a course of continued monetary restraint. Since 1969 both fiscal and monetary policy have eased, but the degree of relaxation in both spheres has been limited by concern about inflation.

What can now be said about the outcome of this anti-inflationary effort? Four cardinal facts stand out.

First, at a minimum the rate of price increase, which had been rising, has stopped rising.

Second, some important measures indicate that there has been a significant decrease in the rate of inflation.

Third, although the evidence is less clear on this, the rate of wage increase has probably also stopped rising.

Fourth, the rate of increase of labor costs per unit of output has declined, as productivity increases have accelerated while the rise in labor compensation per hour has continued at a rather steady rate of just over 7 percent per year.

The evidence in support of these propositions is shown in the accompanying tables. However, it may be briefly summarized.

The deflator for the private gross national product with constant weights (in order to reduce the consequences of shifts in the composition of output) reached an annual rate of increase of about 5 percent early in 1969, and while it has fluctuated since, possibly for statistical reasons, it shows no persistent tendency to rise further. The index of industrial prices at wholesale reached an annual rate of increase of about 4 percent early in 1969 and has remained in the neighborhood since (if we look at 6 month spans to minimize erratic variations). Evidence of a decline in the rate of inflation is found in the Consumer Price Index. In the six months that ended in May 1971 the CPI increased at an annual rate of 4.1 percent, compared to 6.5 percent in the six months to May 1970 and 5.7 percent in the six months to May 1969. The force of this comparison is somewhat weakened by the erratic and transitory influence of mortgage rates and food prices in the total. If these two elements are removed the comparison becomes an annual rate of increase of 5.0 percent in the six months ended in May 1971 compared to 5.8 percent and 5.2 percent in the similar periods one and two years earlier. On this basis one could say that the measure of inflation that is most relevant to the average American has slowed up significantly.

Measures of wage change are more varied and difficult to interpret. Probably the most significant figure is compensation per hour for all persons engaged in the private economy. The rise of this figure over the same quarter a year earlier has been between 7.2 percent and 7.4 percent for each quarter since the beginning of 1969 except for the fourth quarter of 1970 when it was depressed by the auto strike. This level, a little over 7 percent, is important to note because of the impression of a much higher rate of wage increase commonly obtained from reports of big settlements. The rate of increase of labor costs per unit of output, compared to a year earlier, has declined from 7.8 percent in the first quarter of 1970 to 3.8 percent in the first quarter of 1971.

The restrained growth of demand which ended the acceleration of the inflation and initiated a reduction also caused a slowdown of output and employment and a rise of unemployment. The reduction was limited, however, and output and employment have now risen from their lows and the rate of unemployment has flattened out and in June registered a substantial decline. The mildness of the economic slowdown was due in part at least to the prompt turn of policy, at the beginning of 1970, in a more expansive direction.

Total output, as measured by the real gross national product, declined about 1 percent from its peak in the third quarter of 1969 to the first quarter of 1970. After a slight rise in the second quarter of 1970 and a larger one in the third quarter, real output dropped again in the fourth quarter, under the impact of the auto strike. However, output rebounded in the first quarter of 1971 to exceed its 1969 peak rate and rose further in the second quarter, although we do not yet know by how much. Total employment, seasonally adjusted, declined about ½ of one percent from the first quarter of 1970 to its low in the third quarter but has since risen and in the second quarter of 1971 was ¼ of one percent below its peak. The unemployment rate rose to 5.9 percent in November 1970 and hovered in the range 5.8 percent to 6.2 percent from then until June when it fell to 5.6 percent.

In sum, progress has been made against inflation, the slowdown of the economy associated with the start of the anti-inflation effort was mild, and it has given way to a rise in economic activity.

Progress against inflation has come more slowly than we hoped and expected. The decline of output and employment, while mild by historical standards, was also more than we expected. These two facts are, of course, related. That is, given the rise of money GNP, which was much closer to our expectations, the decline of output and employment would have been even smaller than they were if inflation had subsided more promptly. There are probably several elements in an explanation of the stubbornness of the inflation:

1. The major factor was the extraordinary strength and duration of the inflationary movement in the period before the excess of demand was significantly reduced. It must be remembered that although policy turned in an antiinflationary direction in the second half of 1968 and it was not until the second half of 1969 that the overall effects on demand were visible. Thus there were about four years of demand-stimulated inflation, which generated strong claims for further inflationary price and wage increases which survived the end of the excess demand.

2. The increased prevalence of three-year labor contracts has strengthened the tendency for large wage increases to continue to be obtained after the initial inflationary stimulus has passed.

3. The relatively low productivity growth during 1968 and 1969 meant that the disinflationary process began from a condition in which workers had not received the real wage increases they had come to expect whereas profit margins were exceptionally low. As a consequence the pressure for lower price increases that was exerted by the demand restraint encountered unusually strong resistance on the cost side.

4. The composition of unemployment may have weakened the price and wage restraining force of the slowdown of demand. The unemployment rate for adult men was low, relative to the total, and the geographical distribution of the unemployment was somewhat more uneven than in earlier periods of 6 percent unemployment. This latter phenomenon may have been related to the incidence of defense cutbacks.

5. The moderateness of the whole slowdown, and the expectation that the Government would keep the slowdown moderate, may have delayed the inflation-restraining response.

These, and other factors, which have been or might be listed, do not in our opinion mean that we have entered a new era to which previous experience does not apply. In fact, the general character of the events we are now observing has been noted in the past. For example, the inflation rate did not slow down during the contraction phase of the 1957–58 recession, leading many people then to say that we were in a new, permanently-inflationary state. However, the inflation did subside as the economy recovered.

II

Let us turn now to the prospect before us. Two propositions stand out. The first is that output and employment will continue to rise. The second is that the rate of inflation will not rise, and it is reasonable to expect some further deceleration. I believe that these two propositions would be agreed to by most analysts who try to make an explicit forcast of the economy.

There are many ways to reach the conclusion that output and employment will continue to rise. The conventional forecasting technique of adding up categories of demand leads to that conclusion. Housing starts have been rising, housing permits have recently spurted extraordinarily, the supply of funds in savings institutions is large, and the Federal support for housing through the budget is high and rising. All of this points to a further increase in residential construction above the levels already reached. The expenditures of State and local governments have been rising vigorously, these governments have recently been able to borrow on more favorable terms, they have greatly increased the amount of funds raised in this way, and grants to them from the Federal Government continue to expand. The Federal Government's own expenditures for goods and services are now starting to rise, after two years of decline. Consumers' disposable income has been rising sharply as increased social security benefits have been added to growing incomes earned in production, and this should be increasingly reflected in consumer's expenditures. Meanwhile, additions to business inventories have been low, and inventory-sales ratios have declined sharply as the rise in sales has outpaced these small increases in stocks. At some point production schedules must be stepped up further if inventories are to be adequate for this rising sales volume, and this will boost the rate of expansion further.

The behavior of the monetary aggregates also points to further expansion. The money stock narrowly defined increased 7½ percent from June 1970 to June 1971, and at the annual rate of 10½ percent for the past six months. The money supply including time deposits rose by 16½ percent for the year and at about the same rate for the six months. It would be extremely unusual if these rates of monetary expansion were not to be followed by an increase of money GNP in the next six months sufficient to raise production and employment.

Finally, the index of leading economic indicators has now risen for seven months in a row, and it would be unprecedented for such a long rise in the leading indicators not to be followed by general expansion of the economy.

On the other side of the coin, it is reasonable to expect a further deceleration of inflation. This statement is made cautiously, because the record of economists and others in foercasting the behavior of the price level in recent years has not been inspiring. However, the statement I have just made is a cautious one. The explanations of the "peculiar" behavior of the price level to which I have already referred are explanations of the failure of the rate of inflation to decline as rapidly as might have been expected. They are not reasons for thinking that the rate of inflation would rise under current and prospective conditions.

There are several cogent reasons for expecting a decline in the rate of inflation in the next year.

1. Even though the economy is rising, a good deal of slack will remain in the economy for at least a year.

2. We can expect a rapid increase of productivity as total output rises.

3. The last of the labor contracts negotiated in 1968 and earlier will soon have been renegotiated and we shall leave behind the time when workers had a strong claim to big settlements to catch up with an amount of inflation that had not been anticipated in their previous contract.

4. The number of workers covered by new settlements and therefore getting the large increases typical of the first year of a three-year contract will be less in 1972 than in 1971 or 1970.

This combination of conditions should lead to a slower rise of labor costs per unit of output and therefore to a slower rise in prices, which will in turn reduce the rate of wage increase, especially in view of the prevalence of cost-of-living escalator clauses.

The question today is not whether employment and output will be rising and the rate of inflation declining. Every quantitative forecast of which I am aware answers this question affirmatively. The question is how fast these developments will occur and how far they will go. More specifically, will the economy rise fast enough to achieve the fundamental goals for the nation—as, for example, stated in our 1971 Economic Report, namely, "that the rate of unemployment should decline as fast as is consistent with a reasonably steady and durable decline in the rate of inflation."? And operationally, the question has been whether policy should be changed to try to make the economy rise faster.

In our Economic Report we said that we thought the fundamental goals for unemployment and inflation could be represented by the achievement of an unemployment rate in the 4½ percent zone and a decline of the inflation rate to approach the 3 percent range by mid-1972. We also said that we believed those figures could be reached with an expansion of money GNP along a path that would yield $1065 billion in 1971.

Money GNP so far this year has probably been running below the path we envisaged in January, while inflation has continued higher and the rise of real output and employment have risen less than we expected. The lag in the increase of money GNP is reflected mainly in the lower-than-expected inventory increase so far this year, which as I have already indicated may portend greater strength in the second half of the year. Nevertheless, there is a danger that if money GNP were now to rise, or be pushed up, to reach the targets previously put forward that would revive inflation or at least seriously delay its abatement. This is because to regain the original path from the present apparent starting point of money GNP would require a steeper rise of money GNP than was originally contemplated and because the rate of inflation has been very persistent.

Even if a somewhat reduced target for the rise of money GNP is accepted, questions have been asked about whether existing and prospective policies, added to the private forces in the economy, are likely to be adequate to reach that target. In answering that question we must recognize that the budget for fiscal 1972 is already much more expansive than the budget that was submitted in January.

Actions taken since January have reduced the prospective fiscal year 1972 revenues by almost $2 billion. Congressional actions on expenditures have increased expected outlays for that year by about $3 billion, and further increases in "uncontrollable" outlays for public assistance, medicaid, veterans benefits and farm price supports will apparently add almost $2 billion to what had been anticipated. So we have already confronting us a net further expansive fiscal effect of $7 billion beyond that already put forward in the President's Budget Message, and many actions on appropriations for FY 1972 have not yet been taken.

We should also give weight to the fact, which I have already noted, that the money stock has risen from June 1970 to June 1971 by 7½ percent and the rise during the first half of 1971 has been at the rate of about 10½ percent per year. The effects of this relatively rapid rate of expansion (following, it must be pointed out, an abnormally slow rate of expansion in the latter part of 1970) have yet to express themselves in economic activity. The rate of monetary expansion in the future will, of course, be determined by the Federal Reserve, and we cannot foretell it. However, if the rate of expansion in the second half of this year were to be half the rate of the first half, the increase from the average of 1970 to the average of 1971 would not be much below 7 percent. Thus, even with a substantial moderation of what most people would regard as an exceptionally high rate of expansion during the first half we would still have a large year-to-year change.

Whatever the unemployment rate we, of course, have unfinished business so long as anyone is searching for work and unable to find a job. In the light of the stance of both fiscal and monetary policy, however, we regard it as probable that money GNP, output, and employment will rise, and unemployment will fall, about as rapidly as is consistent with satisfactory reduction of the inflation rate. Of course, no one can be obsolutely certain of this, and there are risks in any policy that is chosen. The Administration's rejection of a policy of further economic stimulation reflects the belief that we cannot temporize with the inflation problem with yet more stimulus. Indeed, it is now unlikely that even a very temporary gain on the unemployment front can be obtained by so stimulating the economy that the inflationary rate would accelerate. The system seems to be very sensitive to the expectation of inflation, so that policy moves intended to be expansionary may generate expectations which raise prices and interest rates and retard rather than advance recovery. This sensitivity to expansionist government policy, which inhibits efforts to restore high employment, is the legacy of many years of inflationary action by government.

This decision against further stimulative measures is a difficult one. Nevertheless, the Administration believes that its responsibility for the future of the American economy requires it to take this course. We are now seeing how difficult it is to remove from the economy the consequences of the inflation that was allowed to develop from 1965 to 1968. To permit the inflation to revive, for some short-run and doubtful advantage to ourselves would be highly irresponsible.

In decisions about the proper course for the domestic economy, and the emphasis that is placed on achieving further progress against inflation, we must also keep in mind our external payments position. A strong and vigorous domestic economy is, of course, essential for our international position. It is the economies with a strong domestic performance that generally have also done well in the international arena, and historical evidence is clear that for the United States the surplus in its balance of payments position tends to be positively related to the operating rate of its domestic economy. Moreover, it is also true that our price performance now is better than that for the industrial world generally. Even so, we cannot ignore the fact that our trade position has not come back strongly from its low in 1968, and in April and May the United States ran a net merchandise import surplus.

There is another important reason for the Administration's decision not to recommend tax reductions or expenditure increases at this time. That reason is the long-run consequence for the Federal budget. Once new expenditures are introduced to give the economy a temporary stimulus it is hard to get them out. Therefore we must realistically expect that further stimulative fiscal action now would leave a permanent or at least long-continuing residue of higher expenditures relative to revenues. This would be added to a budget trend which already shows the costs of present programs for several years beyond fiscal 1972 exceeding the revenue that the existing tax system would yield under conditions of high employment. The result would be a continuous drain by the Federal Government on the capital supply to finance large Federal deficits, high interest rates, more difficult financing conditions for housing and for State and local governments, and an inadequate rate of investment in producers' plant and equipment.

For these reasons the Administration does not favor further fiscal actions to pump up the general economy. However, the Administration does support actions, through the budget, that will have a large effect on unemployment, per dollar of cost, and relatively small effect on inflation. It is for this reason that the Administration has supported an enlarged manpower program, now embodied in the Manpower Special Revenue Sharing, including provision for increasing manpower funds when the unemployment rate exceeds 4.5 percent. Also for this reason the President has supported the temporary public service employment bill. H.R. 1, the welfare reform bill, would provide additional public service employment jobs and also training subsidies for private sector jobs. The Administration has initiated a Federal program to provide 674,000 temporary summer jobs for teenagers and has enlisted the support of the National Alliance of Businessmen to find 150,000 additional summer jobs.

III

The suggestion is repeatedly made that our present economic difficulties could be resolved, or at least radically reduced, by something called "incomes policy." The underlying idea is that if workers and businesses can be kept from raising prices and wages, demand for output can be stimulated and output and employment raised without any inflationary consequences. Few supporters of "incomes policy" mean comprehensive, mandatory price and wage controls. Congress has given the President authority to impose mandatory price and wage controls, but when faced with the opportunity to do so the House of Representatives voted overwhelmingly against imposing such controls on its own initiative. Why this great reluctance to impose mandatory controls? It is because the element of control makes clear that what is involved is forcibly preventing workers, businessmen, lenders and other individuals from doing what they want to do, which they regard as equitable, and which may be equitable by a more objective standard, and which may be in the general economic interest. Naturally there is reluctance to adopt measures which have this transparent result.

But still, being determined to find a less difficult solution, many resort to willing the end without willing the means, calling for the results of control without the controls. This is what is meant nowadays by an effective incomes policy—a policy that compels without being compulsory and operates by force of government without legislation. There is a question whether the end would be desirable even if it could be achieved without compulsion. However, the question is moot, as the lawyers would say, because there is no evidence to suggest that the results can be achieved voluntarily, except very temporarily or in limited sectors of the economy.

No amount of repetition of calls for an effective incomes policy will get around this fact, and neither will the repetition of calls substitute for the study of experience of the attempt to work out detailed, specific standards and procedures. These matters have been the continuing concern of this Administration, and particularly of this Council, for two and a half years. We have studied American and foreign experience, we have had a study made by outside experts, we have participated in numerous discussions of the subjects with responsible officials of other governments, at the OECD and elsewhere. The lessons of this experience are clear. There are countries where voluntary incomes policy seems to have worked for a time. These are small countries, in which the social and economic sectors are highly organized, like Finland and Austria. In such countries representatives of labor, capital and other claimants on the national income can meet together and bargain over its distribution, each aware of the limits of the total and of a point at which excessive demands become self-defeating. Moreover, the scope of the bargaining can extend to issues of public policy that also affect the distribution of the national income, such as taxation and social services. However, in large, complex, decentralized societies, where the political and the economic organizations are not congruent, this kind of coluntary agreement to divide up the natonal income without inflation does not work. I believe that the governments of most of the large countries have come to that conclusion.

The reason for the general frustration of efforts at incomes policy can probably be summarized as follows: If the policy is to succeed it depends on voluntary assent of millions of people to not receiving the increases of prices or wages or other incomes, in money terms, that they could get. A necessary condition for this voluntary assent is the feeling of the parties that they are fairly treated, or that they are receiving what they regard as their just deserts. However, the sum of what people regard as their just deserts exceeds what the economy is capable of delivering, and the attempt to obtain their assent by assuring them all that they will get their just deserts is inflationary. Thus, wage standards under voluntary incomes policies commonly allow for productivity increases, plus increases to keep pace with past or future changes in the cost of living, plus increases for wages that are absolutely low, or inequitably low relative to some other wages, and increases where necessary to attract labor or raise productivity. And price standards turn out in practice to be equally complex and difficult to apply in an effective way. The comprehensive incomes policy programs have turned out in practice to be ineffectual or with temporary effects that have disappeared in a subsequent wage-price explosion as the suppressed pressures erupted.

Nevertheless, government intervention in some particular cases may be helpful. These occur when the government has a special involvement as purchaser or regulator, when even the parties involved recognize that the increases being obtained exceed reasonable norms, or where there is a clear divergence between the short-run and long-run interests of the parties. The leading case of intervention by this Administration has been in the construction industry, where all three of these conditions were present. A tripartite Board has been established to pass on wage increases in the construction industry. Increases approved by the Board up to June 30, 1971, were on the average much lower than those commonly obtained before it was established. Average approved increases were 9.7 percent compared to average actual increases of 15.3 percent in 1970. Parallel procedures are now being established to restrain other incomes in the construction industry.

And the President has said that the Administration will also act in other cases where the appropriate conditions exist.

IV

When this Council first appeared before your Committee in February 1969 we said that the country had run out of easy ways to do things. Experience had exhausted the great national asset which is the expectation of reasonable price stability. The country had run out of the credibility of Presidential guideposts.

The slack in the economy and in the budget had been used up. And a deep cynicism about government policies had been generated. Even though we pointed these difficulties out two and a half years ago we did not appreciate how serious their consequences would be. That is water over the dam now, and these conditions are in the process of being corrected. But the experience leaves behind it a basic lesson. That is how transitory are the gains and how abiding the losses from temporizing with inflation. That lesson underlies the policy of this Administration.

At the same time much of the foundation for orderly and enduring expansion of the economy has been established. The long acceleration in the rate of inflation has been halted, and there is some evidence that the rate has been moving to a lower level. Increases in labor costs per unit of output are now on the average smaller than at any time since 1966, reflecting better productivity gains and a cessation of the tendecy for compensation per man hour to accelerate. Monetary and fiscal policies are strongly expansive. Much of the effect of these policies, if experience is any guide, has yet to express itself in the economy. With the cautious inventory policies followed by businesses, rising demand should translate fairly promptly into stepped-up production schedules. These are the building blocks of an improving economic performance in the months ahead.

TABLE 1A.—PRICES, WAGES, AND COSTS

[Seasonally adjusted annual rates]

Period	Private GNP deflator percentage change from 2 quarters earlier [1]	Period	Percentage change from 6 months earlier: Wholesale industrial prices	Consumer prices: All items	Consumer prices: All items less food and mortgage interest
1965:					
I	NA	May	1.2	1.8	1.9
III	NA	November	2.0	1.7	1.1
1966:					
I	NA	May	2.8	3.9	2.7
III	3.6	November	1.6	3.3	3.3
1967:					
I	2.4	May	.8	2.0	3.1
III	3.1	November	2.4	3.7	3.6
1968:					
I	3.5	May	2.8	4.4	4.2
III	4.4	November	2.4	5.1	4.7
1969:					
I	4.5	May	4.0	5.7	5.2
III	5.0	November	3.8	5.8	4.7
1970:					
I	4.8	May	3.9	6.5	5.8
III	4.8	November	3.3	4.7	5.9
1971: I	5.2	May	4.0	4.1	5.0

[1] 1965–IV weights.

Source: Department of Commerce and Department of Labor.

TABLE 1B.—PRICES, WAGES, AND COSTS

[Percentage change from year earlier]

Period	Total private (all persons) Compensation per man-hour	Unit labor costs	Period	Total private (all persons) Compensation per man-hour	Unit labor costs
1965:			1968:		
I	3.9	1.4	I	7.3	3.8
II	4.0	1.4	II	6.9	4.3
III	4.1	.5	III	7.6	4.8
IV	4.4	—.6	IV	8.5	5.3
1966:			1969:		
I	6.0	1.1	I	7.3	5.4
II	7.3	2.3	II	7.2	6.6
III	7.1	3.8	III	7.2	6.7
IV	7.5	4.3	IV	7.3	7.1
1967:			1970:		
I	6.1	4.8	I	7.4	7.8
II	5.9	3.4	II	7.3	6.3
III	5.9	3.0	III	7.2	5.5
IV	5.3	3.5	IV	6.7	5.2
			1971: I	7.3	3.8

Source: Department of Labor.

TABLE 2.—OUTPUT, EMPLOYMENT, AND UNEMPLOYMENT

[Seasonally adjusted]

Period	GNP, billions of dollars, 1958 prices [1]	Civilian employment (millions)	Unemployment rate (percent)	Period	GNP, billions of dollars, 1958 prices [1]	Civilian employment (millions)	Unemployment rate (percent)
1965:				1969:			
I	601.6	70.19	4.9	I	722.1	77.36	3.4
II	610.4	70.90	4.7	II	726.1	77.58	3.5
III	622.5	71.37	4.4	III	730.9	78.11	3.6
IV	636.6	71.82	4.1	IV	729.2	78.58	3.6
1966:				1970:			
I	649.1	72.18	3.9	I	723.8	78.90	4.2
II	655.0	72.61	3.8	II	724.9	78.60	4.8
III	660.2	73.09	3.8	III	727.4	78.52	5.2
IV	668.1	73.66	3.7	IV	720.3	78.57	5.9
1967:				1971:			
I	666.6	73.81	3.8	I	732.7	78.63	5.9
II	671.6	73.98	3.8	II		78.70	6.0
III	678.9	74.64	3.8				
IV	683.6	75.11	3.9				
1968:							
I	693.5	75.32	3.7				
II	705.4	75.91	3.6				
III	712.6	76.05	3.5				
IV	717.5	76.42	3.4				

[1] Annual rate.

Source: Department of Commerce and Department of Labor.

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Chairman PROXMIRE. Thank you gentlemen very much for a very informative and candid statement.

Last week, the White House indicated that the economics spokesman of the administration would be the Secretary of the Treasury, Mr. Connally. I have the greatest admiration and respect for you and for your economic capability.

I always thought the Chairman of the Council of Economic Advisers was the economic spokesman for the administration, at least in many senses. To the best of my recollection, this is the first time that I can recall, since the Council of Economic Advisers was established under the 1946 act, in which an administration has designated a person who is not chairman, as the economics spokesman, and it puts this committee in a dilemma. When you come before us, I have always thought of you as being the spokesman for the administration and qualified professionally to speak on economic policy, but now we hear the Secretary of the Treasury is the spokesman for the administration in economic policy.

What does that do to your position?

What does that do to your authority?

Mr. MCCRACKEN. I don't think the basic position of the Chairman of the Council of Economic Advisers or the Council itself as an agency, is changed. We are still where we were before, both organizationally, and otherwise; we are here today speaking for the administration.

On the other hand, there is no question but that the Secretary of the Treasury is the ranking administration official in the broad financial and economic area.

Chairman PROXMIRE. Well, in view of the fact that he's been designated apparently as economic spokesman, can you speak with assurance that you speak for him?

For example, was your statement that you just gave to us cleared with the Secretary of the Treasury?

Mr. MCCRACKEN. We always have a very elaborate clearance procedure. Yes, I can say that this statement is far more than just a CEA document.

It represents the administration.

Chairman PROXMIRE. It was cleared with the Secretary of the Treasury?

Mr. MCCRACKEN. It was cleared, as usual, with OMB and Treasury.

Chairman PROXMIRE. I think this statement is disturbing and distressing. Essentially your statement seems to say three things:

No. 1, that despite the high prices we have paid in unemployment, our progress against inflation has been very limited and disappointing.

No. 2, the employment goals set by the administration earlier this year are not being met.

No. 3, because the administration is so concerned about inflation. what you seem to say in your prepared statement would imply that no further action is going to be taken to try to reduce unemployment. except as it is possible to do so consistent with also reducing inflation.

I refer to, and I will quote you expressly. You say:

Unemployment will fall about as rapidly as is consistent with satisfactory reduction of the inflation rate.

Now, does that mean that the principal guide to your economic policy is rate of inflation and that unemployment policy will hinge on that?

Mr. McCracken. The management of economic policy always requires taking cognizance of a great many different objectives and trying to have, or trying to find, an appropriate balance among these objectives.

We certainly consider the unemployment problem and the objective of reducing the rate of unemployment to be a very high priority objective.

On the other hand, because of what has happened over the last several years as the distortions of inflation have been built into the economy, it has to be given high priority too.

But I want to go back to the beginning. To say that we would like to have made further progress is not to say very important progress has not been made.

If one looks at these charts here——

Chairman Proxmire. Well, the second one, as I pointed out, the GNP deflator, leave that chart up there. And in the upper left hand corner, the GNP deflator, many feel, is the best indication of inflation.

Of course, there's dispute about that, but that is the general view of many in the economic profession, and it is clear, as I say the last date for that figure is the highest of all. The rate of inflation seems to be on the basis of the statistics you give us to be as high as it has been at any time on your chart.

It goes up to apparently over 5 percent.

Mr. McCracken. Yes, but here is the point I am talking about.

This is the kind of track the economy was on. Now, if you follow that kind of a track, and if nothing had been done to try to counter the inflation, then this would suggest that the rate of inflation would be up to the 6 to 8 percent range or more.

The only thing one can confidently say in regard to the GNP deflator at this moment is that it has a more level rate of increase. After having risen for a period of years, it has recently been on essentially a plateau. It may be—I won't try to fortell the future here—it may be that the rate will go on up. But the last upward shift is only 0.2 of a point and I would not try to make anything out of that.

If one looks beyond the GNP deflator, if you look at the Consumer Price Index, which for most people is probably the most meaningful index, this is broadly speaking the kind of trend that inflation was on during that period. If that trend had continued, we would be looking at something like an 8-percent rate of inflation today. In fact, thus far this year it's only about a 4-percent rate. We haven't made as much progress here as I would have liked. Certainly, even here there was a trend which, if projected, would bring you substantially above where we are now.

Now the question can be raised whether this is getting up into numbers that have little relevance to the American economy. No one knows.

I think 2 or 3 years ago we might have raised the question as to whether numbers in the rate of inflation that you are seeing in the United Kingdom would ever be seen in that kind of economy.

But, on the first basic question, very important progress has been made. The acceleration has been halted, and in this case there has been some decline. In all of the indexes, there has at least been a deceleration.

Chairman PROXMIRE. Let me tell you why this is so disturbing to me.

I understood Secretary Connally last week to say that the notion of a 4-percent unemployment level was a myth. He argued, I think, with complete inaccuracy, that we never achieved it in peace time.

We have, in fact, as you know. We achieved it many times in peace time. It is not easy and it has been the goal of this action until what I think is an historic statement by this administration that they don't feel that they can responsibly try to achieve a 4-percent level of unemployment.

Now, is this your position too? Because I understood the council to make that statement to us earlier this year saying that the goal is 4-percent unemployment.

Have you now modified that so your goal is 4.5 percent?

Mr. McCRACKEN. First, with regard to the comment that Secretary Connally made, the Secretary certainly was not in any sense trying to make light of the problems of unemployment. I don't think there's any question about that.

What the Secretary was trying to point out is the complexity of this matter of unemployment, and the importance of looking behind some one ratio, such as the overall rate of unemployment, as a shorthand for a very complex phenomenon.

It is interesting, for example, to take the composition of the labor force as it existed in 1956 and apply to that the unemployment rates, group by group, which prevail now. The average unemployment rate would, in fact, be about 0.5 percent lower than it is, because today we have a relatively larger percentage of people with a somewhat looser attachment to the labor force. In other words, the composition has changed.

The importance of not just having this total unemployment phenomenon described by one single figure, is increasingly important.

Chairman PROXMIRE. Well, Secretary Connally was very explicit, very clear I thought in his statement. He said that it is a myth; it has never happened—that is, 4-percent unemployment has never been on an annual basis, unemployed at the rate of 4 percent, so 4 percent is not the norm. We have never achieved it.

He goes on to say, "I don't think the American people are willing at this point in time to continue the work, to conutinue all it means in order to achieve a 4-percent level of unemployment."

So he was—two or three times in this statement he made it clear that 4 percent was being abandoned as far as he was concerned.

Now, you say that you are just not sure the precise figure, but you don't think the figure is satisfactory. But he seemed to be very explicit in dismissing the 4 percent.

Do you disagree with that?

Mr. McCRACKEN. We have always said, as we did here in our statement again today, that so long as people are looking for work and can't find a job we have unfinished business. But I would emphasize the importance of our looking at the multi-dimensional aspects and not trying to identify some specific figure as the target at which point we quit and that short of which we have to keep at it.

I think that is the basis.

Mr. STEIN. I think perhaps the Senator misspoke in saying we have put forward a goal of 4 percent in our most recent report. Our January report spoke of the goal for the middle of 1972 as being in the zone or neighborhood, some such words, of 4.5 percent unemployment. Now, we have previously spoken of lower number. In fact, at one time we held 3.8 percent as a goal, but I think it is important to bear in mind that then we were talking about goals which might be achieved over a considerable period of time as a result of considerable improvement in labor market conditions, which could be furthered by public policy and not to be achieved solely as a result of pumping up demand.

Chairman PROXMIRE. Well, maybe I'm deceived, but the memorandum that was written to us, and I quote from it, a year and a half ago, you clearly point to a long-term goal of at least 4 percent unemployment with inflation of 2 percent.

Now, Secretary Connally, you say, in saying 4.5 percent as referring only to a temporary goal. A goal for the next 2 or 3 years, something of that kind? That is what this 4.5 percent means?

Mr. STEIN. I think this is a time-related goal and also a policy related goal. When we spoke of the 4.0 percent and at one time the 3.8 percent goal, we were talking about the results to be achieved through a process of improving labor markets and improving employment services and all that sort of thing which we said would work out slowly in any case.

Chairman PROXMIRE. Well I hope you have further conversations with the Secretary because he was so emphatic when he said 4 percent is not the normal. He said, "Never have we achieved it except in war time." He was about as clear and explicit as I think an official can be on that and you gentlemen are indicating that that isn't your view as far as a long term goal is concerned.

Senator Miller.

Senator MILLER. Thank you, Mr. Chairman. Mr. McCracken, as juxtaposed to my colleague from Wisconsin I find your statement moderate, logical, comprehensive, and hopeful.

Chairman PROXMIRE. What was that last adjective, wholesome?

Senator MILLER. Hopeful. [Laughter.]

In your prepared statement you point out the money stock increased 7.5 percent from June of 1970 to 1971 and at the annual rate of 10.5 percent for the past 6 months. I believe you also pointed out elsewhere that there were large supplies of money in savings. Now, how do you reconcile that with the recent increase in the prime rate of interest?

Mr. MCCRACKEN. I note in the newspaper there seems to be some evidence of a tightening up in the money market which may suggest such actions as we try to move away from this 10.5 or 16.5 percent track. And, of course, any kind of a change such as that would put pressure on the money market. Apparently what we have seen, at least among other things, I think are two things that are pertinent to the interest rate development. One of them is that we have had an enormous volume of financing of corporations and also of State and local governments. The volume of flotations so far this year in each case is roughly 50 percent larger than last year and about double that of 2 years ago. So the market has been under heavy pressure. This evidently tends to transmit itself to some extent across the interest rate spectrum, including short term rates.

Having said that, I must say I think we have to watch this. Certainly, the high interest rates are not good news for housing or for State and local financing either for that matter. It is another concern.

Senator MILLER. Well, if I follow what you have said, your suggestion is that there might have been a lowering in the increase in the money stock for the month of June which is not included in that 10.5 percent rate of increase for the first 6 months of this year and that on a short range, a matter of days, that this could be reflected in the prime interest rate?

Mr. MCCRACKEN. Well that would be a rather brief transmission process. I was merely trying to tick off the various factors which may be impinging on the market. Certainly most students of monetary conditions have indicated that the rate of monetary expansion we've had so far this year ought not to be continued indifinitely as we move away from that path to a somewhat more modest rate of expansion. This could have a rather immediate effect on the money market. I'm talking about relatively short term rates.

At the same time, as I say, I am not happy with either the rising rates or the level of rates we have.

Senator MILLER. Well I understand you would't be happy although I can see some possible benefit on our balance-of-payment situation.

Mr. MCCRACKEN. That is true.

Senator MILLER. With respect to foreign market?

Mr. MCCRACKEN. Yes.

Senator MILLER. But I am just wondering if another reason is possibly the expectation on a part of the major banks which set a tone of continued inflation at about the same rates because of what is happening on the fiscal front here in the Congress. Is that another possibility?

Mr. MCCRACKEN. That is a very important point and we hear this cited over and over again. A substantially more expansive policy could be counterproductive because it could support fears of inflation and the inflation premium, the added interest rates, would be that much larger. This would have an adverse effect on housing and so on. This does seem to be very much on the minds of financial managers and we alluded in our statement to the high sensitivity of the economic system to things which may indicate a quickening in the pace of inflation.

Senator MILLER. Well, as an economist would you say that the factors you pointed out totaling $7 billion in further expansive fiscal effort and the 10.5-percent increase in the money stock during the first 6 months of this year would have an inflationary impact which could be reflected in that increase in the interest rates?

Mr. MCCRACKEN. These developments may well have played some role in expectations about inflation as they are translated into interest rates. I would point out that these developments to which we allude are, or have been, of course, relevant to the question of whether we should go for further measures to expand the economy. If the lags between fiscal and monetary policy on one hand and the economy on the other are anything like what the evidence seems to suggest the visable effects of these more expansive effects on the economy are yet to show up. They ought to be showing up in the latter part of the year.

Senator MILLER. Well, I take it that prudence would indicate or dictate that it was these factors which you call attention to and with the increase, the very substantial increase, in the money stock for the last 6 months and now with this increase in interest rates that prudence would dictate that we had better be very, very careful about any further fiscal expansionary activities here in the Congress.

Mr. MCCRACKEN. Yes, very definitely. And we do have to take cognizance of the fact that these would have a significant backlash effect on financial markets, interest rate levels, and so forth.

Senator MILLER. I don't want to bore you with an old classroom question but I have always been taught that if there is persistent inflation that sooner or later it is going to result in unemployment and especially when we have such a great dependence upon our foreign trade that if we let the inflation keep right on going sooner or later it is a matter of more imports coming in and fewer exports going out; it is going to mean higher prices, lower purchases and therefor less employment at least in the long run.

Now are we trying to straddle here? Are we trying to follow a policy of short term gain in employment, which in the long run because of the inflation that will persist, will lead to greater unemployment? What is the policy we are trying to solve here or am I wrong in what I have been taught all those years?

Mr. MCCRACKEN. No; I think that has been an important rationale included in our policy that it would be irresponsible not to face up to the inflation problem. We could not ignore the unemployment consequences just by failing to face up to them because in a variety of ways if we ran out the inflation or allowed the rate of the rising price level to continue to accelerate there is no assurance that we could thereby avoid the unemployment problem.

Now, having said that, we have tried of course to hold the adjustment in the economy to a fairly narrow proportion. Obviously we have to be concerned about that side of it too but we do not, I think, have the option of being able to handle the unemployment problem if we are just willing to accept more inflation.

Senator MILLER. Well, what you are trying to do is steer a middle course between long- and short-range results.

Mr. MCCRACKEN. Exactly.

Senator MILLER. By expanding the economy to attack the unemployment problem without aggravating inflation, you are avoiding short-range rapid expansion which would aggravate inflation on the one hand and overriding a stagnant economy to stop inflation at the costs of long-range high unemployment on the other hand.

Mr. MCCRACKEN. Yes.

Senator MILLER. Thank you.

Chairman PROXMIRE. Senator Fulbright.

Senator FULBRIGHT. Thank you, Mr. Chairman.

Mr. McCracken, in your statement you say April and May the United States had net merchandise import surplus. Is this the same thing as a deficit in our balance of trade?

Mr. MCCRACKEN. Yes, sir; that it is. That could have been worded the other way, the net merchandise export deficit. In other words we have a net merchandise export deficit. We have a net excess of imports over exports of roughly $200 million in each month.

Senator FULBRIGHT. The word "surplus" has a more euphonius sound. Is that the reason why? [Laughter.]

It reminds me of the "protective reaction" strikes. That sounds better than a bombing raid. Do the same people rephrase these statements whether they are made in the Pentagon or CEA?

Mr. McCRACKEN. No, the CEA will take full responsibility for this line here.

Senator FULBRIGHT. What was the deficit, if I may use that word, in our balance of trade in fiscal year 1971?

Mr. McCRACKEN. 1971 or 1970?

Senator FULBRIGHT. 1971, which has just ended. Do you have those figures on 1971 fiscal year?

Mr. McCRACKEN. The balance of trade?

Senator FULBRIGHT. Do you keep them on that basis?

Mr. McCRACKEN. We don't have the final ones.

Senator FULBRIGHT. What is the last one you have?

Mr. McCRACKEN. Well, the last month we have is May.

Senator FULBRIGHT. That was a deficit of $200 million?

Mr. McCRACKEN. About $200 million. I can give you the monthly figure.

Senator FULBRIGHT. Well, I don't want to burden the record with all of them but the point is these last 2 months you did develop a deficit in trade, did you not?

Mr. McCRACKEN. That is right.

Senator FULBRIGHT. And how long has it been since we've had a comporable deficit in our trade balance?

Mr. McCRACKEN. One would have to go back roughly 20 years to find 2 consecutive months with a trade deficit.

Senator FULBRIGHT. Don't you find that rather ominous?

Mr. McCRACKEN. Yes; I am disturbed. I think this is something we have to be concerned about. If one goes back and projects what would seem to be the basic pattern or trend of both exports and imports; it would suggest that there may have been some special factors in those 2 months. The accumulation of foreign steel inventory and that sort of thing may have added some unusual things. We don't have the full detail yet so I just can't be sure, but the basic trends would still suggest that we should be having a net export surplus in this period of $100 to $150 million per month.

Senator FULBRIGHT. But hasn't the trend ever since inflation took over been toward a lessening in our balance of trade? I mean inflation is gradually pricing us out of the market isn't it?

Mr. McCRACKEN. Well, that is the peculiar thing.

We had our strongest trade surplus, that is the excess in merchandise exports over imports in 1964 of $590 million per month or roughly $7 billion per year. That generally moved downward in succeeding years and in 1968 it averaged only $70 million per month. Then in 1969 it went up to $107 million. In 1970, to $225 million. But in the latter part of 1970 it deteriorated again somewhat.

Senator FULBRIGHT. Mr. McCracken, what assumption did the council make with regard to the continuation of the war in Vietnam in making these estimates. Do you assume that it is going to be over in the foreseeable future?

Mr. McCracken. In making our projections for the economy we make our projections on the basis of the President's budget.

Senator Fulbright. So that means you make it on the assumption that the war will continue at the present level?

Mr. McCracken. Of course, there has been a substantial decline in defense spending.

Senator Fulbright. Oh, has there? Would you elaborate that? I thought the Defense request in this present 1972 fiscal year was up to $76 billion. I wasn't aware there was any substantial decrease in military spending.

Mr. McCracken. The point I made was that there has been a substantial decline in defense spending in real terms.

Senator Fulbright. What do you mean by that?

Mr. McCracken. Washing out the effect of inflation, in other words, in terms of real goods and services allocated to the defense effort, on the national income basis. Defense spending reached a peak in calendar year 1968 of $96 billion in first-quarter 1971 prices. It was running at the rate of $74 billion in the first quarter of 1971. That is a decline of over 20 percent.

Senator Fulbright. Well I am not sufficiently agile mentally to follow those changes. The dollars are still as high or higher as they have been; the nominal dollar, however depreciated they may be. The budget figures are still up, aren't they?

Mr. McCracken. According to my record here national defense budget outlays in fiscal 1969 were $81.2 billion; 1970, $80.3 billion; $76.4 billion in 1971; and then a projected figure of $77.5 billion in 1972. Now if you also allow for the price rise, in real terms from 1968 to 1971, there has been close to a 20-percent decline.

Mr. Stein. Twenty billion dollars. In retrospect there has been a $20-billion decline in the annual rate of expenditure. Now if we are discussing the real question we should keep this thing in real terms and not in nominal terms. The fact is an enormous increase in the rate of pay granted to the Armed Forces and an enormous increase in the prices paid for military supplies just as for other things. No real question is answered by looking at these nominal amounts.

Senator Fulbright. Well, is your income in real dollars or fancy dollars? Does your income come in on these real dollars that you are talking about? Your taxes, are they in real dollars or these other kinds of dollars?

Mr. Stein. Well, I don't know whether you are asking a real question now or not. [Laughter.]

Senator Fulbright. Well, I don't think I got a real answer. But let's come back to another matter.

Mr. McCracken. Is it correct to interpret from what you say in your statement that you think it is the responsibility of Congress to take hard decisions and not the President? Is that what that means? That if anybody is going to take the hard decision of putting in controls that it has got to be Congress; the President shouldn't be expected to take the hard decision?

Mr. McCracken. Well, it means several things.

Senator Fulbright. What is its real meaning?

Mr. McCRACKEN. It means several real things. The President did indicate when he signed the act in regard to the authority for wage and price controls, that this was the kind of action of such momentous nature that he wanted to come back to the Congress if a thing like that were ever contemplated. However, I think the basic point beyond the question of how the Government's decision ought to be made, is a caution against excessive hopes or something, which as we use the term, would compel without being compulsory, and so forth.

We do have a vexatious and stubborn problem of inflation, of prices and, of course, costs. It is a phenomenon of the industrial world generally. There has been enormous experiences now internationally with various forms of what is coming to be called incomes policy. As we indicated in our statement, it is very difficult to read that record and be very encouraged about what, in fact, it is realistic to expect. We have examined that record rather carefully ourselves. There have been other studies. The OECD recently published a study reviewing this.

Everyone seems to get a pattern something like this: In some cases, after a period of following the more voluntary type of approach, the country moves into direct wage and price controls. Finland, for example, is often cited as a successful example of income policy. If I remember correctly, something like 70 percent of the items in their cost-of-living index are under price control. In other words, Finland moved on into price control. In other cases, it does appear that in initiating some kind of program such as this there was, for a time, a displacement effect. In other words, the rate of price and wage inflation did seem to level out, but not infrequently the brief experiment resulted subsequently in an explosion in wages and prices. It has been a very characteristic experience in the United Kingdom. It also characterized the experience in the Netherlands in the mid-1960's. In Germany, which I suppose is as sensitive as any country to the problem of inflation, they have been trying what they have called concerted action policies since about 1967. They have one of the most difficult wage and price problems of any country in the world today.

These experiences caution against holding out excessive optimism, that an extremely vexatious problem has some kind of solution in this term of incomes policy.

Senator FULBRIGHT. I can only say that the Executive's concern for the Congress, its opinion in this field, is in marked contrast to the Executive's concern about Congress' concern in foreign policy, such as invading Cambodia or ending the war.

My time is up, Mr. Chairman.

Chairman PROXMIRE. Mr. McCracken and Mr. Stein, a big economic problem in this country now is 5½ million Americans are out of work, the largest number of people we've had out of work in 10 years, and in spite of that you have made a decision which as you say in your paper against further stimulative measures you say it was a tough decision to make and I am sure that is true. But in view of the large number of people unemployed and in view of what I thought was a bipartisan determination to reduce unemployment as rapidly and completely as we could, I am concerned as to why you didn't at least wait for the second quarter GNP figures. Why you didn't wait until you had a case more clearly documented, that we are moving ahead or that unemployment is going to improve.

I hope and trust that you aren't placing your reliance primarily on those very tenuous and questionable unemployment figures that we had on the 2d of July.

Mr. McCRACKEN. I think I can confidently say that the decision was not based on this one statistic alone. I want to emphasize that the decision not to go for yet more expansive measures is not a decision to stop further economic expansion, obviously.

The budget message, for example, which the President put forward calls for something like $16½ billion in additional expenditures from 1971 to 1972. As I indicated in the statement, some further actions have increased that expansion by, I believe, $5 billion more and other actions had produced a somewhat similar effect on the revenue side of about $2 billion, so that we already have in place a highly expansive fiscal policy. Also, we had in the first half of this year a highly expansive monetary policy.

Chairman PROXMIRE. Now just at that point can we really argue that these are highly expansive fiscal policies when the full employment budget is really in balance?

Mr. McCRACKEN. Yes, I would. Let me ask the question if the economy is otherwise holding in a level position, what kind of things in the budget would tend to move the economy up? Well, there are obviously two things. One of them would be a direct increase in spending. The second would be a reduction in tax rates and therefore an increase in after-tax incomes.

Now if you look at the magnitude of this expansive fiscal thrust on both sides of the budget, both the rise of spending and the change of tax rates from 1971 to 1972, it is very large. And, it is larger now than was projected in the February budget message.

Chairman PROXMIRE. Earlier this year when you appeared before this committee in February or March I understood you to testify that a balanced full employment budget was neither stimulative nor restrictive, that it was pretty much neutral.

Mr. McCRACKEN. Relative to the full employment growth path.

Chairman PROXMIRE. Yes; and now taking a look at what you have said at that time at that point you were aiming at a $1,065 billion budget. It seems less realistic with every month that passes. And you said this:

> We are saying that that is the probable outcome and this surely differs with the concensus. There is one basic reason of this difference. We incorporate in our view of 1971 as earlier private forecasters have not always done the fact that 1 trillion, 65 billion GNP is the target of government policy for 1971. That the government has the means to achieve the target and that the government will use them. That is the target of government policy because it describes the path that would reduce unemployment as rapidly as is consistent with the reduction of inflation.

And so forth.

Now in view of the fact that you are not going to achieve that $1,065 billion, and correct me if I am wrong about that—it seems to me that you simply are not using, the government is not using the tools that it has to reduce unemployment to achieve a greater degree of economic growth. Isn't that the case?

Mr. McCRACKEN. The $1,065 billion projection really was, of course, an arithmetic expression of a path to try to find a balance that would make progress against inflation and also economic expansion.

Chairman PROXMIRE. Well you called that a probable outcome. I just quoted your own statement Mr. McCracken.

Mr. McCRACKEN. One must evaluate or monitor the situation as we go along. The persistence and stubbornness of inflation was indicated in our statement. I think it would be irresponsible to try to push the economy now hard enough to achieve in a second half of the year what would be necessary in order to achieve $1,065 billion for the year 1971. It certainly would reactivate widespread fears of inflation and this would be counterproductive. The path that we are on is still the path where we have, I think, a reasonable chance of making good progress on both fronts. Of course we will have to watch it as we go along.

Chairman PROXMIRE. Now constantly in your testimony and in your response to questions Mr. McCracken, you've indicated your fear that if you stimulate the economy you will reactivate fears of inflation and that it might become counterproductive as well as harmful because of the inflation effect. We are having in a couple of days, in a few days we are having Professor Gordon of the University of Chicago who has quite a contrary view and I would like you to comment on what he says. He says this:

> A policy to hold the unemployment rate at its present level of about 6 percent for another two years to beat the inflation out of the system will cost an additional 171 billion dollars in real output to achieve a further reduction in the inflation rate which reaches a maximal of 1.5 percentage points but then disappears. In short, whatever the target for the unemployment rate in the long run, the best short run stabalization strategy is to guide the economy to it as rapidly as possible and remain there permanently.

Now how would you evaluate that by a reliable and competent economist?

Mr. McCRACKEN. Well I am certainly all for getting to the optimum position and remaining there permanently.

Chairman PROXMIRE. But if you are going to get there the argument by Mr. Gordon, as I understand it, you might as well get there rapidly because in the long pull the effect on inflation is going to be no more if you get there rapidly than if you get there slowly.

Mr. McCRACKEN. I am familiar with Gordon's paper. I think it is a very interesting paper on an extremely complex subject. I think it is fair to point out that we got there rapidly the last time we gained full employment and I think this is one of our problems. We didn't ease into the full employment growth path and therefore never really had a chance to avoid breaking things loose. It is once again a question of balance. There are those who suggest we must stay stuck on dead center because any expansion in the economy would simply carry with it a parallel acceleration to inflation. That is a view I would not buy. We go through a sequence of phases in trying to restabilize the economy. We do have to go through a period of disinflation. That is a period, a painful period, when businesses are cutting costs. So long as the economy is sluggish of course you don't see improvement in output per man-hour, but then as the economy starts to expand we get stronger gains in output per man-hour and that helps to relieve the pressure, the cost pressure, underneath the price level—so that we can, as we indicated in our statement, have strong gains in the economy without automatically tripping off and accelerating the rate of inflation. There is no question on that.

Now, on the other hand we do have to recognize that if we would go all out for expansion we would certainly reactivate widespread fears of inflation and the fact of the matter is the inflationary record of the last 5 years or so is such that it is a little hard to argue about this. And this in itself would produce severe distortions. It is a question of balance again.

Chairman PROXMIRE. Well, I am going to yield to Senator Javits right now but what this panel hasn't gotten into that I want to get into in the next round of course is the question of strategy. The only way you can reconcile this if you can stimulate the economy to reduce unemployment as rapidly as possible with a lessening degree of inflation at the same time is either wage price controls or a wage price guideline system which you gentlemen have dismissed with some vigor in your statement. But I don't think we questioned you adequately. I expect to do that when our next round comes up.

Senator Javits.

Senator JAVITS. Mr. McCracken, I have one fundamental question on the importance of this statement. Is this an answer by the administration to the attacks upon it that its so-called game plan for the economy has been demonstrated to be invalid by the fact that both unemployment and inflation have continued at unacceptable rates?

Mr. MCCRACKEN. It is put forward here, of course, as a straightforward statement on the status of the economy and economic policy. The fact that unemployment and particulary inflation have turned out to be more stubborn than we had expected, does not invalidate the basic strategy of economic policy. I am sure economic policy is like football. If you are a Monday morning quarterback you can see a number of things possible that one would do different. The basic strategy was one of pursuing a policy of trying to hold any decline of business activity to a fairly limited level and then starting a policy of expansion again while trying to avoid having it so strong that you reactivate price increases. It seems to me the experiences of this effort based on the response patterns of the economy, suggest that a lot of these things are on track.

Senator JAVITS. Well, there are major elements in your calculations that could change, that is, 1, the ending of the Vietnam war, and 2, a major burst in productivity; is that correct?

Mr. MCCRACKEN. Yes, sir; both would be quite significant.

Senator JAVITS. Now has any concept of the ending of the Vietnam war, which many predict is going to be signaled this very year, been cranked into these estimate expectations?

Mr. MCCRACKEN. These projections, or expectations, take the President's budget together with the changes which have come into the picture that we can take cognizance of. I outlined them in my statement. About $7 billion more of fiscal expansiveness has been added since the January public message. But they are based on the budget message.

Senator JAVITS. Does this assume then that we will have or we will be operating for the whole of this fiscal year with 184,000 troops in Vietnam and the continuence of that war?

Mr. MCCRACKEN. This is based on the projections for the military budget in the budget. I don't have the numbers at hand. I could check that.

Senator JAVITS. Well the 184,000 men are the December 1st level which the President has stated he will achieve. But suppose there was an announcement by the President on November 1st, let's say, that we are getting out of Vietnam within the next 6 months. What impact would that have in this whole outlook?

Mr. MCCRACKEN. Anything that altered the budget picture substantially of course would have to be taken into account. And if something along that line developed which substantially altered the budget picture, we would have to add that into our analysis.

Senator JAVITS. Well, is it only the budget picture that counts or is it also consumer confidence and work motivation that counts, and if so, what do they count for?

Mr. MCCRACKEN. I was addressing myself just to the budget problem as such. Consumer confidence is a very important matter. The work which has been done at my own University of Michigan has pretty well established that consumer spending swings are associated with changes in consumer sentiment. Now you alluded to one other thing, namely, a substantial burst in productivity, a major change in productivity.

Senator JAVITS. Right.

Mr. MCCRACKEN. This of course would be enormously important. We see in the lower right hand of chart 1—the lower line—which is labor costs per unit of output. This rate of rise declines because increases in compensation per man-hour are rather flat while there have been much stronger gains in productivity. So, rate of increase of labor costs per unit of output is lower than at any period of time since 1966 or 1967. This is a very important factor.

Senator JAVITS. And right now you say in your statement that we have had a gain in productivity. You say that that gain is a plus to the viability of the economy in the terms that you speak of or is it just relative to the various points of performance which have preceeded it?

Mr. MCCRACKEN. The gain of productivity in the first quarter was large, very large. Now it is true, if you look at our experience for the first year or so of resumed expansion that you normally get a large gain. During each recession during the postwar period, the four or five such periods, the first annual gain in productivity after the expansion begins is apt to be in the neighborhood of 5 or 6 percent. Of course in the long run it is nearer to about 3 percent.

We are getting once again strong gains in productivity from the combination, I think, of the actions taken earlier on the cost cutting side and the resumption of a better operating rate for the economy.

Senator JAVITS. You indicate that properly anticipated increases in wages is 7 percent a year. At that rate, considering the improvement in productivity, are we beginning to catch up so that wage increases are no longer coming out of the bone and sinew of the economy but are rather equal to productivity increases?

Mr. McCracken. Productivity increases aren't large enough to neutralize that and give us stable costs per unit of output where the compensation for men are rising that fast. On the other hand we are getting much better gains in productivity and the rise in labor costs per unit of output is much lower than it has been for some time.

Senator Javits. So we are not yet home free but we are improving. Is that fair to say?

Mr. McCracken. That is fair to say.

Senator Javits. Alright now, under those circumstances, what has happened to the President's Productivity Commission which has been going for about a year and from which one doesn't hear a single word?

Mr. McCracken. The Productivity Commission is active. As a matter of fact we had a meeting of the commission last week. This is the kind of operation which gets underway a little slowly, probably because we were having to feel our way along concerning the development of the program. The members, of course, can meet only infrequently. But I find myself very encouraged about this. I think it can make quite a difference, over a long period, of course.

Senator Javits. In World War II we had local productivity council right down to the factory level. In an emergency like this when we are at war why shouldn't we revert to that experience?

Mr. McCracken. This is something we will want to look at.

Senator Javits. But you haven't looked at it yet?

Mr. McCracken. Not yet, but this is the kind of thing I think that the Productivity Council will be examining.

Senator Javits. Now you have expressed, as has been noted, fundamental opposition to any kind of an incomes policy or a wage price board and/or wage-price freeze except some modified plan which even the President is beginning now to engage in with respect to the steel indusry. But would you give us your opinion of the effect upon consumer confidence if the administration did adopt some kind of a wage price board approach? I might tell you personally I am deeply convinced that the two are intimately tied together and that one of the great reasons for the wage price board approach, aside from doctoring their economics, is that it will make consumers feel that well now it is safe to buy.

Mr. McCracken. The thrust of our statement here was not to take a doctrinaire position, but to examine the lessons of experience. By now there has been an enormous amount of experience in Canada, the Netherlands, United Kingdom, Austria, Finland, Norway, and Belgium involving a variety of experiences with different formulations. And, of course, we have had our own guidelines in the United States. I think it is fair to summarize that evaluation as indicating that this approach has not been very effective in getting at the problem. If it starts to be effective, it tends to bottle up pressures which subsequently erupt into wage price explosions. This has been the experience in the United Kingdom. In the Netherlands, there seemed to be a significant effect in 1963, but then, I think it was a year later, they had a 15-percent wage increase.

In other countries the machinery is set up and for a variety of reasons it just doesn't get hold of the problem. In the more recent

Canadian experience, they did have some short run effect on their prices. It was destined to be short run unless they could get at the wage problem. This they were unable to do. Finally after less than a year they gave up on this. There has been very much the same experience in Germany with the policy of so-called concerted action.

So the basic thrust of this statement is to introduce another caution about what experience has suggested is reasonable to expect. If there is no substantive differences, then I think the contribution to consumer sentiment has to be short lived.

Senator JAVITS. Well, as a practical matter, Mr. McCracken, it all depends, does it not, on the frame of reference in which you speak? We have a situation in which increases in compensation have for a number of years outstripped productivity gains. You have a serious errosion of consumer confidence which has been our enemic difficulty in bringing the economy back for health and therefore aren't we entitled to consider wage price board methods? You are no less an authority than the chairman of the Federal Reserve Board who speaks in the same vein. Wouldn't such an approach allow us balance?

Mr. MCCRACKEN. Yes; but in examining this we are also able to examine the lesson of experience where these kinds of approaches have been tried. Now as to the impact on the lower level of consumer confidence, most measures of consumer sentiment are lower than they were 2 years ago. I think the inflation problem is a part of that but it is a very complex thing. The unemployment problem would be a part of this also. So the thrust of our statement was: let us examine the experience, so that we have a realistic expectation about what this kind of thing might produce.

Senator JAVITS. Well, the Chair has given me permission for a couple of more questions and I shall return in a minute. But aren't we in a generous situation? We fought a war without any of the economic accompaniments of war and now we want to reclaim the peace without making up for it in any way.

Do you think that can possibly work? We fought a war without controls, without the necessary taxation, without the necessary belt tightening, without the necessary restraints and now you say that we can make up for it and we can get over it without doing anything about it; just allow the natural processes to continue.

Does this seem logical?

Mr. MCCRACKEN. I am sure that all of us, if we had the last 5 or 6 years to run through again, would suggest some differences. Certainly Federal spending should not have taken off on the track it did in early 1966 without a major tax increase. I think the very large deficit even though the economy was at full employment during that period is in many ways the source of our economic problem today. But, on the other hand, that is history and the question is, where do we go from here?

Now, I think we are making progress. The administration has certainly not foresworn moving beyond or outside fiscal and monetary policy. A great deal has been done. What it has tried to do is be selective in what kinds of action in those areas where there is some reason to think you can be effective. I think action in the construction area is an example. There is no question in my mind but what the settlements that we would have had so far this year would have been significantly more had it not been for what was done. The President did suspend Davis Bacon for a period. There were factors there that made this look like the place where something could be done. More generally, the evidence, I think, is less encouraging.

Senator JAVITS. Well one last question and my time is up.

Suppose this sticky situation, 7 percent inflation, 6 percent unemployment, continues for another year. Can you see any situation in which the administration would go for a freeze or a wage price board or an income policy or some change in the game plan? What do we look forward to?

Mr. MCCRACKEN. The current situation, by the way, I think is more nearly something like a 4-percent rate of inflation and the basic unemployment path slightly below 6 percent now. The policy has been evolving. Overall the monetary and fiscal policies are quite expansionist now, and there is certainly a lot of coal under the boiler which has not yet burned.

Outside of that, the tempo of activity has increased. The recent activity in construction being the case in point, or, for example, the meeting with the steel industry. This tempo has been stepping up, but we have not attempted to claim more than what a realistic appraisal of the results would lead one to expect. There is the possibility that there will be further actions, although I do not want to prejudge in advance what that would be. I would merely want to register that economic policy is an evolving thing that changes as you go along.

Senator JAVITS. Well, Mr. McCracken, I think that the big weak point of the national picture right now is the national economy, and I hope that just as we try to learn from you, you perhaps may try to take some messages home from us, and perhaps improvements can be made which we all devoutly hope for. But I must tell you in all honesty that I just cannot see how we can make up for these admitted serious deficiencies and accept the suffering which it entails and the natural remedies on natural development will bring it back.

I really think, for myself as a Senator from my State, that we have to take, even if overdue, some of the action we should have taken before in order to bring the situation into a stable character.

I will tell you, however, I hope the administration is prepared for what I think will be a tremendous unleashing of receptivity by the American people, increased productivity, and consumer confidence if the end of the Vietnam war is signaled by the President. I hope very much that the administration will have clearly in mind another major reference point, and that point will be the feeling of the American people that inflation is behind them and that they can get value for what they spend.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Mr. McCracken, going through your prepared statement, it appears that you traced some history for us. Did I understand it we had 4 years of demand pull inflation, tapering off somewhere in late 1969? And that then the cost push inflation has continued until now, but it seems to be abating somewhat. And that being the case, the administration hopes that the Congress will still manage our national fiscal policy as to not get us back into the demand pull inflation cycle all over again; is that so?

Mr. McCRACKEN. Yes; I think that is crucially important.

Senator MILLER. And then you more or less underscored that by your statement that the administration believes that its responsibility for the future of the American economy requires it to take the courses you have outlined.

We are now seeing how difficult it is to remove from the economy the consequences of the inflation that was allowed to develop from 1965 to 1968. To permit the inflation to revive for some short run, doubtful advantage to ourselves would be highly irresponsible. Isn't that pretty much the answer to the statement from Professor Gordon that the chairman read?

Mr. McCRACKEN. Well, yes; this does simply lay out in words the crucial importance of finding the narrow and somewhat indistinct path between overdoing it one way or the other. The policies are at least based on what we now know would be a reasonable expression of the path.

Senator MILLER. Well, your statement, while prepared by the press department, pretty well represents administration thinking all the way through; you say therefore, and it seems to me to be very significant, we must realistically expect that further stimulative fiscal action—and, of course, you are now speaking to Congress, because Congress has the fiscal stimulative power—now would leave a permanent or at least long continuing residue of high rate expenditures relative to revenue. This would be added to a budget trend which already shows the cost of present programs—just present programs—for several years beyond fiscal 1972 exceeding the revenue that the existing tax system will yield under conditions of high employment.

Now, if you have high employment, which I would assume is pretty close to full employment, and you have the spending exceeding the revenue, you will end up back in that demand pull inflation situation again; won't you?

Mr. McCRACKEN. Yes, sir; that is the problem.

Senator MILLER. Well, then, what you are really saying here is you are saying to the Congress which has control over the fiscal policy of this country, let's not kid ourselves about that, that if the Congress isn't very careful about how it handles this budget business, that sooner or later we are going to be hit by some increased taxes unless we want to have inflation—more demand pull inflation; isn't that it?

Mr. McCRACKEN. That's about it. I would like to make this one general statement. When one looks back over history it seems to me the major problem of economic policy is the tendency to take actions on the spur of the moment which leaves extremely difficult long-range problems to deal with. We want to avoid that this summer, if we can.

Senator MILLER. Finally, you said that the administration does support actions through the budget that will have a large effect on unemployment per dollar of cost and a relatively small effect on inflation. I assume that the President's veto of the accelerated public works bill indicated that that bill failed to meet that guideline.

Mr. McCRACKEN. The bill failed to meet the guideline?

Senator MILLER. That you just enunciated here.

Mr. MCCRACKEN. Yes; I think that it's characteristic of the kind of an action which won't get underway soon enough to have a significant effect on the problem, but leaves you with a longer range problem. It leaves you with an activity when it's not needed.

Senator MILLER. Well, you used the term large effect on unemployment per dollar of cost. Do you recall what the per dollar of cost was for this public works acceleration bill?

Mr. STEIN. Well, there have been estimates of the first round cost per dollar of employment generated of $30,000 to $50,000 for the public works program. Then, of course, there would be indirect consequences, but this is a much more expensive program per dollar of employment generated than public services.

Senator MILLER. You said $30,000 to $50,000 per job per year?

Mr. STEIN. Yes.

Senator MILLER. Now, you recognize there's going to be some capital investment and other benefits, but if you are trying to get unemployment down fast at a low-per-dollar cost or low-dollar cost per job, this $30,000 to $50,000 seems to be extremely high.

Mr. STEIN. Well, the public works program employs, in the first place, a high rate of labor, and then there's large capital and material input.

Senator MILLER. Do you know what the estimated dollar per job cost was for the public service bill?

Mr. STEIN. Something like $5,000 or $6,000.

Senator MILLER. So, I take it that the administration feels that stimulated activity to relieve unemployment within a range of cost per job of $6,000 per year is acceptable and is desirable, but when you get into the $30,000 to $50,000 per job per year range, then that is off limits.

Mr. STEIN. Well, that was also the point that Mr. McCracken made about the time and how the effects would be felt. The effects would be felt promptly in the public service case.

Senator MILLER. In other words, the public works takes much longer to have the impact, but even if it has a short range impact doesn't that $30,000 to $50,000 per job per year cost seem pretty high? Isn't there some way we can get it better, like the public service bill?

Mr. STEIN. Certainly. That is the administration's conclusion.

Senator MILLER. Yes.

I have no further questions.

Thank you gentlemen. Thank you, Mr. Chairman.

Chairman PROXMIRE. Gentlemen, I'm just astounded that you indicate your present concern about demand pull inflation. It doesn't make any sense at all to me. We are operating an economy now with a plant capacity of about 75 percent, where 90 percent is the preferred and efficient rate. We are operating with 5½ million people out of work.

It seems to me we could have a tremendous stimulus of the economy without getting into a position of demand pull inflation. A cost push is something else. Maybe now you have a psychological situation where labor insist on higher wage settlements that tend to push up prices.

But do you really seriously argue that there is any prospect that if we took such action as, for example, stepping up the tax reductions of

1972 and 1973, pulling them into this year, or had any kind of a public works program. Incidentally, I tend to agree with you on the effects of the public works program. Say we went ahead with them. Would you seriously argue that this could put us into a demand pull inflation situation?

Mr. McCRACKEN. If we moved in that direction there are two or three adverse consequences, that is if we were to move substantially more rapidly. Incidentally, concerning the 75-percent figure—I think we need to bear in mind that in terms of the overall operating rate of the economy it is probably not 25 percent below par. In other words, if we try to increase sharply the output by a third in order to get from 75 to 100, long before that, we would have all kinds of pressures in the economy.

Chairman PROXMIRE. Well, that may well be, but we're still far below that, so we should get to a level of 85 percent. But you still have such a long, long way to go. Such a tremendous improvement we need in demand to put people to work and to use our great resources that it would seem to me that to have the spector of demand pull inflation as something inhibiting economic policy makes no sense at all.

Mr. McCRACKEN. The gap in the economy is probably in the neighborhood of 5 to 6 percent in terms of the short fall of output relative to reasonably full employment. But, that is not the only reason. The degree of pressure that you put on the economy, in other words, the rapidity with which you try to regain reasonably full employment is itself a factor in increasing the possibility of demand pull. And finally, we have to recognize there is an enormous sensitivity or sensitization of the economy to concern about inflation. If we started to go all out through fiscal and monetary actions to regain full employment as quickly as we could, we would certainly court the risk of triggering inflation rather promptly, and we would probably make it almost impossible to effect a reentry into full employment without having a recurrence of the same thing as occurred in 1965.

Chairman PROXMIRE. Well, I suppose it would be easy to design a program that would insure inflation, that would insure demand pull inflation within a year and a half or two. But that would be so enormous and so unrealistic. The kind of recommendations we have had from competent economists who have appeared before us is that we step up the income tax reductions we are going to get in 1972 and 1973, we provide for more ambitious public service employment programs instead of 160,000 jobs, perhaps twice that many.

This kind of an approach which is rather moderate, it seems to me, and certainly doesn't fall into an all or out category, or a category that could conceivably stimulate demand pull inflation.

Let me get into something else, because the hour is late and I did say at the end of my last line of questioning I wanted to come to this incomes policy. Senator Javits discussed it with you, and that was useful, but I'd like to go a little further. What you seem to be saying is that workers are motivated solely by desires to maximize their gain in the short run. And I think that is an extreme view of economic man, one that I just don't think is true on the basis of our experience.

People are responsive to the needs of society if these are honestly and vigorously presented by the President. I think the best evidence of that is the one experience this country had had only less than 10 years ago with wage-price guidelines.

Now, there's one study I know of by John Sheehan of Brookings. It's probably the most definitive study made, of this Nation's experience with incomes policy. John Sheehan does not conclude this is the answer to all of our problems by any means. As you well know. But he does make the conclusion. That policy gave us the following anti-inflation advantage. For wholesale industrial prices the change that would be expected on the basis of prior behavior appears to have been about eight-tenths percentage points better per year on the lowest basis of estimation, and 1.6 percentage points on the highest, from the period of 1961 to 1965.

He also pointed out it had a cumulative effect and there isn't any question that during that period when we had it, our wage costs were stable. They weren't increasing. So, if studies are the answer to whether or not we ought to try the prescription that some of the economists have urged on the committee, and the Chairman of the Federal Reserve Board said we ought to try, what study do you have that is more acceptable or comprehensive than Sheehan's study?

Mr. McCRACKEN. The basic point that I can make in my statement can be expressed something like this.

Here's the kind of problem that we have that is not singular to the United States. It characterizes the entire industrial world. We see it in Europe. We see it in almost all industrial countries. All right. And it is a very vexatious problem. Looking at what might be appropriate in the United States, it is crucially important that we examine carefully the experience of these nations that have the same kind of problem we do to see what lesson we can learn.

And, as I examine experience, and there has been an enormous amount of this experience, it is very difficult to see where the successes are. There are temporary successes, as I say, which——

Chairman PROXMIRE. We certainly would welcome a temporary success here.

Mr. McCRACKEN. Not necessarily.

Chairman PROXMIRE. We don't have any success at all so far. We have both serious inflation and very serious unemployment.

Mr. McCRACKEN. Not necessarily. Because if this temporary success is followed by a wage-price explosion, then it is not good. It is not good to do that at all. And it's not automatic that you are better off. You are worse off. And I think if you look at this experience it is fair to say, as I indicated, that in some cases it just seems to have no effect at all.

Chairman PROXMIRE. But Mr. McCracken, I didn't talk about a study of what went on in Luxenboug or what went on in Japan, or what went on in Thailand. I talked about a study of what went on in the United States of America from 1962 to 1966 when we had a wage-price guidepost policy. And I agree that it wasn't everything that we hoped it would be, and it didn't succeed as much as we hoped. But the most comprehensive study I've been able to get my hands on said it did help hold down the cost of living by a substantial amount.

Mr. McCRACKEN. All right. Let's comment on the U.S. experience. There is an enormous amount of econometric analysis. Various studies have tried to measure the extent to which these guidepost policies may have had a displacement effect. I think the most straightforward statement that one can make is that the evidence is extremely inconclusive as to whether there was any real effect. There are studies which seem to suggest that for a period it may have had some effect. There are other studies equally technically credible, including, incidentally, the Gordon study which you alluded to, which come to the conclusion that they find no visible effects.

I don't think one can point to one study. There are a variety of studies, and I think the most you can say is that verdict is still out. And if the evidence is that inconclusive, it is a fairly slender reed to lean on.

In any case, the guidelines went by the board. When we had the airline mechanics strike in 1966——

Chairman PROXMIRE. They did, indeed.

Mr. McCRACKEN. In other words, when we begin to move into this basic problem it didn't hold.

Chairman PROXMIRE. Well, we didn't try to hold them. President Johnson, I thought in error, maybe he was right in doing so, but I thought, in error, failed to recommend after the airline strike he failed to recommend a guideline for us.

Mr. McCRACKEN. But recognizing international experience he may simply have been recognizing reality because several countries have tried the guideline approach and it simply has had no visible effect.

Chairman PROXMIRE. Well, as I said, the Chairman of the Federal Reserve Board has proposed this, and I think for a very significant reason. As you know, he's a competent economist. He's a conservative man. He has great sympathy for the administration. He simply doesn't want to cause any embarrassment.

But he is in the position you alluded to in your statement, and I think the full consequences have been—haven't quite been spelled out. You said a very sharp increase in the money supply, you said had increased at the rate of 7 percent in the last year and 10 percent in the first part of this year.

Now, what does that mean? On the basis of everything you've told this committee, it would seem to me, then, in the latter half of this year he is going to reduce the rate of increase in the money supply. If he does that, say you come out to a 6- or 7-percent average for the year, it would seem to me that would mean several things.

One, it would mean high interest rates.

Two, it would mean less stimulus for the economy.

Three, it would probably mean that this element, at least, in the economic picture is going to be restraining rather than expanding.

What is your reaction to that?

Mr. McCRACKEN. Well, my reaction to that, in relationship to the proposal for an incomes policy, is really what I have said already. Experience with incomes policy has been one of almost unrelieved failure.

So the question about an incomes policy is not one you need theorize about. It is one that we've had a lot of experience with. And it is very difficult to point to the considerable body of experience that we've had and find anything that is a success.

Chairman PROXMIRE. Well, there's a lot of indications in this country with inflation and unemployment. You mean, when we write an income policy that it won't work, the next step that we have to take, if we don't accept that and are determined to do what we can to reduce unemployment, might well be price controls and wage controls.

At what point do you feel that we could seriously consider taking that big step?

Mr. McCRACKEN. I wouldn't want to speculate as to when or the circumstances that might promote that.

Chairman PROXMIRE. You reject the wage-price controls. You reject a wage-price guideline policy. Now, would you comment, and I didn't mean to move around too fast for you, but would you comment on the implications of this monetary situation where we've had the sharp increase in money supply in the first 6 months of the year and the likelihood that the Federal Reserve, if it follows the policies that it assured this committee, that it would try to have a 6 percent annual growth in the money supply, that it would probably have to reduce the rate in the rest of the year.

What does that mean for the economy?

Mr. McCRACKEN. Well, just translating the pattern for monetary expansion thus far into what it subsequently would mean to the economy, it of course ought to mean that some acceleration in the rate of the expansion of the economy in the second half of the year.

Chairman PROXMIRE. Acceleration? If the rate of increase in the money supply declines?

Mr. McCRACKEN. No; the expansion of the economy.

Chairman PROXMIRE. Because of the lag?

Mr. McCRACKEN. Because of the lag.

Chairman PROXMIRE. Well, I can understand this effect on industry and so forth as far as that is concerned. But isn't it likely on the basis of all of our past experience that—if the Board does slow down the increases in the supply of money which is logical to expect, that it would have a prompt effect on interest rates and a rather prompt effect on the one clear stimulus our economy enjoys from housing.

Mr. McCRACKEN. Yes. I think so. As a matter of fact, we may be seeing this now. And our housing starts, of course, have remained high. Apartments are very strong. I think that housing is going to continue to be very strong this year as well as next year. But this is something that is going to have to be watched carefully.

Chairman PROXMIRE. I know the depressing element in the situation is the policy to be followed with respect to social security taxes. As you know, those were deferred. We didn't increase our social security tax at the beginning of this year. We postponed that until the beginning of January 1972. As I understand it, it would be the biggest single increase in social security tax this country has ever had.

Does this come at a propitious time? We have a rising interest rate, slowdown in housing, and a sharp increase in social security taxes. Aren't those elements that could be depressing in our economy?

Mr. McCRACKEN. It might be. Of course, there are several things. Anything that improves the basic position of the budget and forces the Treasury to borrow less will have a therapeutic effect. The therapeutic effect that you have in mind. Incidentally, the impact of fiscal changes on the economy through the impact on the capital market is one aspect of economic analysis which economists tend to neglect.

Chairman PROXMIRE. But the major effect certainly is that it would be rstraining rather than expansionary in a tax increase.

Mr. MCCRACKEN. That probably is true.

Chairman PROXMIRE. Well, the big element that's disturbed us very much, I'd like to have your reaction to it. You don't discuss it in your statement, but I think it is right over the horizon, is the steel situation.

Now, we have been praying all of us next month that we won't have a steel strike. If we have a steel strike this will have an adverse effect on the economy. If we don't have a steel strike, as I understand it, there has been a tremendous amount of stockpiling of steel so that in any event there will be a sharp slowdown in the production of steel as that particular inventory is worked off.

What effect is that likely to have on the economy? Is that likely to be negative too?

Mr. MCCRACKEN. As such, of course, that has a negative effect, but we do have to remember that the steel industry, as important as it is, does not determine the pace of the entire economy. It counts for somewhere around 1 to 1.5 percent of the gross national product. And one has to evaluate that in the context of the inventory situation, generally.

As I read the inventory situation for the whole economy, actually inventories are fairly thin and it is not at all inconceivable that what we could see, outside of the steel inventory situation, developments that would tend to balance it.

Chairman PROXMIRE. Well, I notice that you place quite a bit of reliance on inventories, and that's a helpful point, but the actual difference is only about $1.5 billion, I understand, in inventories, and we have about a $15 billion shortfall in GNP, so this would be a very modest overall element; would it not?

Mr. MCCRACKEN. Fairly modest, but the changes, the differences, are nonetheless rather important. In the first quarter of 1971, inventories were rising at the rate of $1.4 billion. I would think on a normal, ongoing basis with the size of the economy, inventory accumulation would be close to $8 billion, and might even be $10 billion. This is a big economy. So this rate of inventory accumulation together with the fact that inventories are already low does suggest that as the basic demand continues to rise and sales hold up pretty well, production schedules are going to have to step up.

Chairman PROXMIRE. Let me ask you what alternatives are open for the President in the event the steel settlement exceeds the reasonable limits he's hoping. Can he do anything in that area such as he did in construction? After all, we have some—we have some kind of power with respect to (a) Government purchasing, (b) importation of foreign steel. We've had Presidents enter into the steel situation in the past with some success. Will this President go farther than he has gone?

He's called a general meeting. He hasn't suggested any wage or price guidelines. Perhaps that's the policy he should follow at the beginning of this situation. But what should he do now?

Mr. MCCRACKEN. There are several things. In principle there is the question of imports of steel. I think we have to recognize, though, that he has a very difficult problem with an industry which is itself not any longer a strong industry. The profitability position is very low, relative to other industries. Generally its basic costs are high. I think the costs of incremental investment pertaining to steel-producing capacity here are probably close to four times what they would be in Japan, for example.

On the other hand, it isn't just a simple matter, either, of shielding the domestic market for steel and allocating it for domestic producers.

Chairman PROXMIRE. Did you say four times what it would be in Japan?

Mr. McCRACKEN. Three or four times.

Chairman PROXMIRE. Is that correct? Four times. You're talking not only about wage costs but other costs?

Mr. McCRACKEN. No; I'm talking about the investment required per ton of steel-making capacity, but of course, wage factors are important here because of construction costs.

Chairman PROXMIRE. Why is there the sharp difference in investment per ton of steel-making capacity?

Mr. McCRACKEN. I think directly and indirectly it is the wage differential as much as anything.

Chairman PROXMIRE. There's not that much difference in wages now, is there?

Mr. McCRACKEN. I would think so. I don't have the figures at hand, but construction activity has a substantial labor content.

Chairman PROXMIRE. You make the case that this is an industry which isn't as healthy as it has been in the past but it is still our belle weather. It's enormously important in setting prices. What other courses are open to the President?

Mr. McCRACKEN. I wouldn't want to speculate on what he has done now.

Chairman PROXMIRE. Well, I'm not asking what he has done, I'm asking what his alternatives are, what he can do.

Mr. McCRACKEN. Well, obviously he could initiate a series of actions that might influence the market. The factors associated with imports, or other kinds of action which might help to improve productivity. This is obviously one factor.

Or it might be done more directly in the area of labor costs and other costs.

Chairman PROXMIRE. Mr. McCracken, I want to thank you very much. You are highly competent and you've done a fine job today. I do hope you will provide the committee with your studies that you said that you had made of incomes policy, and in your prepared statement I think you referred to a study and I hope you would give that to the committee. We would like very much to have it.[1]

The committee will stand in recess until Tuesday, July 20, when we hear from John Kenneth Galbraith, Homer Jones, and Franco Modigliani.

(Whereupon, at 4:22 p.m., the committee was recessed, to reconvene at 10 a.m., Tuesday, July 20, 1971.)

[1] The study referred to, by Lloyd Ulman and Robert J. Flanagan, entitled "Wage Restraint: A Study of Incomes Policies in Western Europe," was subsequently provided by the Council of Economic Advisers and is available in the committee files.

THE 1971 MIDYEAR REVIEW OF THE ECONOMY

TUESDAY, JULY 20, 1971

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

The committee met, pursuant to recess, at 10:10 a.m., in room S-407, the Capitol, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire and Javits; and Representative Blackburn.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtney M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Bander, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today we resume hearings on the present state of the economy and the prospects for the months ahead. Earlier this month we heard from the majority leader of the Senate, Senator Mike Mansfield, and from Mr. Paul McCracken, Chairman of the Council of Economic Advisers.

We have been attempting to arrange a hearing with Secretary of the Treasury Connally who was recently designated as chief economic spokesman of the administration, but as yet he has not agreed to appear before this committee—even though we have given him carte blanche, any day, week day, Saturday, Sunday, daytime, nighttime.

Today and for the next 2 days we shall be hearing from private experts, and on Friday we shall have the benefit of testimony by Mr. Arthur Burns, Chairman of the Board of Governors of the Federal Reserve System.

There is continuing need to stress the gravity of our present economic plight. For the past 6 months unemployment has stayed uncomfortably high in the neighborhood of 6 percent. Inflationary price increases persist despite a "game plan" which involved a created recession to get prices under control. And now the chief economic spokesman comes forward with a program which at best promises more of the same. He points to the second quarter production results, describing the increase as broad in sweep and deep in the track. Yet the increase was yesterday described by Mr. Houthakker, just resigned as a member of the Council of Economic Advisers, as inadequate to reduce unemployment. And this morning's paper reported that the British Government is adopting a vigorous effort to stimulate their economy, which suffers from the same kind of difficulties ours does, by both a reduction in taxes and an effort to limit price increases which seemed to have at least an initial success.

Our witnesses today are three most distinguished economists; John Kenneth Galbraith, Warburg professor of economics at Harvard, former Ambassador to India, and author of some of the most widely read books on economics; Homer Jones, just retired as Vice President of the Federal Reserve Bank of St. Louis and a long-time student of monetary policy; and Franco Modigliani, professor of economics at MIT, one of the foremost experts in the country on business cycles.

We look forward to hearing from these gentlemen, who are not only top economists but who have been long-time advisers to policymakers at the top levels of government.

Mr. Galbraith, are you the president of the American Economic Association at the present time?

Mr. GALBRAITH. I am president-elect, Mr. Chairman. But I think I should stress that I am speaking here as an individual. The association does not have any official spokesman, no doubt fortunately.

Chairman PROXMIRE. That sounds like the Democratic Party. Go right ahead.

STATEMENT OF JOHN KENNETH GALBRAITH, PAUL M. WARBURG PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. GALBRAITH. I shall not detain the committee with a detailed review of the economic situation as now revealed by the figures for the first half of the year. No aspect of this situation gives satisfaction. Unemployment continues high and very high for blacks, women, and the young. There is no good evidence that inflation has abated. If output expands satisfactorily in the months ahead, inflation will increase. The well publicized production goals established earlier in the year have now been formally abandoned. Mr. McCracken has, indeed, called their continued pursuit irresponsible. The payments balance is still lodging a troublesome excess of dollars in Europe.

We have now fallen behind West Germany as an exporter of industrial products. The policies pursued by the administration to contain inflation, high interest rates, and tight money in particular, until their easing a few months ago, operated with particular effect on farmers and other small borrowers. As ever, the large corporations with internal sources of funds and favored access to the banks were much less affected. On few matters is economics so misguided and so cruel as in the supposition that an active monetary policy is neutral as between big business and small.

It is important, nevertheless, to keep perspective. This is poor performance; it is not a disaster. Some of the unemployment, and much of the new affluent unemployment, is to be attributed to the effective efforts of the administration to lessen military indulgence, especially in the aerospace industries—I think something must also be said for the efforts of the chairman on this point—this all must welcome and, indeed, ask for more. But the pain here would have been eased had the economy been stronger. And one cannot be happy about the most recent step. That, broadly speaking, has been to concede that the results of past policies have been unsatisfactory and then strongly to affirm the decision not to change them.

Still, in seeking to explain why so many things have gone so wrong, not everything can be attributed to this particular administration. It has brought a certain unexpected talent to making the worst out of a bad situation. But its major difficulties are the consequence of the current crisis in economics and economic policy. This crisis would also have afflicted Democratic policymakers of the traditional sort had they been in power in these past years. Let me ask you to consider this crisis for a few moments. It is a development on no slight importance.

The first cause of the crisis in economic policy is an error that is implicit in nearly all economic thought. This is to suppose that underlying change in economic institutions is sufficiently slow so that, for purposes of practical action, it can be ignored. So it is assumed that policies that have worked in the past will work in the present and future. Nothing will have changed to render them ineffective. In fact, institutional change is persistent and rapid. In the 19th century, in an economy in which capital was scarce, trade unions weak, wages flexible, and firms small, and the propensity to consume high, there was, when recessions or depressions were experienced, great power of recuperation in the economic system. By the 1930s, more abundant capital, more powerful corporations, greater rigidity in labor and product markets, greater affluence, perhaps other changes had sufficiently changed the underlying structure of the economy so that its recuperative powers were lost. Economists, the establishment economists as they were not yet called, still agreed on nonintervention as the best cure for depression. A whole generation went down on that ship with Mr. Hoover.

The Keynesian intervention which became policy during the thirties was an accommodation to the new institutional setting. It held that fiscal policy, in some combination with monetary policy, could reconcile reasonably full employment with tolerably stable prices. That policy worked in its time. But in the last 30 years, there has been further institutional change. The market power of the great corporations has increased. There has been continuing accession of trade union power. And what is clearest of all, there has been a diminishing conflict between management and labor an increasing tendency to resolve difficulties not by the traditional conflict but, after some ceremonial insult, for the corporation to concede the more urgent demands of the unions and pass the cost along, in higher prices, to the public. This the modern corporation has the market power to do. This it can do at a level of demand that sustains effectively full employment and one that falls considerably short of that level. The occasional strike, conducted as it now is with considerable decorum, does not alter this pattern of accommodation. In failing to recognize that this new institutional change has rendered them irrelevant, a new generation of economists has been booking passage for the same journey as those that went with Mr. Hoover.[1] It would be amusing were it not sad that

[1] The 1971 Economic Report, pp. 61–62, describes this institutional change in commendably precise form but, alas, only as a prelude to affirming the previous faith.

Mr. Nixon has proclaimed himself a Keynesian at the moment in history when Keynes has become obsolete.

The current crisis in economics has been disguised by the dispute between the advocates of fiscal policy and the so-called monetarists. This dispute is enchanting in its inconsequence although it cannot be doubted that each side is right in its belief that the other side is wrong. The exponents of fiscal policy are right in believing that monetary policy involves a grave uncertainty in the linkage between action and result. This has long been recognized. Indeed, the operations of the Federal Reserve Board itself are founded on the belief that seven men acting in ignorance of the effect of a given easing or tightening of the money supply on the economy will achieve a wiser solution than one man acting with a similar absence of knowledge. The recession we are now experiencing reflects, in its severity, the unforeseen result of a tight money policy. If this effect had been foreseen, no one can be so partisan as to suggest that the administration and the Federal Reserve would have been so callous as deliberately to invite it.

But those who question the efficacy of fiscal policy are equally right. There is not the slightest reason to suppose that any combination of tax and expenditure policy exists which, under present conditions, would curb cost-push inflation with such effect as to reconcile reasonably full employment with reasonably stable prices. While the monetarists and the fiscalists, so-called, have been arguing with each other, the institutional changes that have made cost-push inflation the dominant fact of our time have rendered both irrelevant.

I must, in this connection pay tribute to Arthur Burns, of whom in the past I have occasionally been critical. He is the rare case of a central banker who concedes and indeed urges this point. The more common tendency of the members of his union is to exaggerate the omnipotence as well as the mystery of the instrument, mainly, monetary policy, which they command. I hope that my endorsement of Mr. Burns will not damage his standing with the administration.

The crisis in economics has also been disguised by a series of rationalizations, some of them of no slight artistry in their assault on simple truth and logic. The most prominent example is the emergency of the permanent inertial force theory of inflation. This convenient doctrine I believe to be original with economists in the present administration. It holds that once inflation establishes itself in the economy, it will, by its great inertial power, continue despite the most vigorous counterinflationary policies that may be brought to bear. And it may, indeed, get worse without any blame for ineffectiveness attaching to these policies. In accordance with this doctrine, the administration economists contend that the present inflation is to be blamed more or less exclusively on the deficit financing of the previous administration.

This year's economic report begins with the sentence: "1970 was the year when we paid for the excesses of 1966, 1967, and 1968." And although inflation has greatly worsened under the present administration, it has really gotten better because these policies have been overcoming the inertial force which inflation had established. It follows from this doctrine that what happens to prices in the next administration will all be decided in these years by Mr. Nixon. It is hard to know what to say about such nonsense; perhaps it is sufficient to observe that it has no sanction in any known economic model. It is, in fact, a transparent device for evading responsibility for policies that do not work. It is the wage-price spiral that primarily has defeated the administration efforts to prevent inflation. If anything had an inertial effect on inflation, it was Mr. Nixon's proclamation of a hands-off attitude on wages and prices when he took office in 1969, with the sanction this gave to unions and corporations to practice jungle law in these matters.

Serving also as an excuse for not facing up to the wage-price problem is the argument that any overt action in this area will interfere with the natural operation of the market—and it will invite a black market. This argument, also, is unworthy of any reputable economist. The problem of cost-push inflation arises only because the unions have the power to bargain for, that is, set, wages that are in excess of productivity gains, and corporations the power to set prices that pass the resulting cost increase—usually with something more—on to the public. The problem arises, in other words, because there is already private wage and price fixing.

Let me emphasize this: We have this problem because we already have private wage and price fixing. The market isn't allocating resources; it is the unions and the corporations that are doing so. Thus the appeal to the market is a disguise for inaction. The specter of the black market is also a fraud. Controls are not a substitute for a fiscal and monetary policy that maintains a general balance between aggregate demand and supply; no sensible economist regards them as a substitute. They are an essential supplement to such a policy, one that keeps it from being destroyed by cost-push inflation. If demand and supply are in balance—if there is no excess of demand in search of goods—there will be no black market.

Another consequence of the present crisis in economic policy is the effort to convert failure into success by resort to psychological measures—by the use of faith, hope, prediction and appeal for positive thought as instruments of policy. These devices, it may be observed, were also extensively used, in a sense pioneered, by Mr. Hoover. For the last 2½ years, price stability has been persistently pictured, as was recovery 40 years ago, as just around the next corner. For the last year and a half, the same prospect has been held forth on employment. Statistics that seemed to suggest progress have been brightly featured; any retrograde tendencies have been passed over in dull and heavy silence.

One is tempted to suppose that part of this policy derives from the President's unquestionably very wholesome interest in spectator sports. The football fan has always attached a somewhat exaggerated importance to the impact of the cheering section on the outcome of the game. In any case, we are by way of learning once more that psychological factors are not very important in business behavior. It is firm orders derived from effective demand that count. Even so drastic a step as the recent changing of cheerleaders—of pulling Mr. McCracken out of the game plan and sending John Connally in—will not, one may safely predict, make much difference.

If I might be allowed one mildly partisan comment, I do not think it is even sound politics. One can understand why, given the present state of the economy, and with an election in prospect, the President would wish to have it identified in all public utterances with a Democrat. But I would remind the President and my Republican friends that the Secretary's credentials as a member of our party cannot be considered all that permanent."

Let me now turn to what is required.

There is only one way to have an effective economic policy. That is to leave the monetarists and fiscalists to continue their academic quarrel and recognizance that adequate employment and reasonably stable prices can only be reconciled by coming to grips with the wage-price spiral. That requires controls. Perhaps I will be thought in this statement to have been a bit hard on my friends who serve a Republican administration.

Let me assure them that I have even less to say for those who, in association with Democrats, agree that cost-push inflation is the cause of our difficulties, that the wage-price spiral must be brought under control and who, having willed these ends, then resolutely refuse to will the means. The economist or statesman who identifies the nature of the wage-price problem and then takes comfort in the belief that mandatory controls can be avoided that the problem will yield to incantation, rhetoric or a uniquely virtuous personality, should be regarded only with amusement.

The first step in getting an effective economic policy must be a general freeze. This is necessary to break the structure of inflationary expectations on which all collective bargaining now proceeds. But it is not necessary in the longer run to control all wages and prices; the main burden of that task, as I have said, still rests with the control of aggregate demand. It is only necessary to control where wages act on the prices of firms that have power in their markets and prices act on the bargaining of unions. The permanent control, which should be worked out in the wake of the temporary freeze, need only extend to a few thousand corporations and a few hundred collective-bargaining contracts.

Once the wage-price spiral is tied down, the next step is to expand employment. This should be done by measures that involve the shortest possible linkage as between governmental expenditures and jobs. The first claim should be funds for pressing urban and welfare require of all kinds. And I would place special stress on public service employment—on providing funds well beyond the recent step to enable the cities which are in urgent need of manpower to be employers of last resort. Particular attention must also be accorded to the new problem of the affluent unemployed. Here the emphasis should be on direct employment in education, urban rehabilitation and other civilian functions. I would hope that the Congress would be very resistant to trickling down expenditures and socialism for the rich, such as that manifested in the loan guarantee to Lockheed. Interest rates, since they no longer anticipate inflation, would be greatly reduced. This does not mean, let me repeat, that aggregate demand may be allowed to outrun supply.

Given the pressure of social need, there should be no talk of any kind of tax reduction. This, like loans to indigent corporations and accelerated depreciation allowances, is also social action for the rich. It is a very inefficient way of expanding the economy. I would also be strongly opposed to any revival of the investment credit. This is a poor economic device which works best when investment is strong and it isn't needed and works worst when investment is depressed and it is needed.

The hard decision, needless to say, is that involving controls. Here is a point that I would like to emphasize. It is a lot less hard in the United States than, for example, Britain, for we have a practical-minded labor movement which, given equitable application of the controls, accepts the need. No British, and very few continental, trade union leaders are as sensible on this matter as George Meany. The barrier is not the unions or businessmen, but the intellectual vested interest—the terrible wrench this action involves for those whose mental capital is tied up in the belief that fiscal and monetary policy are sufficient, that the market is still virginal, and that the real debate is between the effect of money supply and the budget. We must all have sympathy for men whose ideas are being so intransigently discarded by history. But we do not minimize their suffering by prolonging the agony. And we must consider the cost to the country as well.

Thank you very much, Mr. Chairman.

Chairman PROXMIRE. Thank you Mr. Galbraith, for another most interesting and highly competent statement.

In your statement you conclude that the first step has to be getting the inflation under control and you contend this does not mean a comprehensive set of price controls and wage controls, the kind we had in World War II, for example. You indicate that a relatively small part of the economy would be controlled. Can you give us any idea of how extensive this would be and what areas of wages and prices would have to be brought under control?

Mr. GALBRAITH. Well, roughly speaking, about 2,000 corporations have around half of the private economy—of the non-Government GNP. This is, roughly speaking, the area in which one would have to function. It is a little more difficult to estimate the number of collective-bargaining contracts which would be involved, but it would be in the hundreds.

The point which I would repeat here, Mr. Chairman, is I think not a difficult one; one must still at full employment, have an approximate balance between total demand and total supply. One needs to support this with action to suppress the wage-price spiral. This spiral does not, for example, occur in agriculture. One does not have unions there for better or worse. One does not have to worry about retail prices. The individual retailer, even the larger retailer, does not have the market power which allows him independently to shove up prices.

Small businesses are mostly unorganized. The aggregate of agriculture, service trade, retailing, and small manufacturing, comprises about half the total economy. These total some 10 or 11 million of the total number of firms. We have very skewed distribution here. None of those would one want to keep under control. One should not have controls because one still depends here on the market, on demand in that part of the economy.

One does not need to control where one does not have the wage-price spiral. This leaves, as I say, the relatively highly organized area of the economy. This makes control a manageable job, much more manageable than what was attempted in the Korean war or in World War II.

Chairman PROXMIRE. So this control would be, No. 1, confined to the large firms and large labor unions and, No. 2, at that level of production and distribution which is largely manufacturing. You would not apply it, you say, to the retail areas, so that as I envision it then, you would set up a system of wage and price controls at the manufacturing level covering a couple thousand firms and any other part of the economy subject to oligopoly or monopoly to such a point where you might have price leadership.

Mr. GALBRAITH. One had a very good demonstration of this in recent years in the area of agriculture. Agriculture prices have not been leading. Agriculture prices have been following. And the tight money and tight budget policy has been effective in that industry as any farmer will tell you.

Chairman PROXMIRE. Perhaps I have not followed this as closely as I should. This is the first time I have heard this kind of limited proposal, although I have heard the proposals of Robert Roosa and Congressman Henry Reuss, who reflected a similar view. They proposed that there be a freeze without controls, just an appeal by the President but for a very short period of a few months there be a freeze, while some kind of a system be set up.

Would you feel that kind of appeal would be necessary first?

Mr. GALBRAITH. Oh, yes, I would agree. I have talked to Congressman Reuss and to the House Banking and Currency Committee at some length about this. If I may say so, I think there has been some general understanding on this strategy. One has to have the freeze at the start to break the cycle of inflationary expectations. Every trade union contract is now being negotiated on the expectations of x-increases in price, plus productivity gains, plus what some competitive union may be getting. This situation can be only remedied by saying no more price increases, no more wage increases, that bargaining will henceforth be on productivity gains, plus equalization factors.

Chairman PROXMIRE. How do you make that effective?

Mr. GALBRAITH. I would, as in the legislation which the Congress has passed, make this subject to penalties, both on manufacturers, on sellers, and on the unions.

Chairman PROXMIRE. You would say as of a certain date, if the President makes a statement as of a certain date, no increase would be legal in prices or wages above a certain level?

Mr. GALBRAITH. This is a ceiling for 6 months. I do not think one can hold this for more than 6 months. It is a very short-run measure, but it then breaks the cycle of expectations. I am following Robert Roosa's suggestion on this.

During that 6 months one would have to do one other thing. One would have to give increases to those unions which are caught at a stage in the bargaining process, different from some union which has just completed its bargaining. One would make all of those adjustments by allowing increases so that you do not have completely level prices under this process. You have to be sensible about it. You have to allow unions that were about to complete their contract comparable with, for example, what the UAW completed last year, to have a comparable increase.

Then I would move during the 6 months to exclude retail prices, agricultural prices, all prices of service enterprises, perhaps all prices of corporations employing fewer than 3,000 to 5,000 people from the freeze.

Chairman PROXMIRE. Did you say 20,000?

Mr. GALBRAITH. 3,000 to 5,000. That, roughly speaking, limits you to about the thousand largest corporations. And then for the rest—and here I depart from the House-Senate bill—I see no practical alternative, Mr. Chairman, to this being permanent. We have strong unions and strong corporations and we are going to have to live with them forever and we should face the fact.

Chairman PROXMIRE. It would be confined to a thousand corporations or so, and the labor unions?

Mr. GALBRAITH. Given the kind of institution change we have, I see no possibility of our ever getting away from it.

Chairman PROXMIRE. How large a bureaucracy would you expect to require?

Mr. GALBRAITH. I think it would be done with a few hundred people.

Chairman PROXMIRE. A few hundred people?

Mr. GALBRAITH. Yes. And I do not think you would need regional offices. I think it could be all done with a relatively small staff here in Washington. It is very important not to think of this in terms of the vast bureaucracies which were set up in World War II and the Korean war.

Chairman PROXMIRE. Has there been any precedent, any experience in any other country?

Mr. GALBRAITH. Yes. The British tried it, not with a great success, until a couple of years ago, with a relatively small staff. The Scandinavian countries are doing it now, Finland is doing it now——

Chairman PROXMIRE. The Scandinavian countries are so much smaller, more uniform.

Mr. GALBRAITH. In some ways this is a policy which, in the non-Communist world, will work only when the United States does it. Because as long as our prices are going up, and as long as other countries are as dependent as they are on our imports, it is very difficult for them to maintain price stability in face of continuing inflation here. The classic case is, of course, Canada, which has experimented with this in the past year or two but has found so many of its prices are made in the United States, that it has no possibility really of maintaining price stability on its own.

Chairman PROXMIRE. Is one of the reasons why you argue that this would involve such a relatively small group of enforcement officials compared with our previous experience, that we are in a position where supply is ample and you would not have shortages?

Mr. GALBRAITH. This is an extremely important point and somewhat a technical one. In World War II we ran the economy with a deliberate excess of demand. One of the great mobilization devices of World War II was to fix all prices and then have substantial excessive demand, 20 or 30 percent in excess of supply, which meant that people were in effect working for savings, working for future goods. We used the excess of demand as an incentive against future production. And indeed one of the reasons we had a relatively easy transformation from World War II to the post war period was the very large volume of savings people had to spend. We ran what amounted to a disequilibrium system. One had to tie down every price because we had excess demand searching for every single article, every single service, or every single good that was available.

This is something we are not talking about now. We are talking about price and wage control in the much simpler context as a supplement to an equilibrium policy—a policy which keeps demand and supply, broadly speaking, equal, and where one is seeking only to suppress the destructive influences of the wage-price spiral.

Chairman PROXMIRE. My time is just about up. Let me ask one other question. A very large proportion of the economists—I do not know if it is a majority, I suspect it may very well be, and very many others—have argued that the wage-price policy does not have to be mandatory, you do not have to have the kind of legal requirements that you suggest. They point to the period in the early sixties and say with all of its shortcomings, with all of its weaknesses, it did accomplish a great deal. And they argue that we would follow that kind of policy at the present time with some success. What is your answer to that?

Mr. GALBRAITH. Well, I would point out that in a way the policy in the early sixties had mandatory aspects. When the steel corporation got out of line, President Kennedy penalized them by some very extremely vigorous language. This carried its own penalty in public opinion. There were also threats of anti-trust action. I think this is wholly unfortunate; the anti-trust laws were not meant for this purpose. The FBI was invited to have a look to see if there were any violation of the anti-trust laws. Now this was action invloving informal and indeed possibly extra-legal penalties. I think it is much more straight forward—is better government—to legislate the penalties. The Congress should specify the punishment appropriate to the particular misbehavior.

I dislike to attribute motives to my fellow economists, but I am willing to do so if I am forced. I think that some who urge voluntary steps are simply trying to evade the hard question. They want to identify the problem but then when it comes to saying what you do about it, they say well, of course, I would not like to be involved in anything that suggests controls. They back away from the hard part of the answer. I frankly think if we are going to do this, we had better do it right.

Chairman PROXMIRE. Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman.

Of course, I always enjoy having Professor Galbraith before us. He is quite famous for his wit, if not for his logic on occasions.

Mr. GALBRAITH. I congratulate the Congressman on being an apt student on this matter.

Representative BLACKBURN. I notice with some interest in your statement you refer to the Democrats as "our party." Are you allowing the Democrats to return to John Kenneth Galbraith, after you renounced them some time ago, or are you allowing them back in your fold as long as they purge John Connally? Is that one of the conditions of your rejoining them?

Mr. GALBRAITH. No; I was not aware that I had departed, Congressman. I am aware some of the southern wing of the party have had some problems in the past; but we who are in the mainstream of the party, Congressman, have never been troubled by this problem of conscience.

Representative BLACKBURN. I suspect that is true.

Mr. Galbraith, I have noticed for some years you are famous for your predictions and prognostications. I recall about 3 years ago you announced the collapse of the Saigon government in 2 weeks. Has the 2 weeks extended or are you still waiting for this to come about?

Mr. GALBRAITH. I have accumulated a reasonable list of erroneous predictions, of which that was certainly one. I did not estimate the extent of the expenditure that we were willing to make buttressing up that gerry-built organization in Saigon.

Representative BLACKBURN. You are saying Yankee-built?

Mr. GALBRAITH. What other areas of prediction do you have in mind?

Representative BLACKBURN. I am afraid we have to go into other areas at this point. I notice in some instances we just cuss out big business and labor leaders whenever prices go up. I do not think it is going to work as a permanent method.

I find myself wondering how you are going to impose partial wage and price controls and you have completely ignored the public sector and how we are going to control tax increases or control Government expenditures. Now, don't you think if we are going to curtail business and labor, they have got to live within their means, and we are going to fix the prices at which they can sell their goods and services, that we should also impose a tax freeze on Government?

This is one of the big items that contributes to increase in cost of living. Real estate taxes are going up around the country, as our local governments try to cope with the demands on their treasuries. Of course, the Federal deficits are becoming more famous or infamous every year. You have spoken out many times in the past that we are living in a society controlled by big business, big Government, and big labor. How do you propose that we control Government?

Mr. GALBRAITH. I would want completely, to disagree with the Congressman on this point. There is a problem implicit in all economics of fiscal discipline. As one comes close to full employment, one must have this discipline in the budget which keeps the budget from adding to demand at that level. I do not find myself too critical of the administration here; my impression is they have not allowed the budget to get in excess of the amount that would be roughly right if we had full employment as distinct from the volume of unemployment we now have.

I also point out that part of the pressure on States and localities is the result of the inflation from which we are so persistently suffering. As the Congressman is aware, active and aggressive trade union development in the last 3 or 4 years, has been in the public services. This is not because unions here have suddenly become militant or aware of their rights. It is because the persistent inflation in the private sector of the economy, including the persistent wage-price inflation has forced the public services and public services employees to organize in their own behalf. They, in turn, have gone for larger increases. Pittsburgh municipal workers fall behind the steelworkers. Having then caught up, this imposes further increases in the property taxes. This has been one of the great misfortunes of the period and it is one of the reasons why I would welcome the Congressman as a strong supporter of wage-price control.

Representative BLACKBURN. Well, the thing that bothers me about any wage or price control movement is it would become permanent, as you yourself have said, that there are certain sectors in which it would become permanent. And when I look at the performance in those nations which have a controlled economy, even though we have some turbulent days in our economy and we have had some in the past, and I suspect we will have some in the future, still overall the growth in our economy, the increase in the affluence the average citizen enjoys, is such a remarkable and refreshingly greater improvement than in controlled economies, that I find myself more willing to accept the occasional lumps and headaches with a free-market economy than I would with a controlled economy.

Mr. GALBRAITH. I would point out to the Congressman, if I might interrupt, nothing is more deeply in the American tradition than a practical and pragmatic accommodation to circumstances. This is what I am urging.

Representative BLACKBURN. Well, I question your statement that our labor leaders would be so completely happy about wage and price control.

Mr. GALBRAITH. I am not suggesting that, but I am suggesting they are much more sensible than trade union leaders abroad.

Representative BLACKBURN. I suspect they have been a lot more reasonable than some others could have been. But yet I recall Mr. Woodcock appeared before our Banking Committee, before his own union started their negotiations, in vigorous opposition to wage and price controls. So it seems everybody is in favor of control of the other fellow's wages and prices but not their own. I do not think you could change this very human tendency, by any form of controls that you would impose on the larger corporations or the smaller.

Let me ask you this: Have you ever considered the possibility of something akin to the antitrust laws for labor unions as a possible means of avoiding this cost-push, which I frankly agree with you, I think that that is one of the big problems we are facing. I think that is one of the things that has priced us out of the international markets. I know you disdain the market as a factor but in a very real sense the market is a factor, because our merchants, our producers, are competing not with other American producers in many instances, but they are competing with Japanese producers and German producers and Italian producers. And our laborer in a like manner is competing with the Japanese. The textile industry is competing with Hong Kong and Taiwan and other places in the Far East. The market is determining whose goods are being bought.

Mr. GALBRAITH. I must say, Congressman, that I would dissent completely and I would do it as a practical man and obviously one who is decidedly more conservative on this issue than you are. Nothing is so intrinsically a part of the American life and American economy as trade union organizations. Nothing, incidentally, is more intrinsically a part of our economy than the large corporations. I do not believe that any congress, any parliament, proceeds to pass legislation that makes its basic institutions as illegal.

I do not believe, therefore, there is any chance of our passing legislation which outlaws the present structure of trade unions as illegal, nor do I think there is any chance of our ever enforcing the antitrust laws in such fashion as to disintegrate the large corporations. Being practical in such matters, I then look for other solutions.

Representative BLACKBURN. What you address yourself to is the political realities and not the possible desirability from a theoretical economic standpoint?

Mr. GALBRAITH. That is right. I would dislike, as a professor, to come before the Congress to lecture a Congressman on practical politics, but again if I am compelled to do it, I will.

Representative BLACKBURN. I get them quite frequently from others who have been elected to office, Mr. Galbraith.

I have no further questions. I always enjoy having you with us.

Chairman PROXMIRE. Senator Javits.

Senator JAVITS. Professor Galbraith, welcome to the committee. I have gone through your statement and I think I get the general thrust of it. I agree with the general thrust of it.

I would like to expand a bit on your views and ask you about two critical points.

One, you say that controls are an essential supplement to fiscal and monetary policy, and an instrument that could keep the economy from being destroyed by cost-push inflation. I fully agree. Under those circumstances, would you give the President authority to turn on or off the controls as the fiscal and monetary situation may dictate?

Mr. GALBRAITH. Well, as a practical matter, I would act as the Congress has acted in the past. I would give authority rather than compel the Executive to act.

Action should only be undertaken by the Executive that really wants to do it and believes in it.

Senator JAVITS. Under those circumstances——

Mr. GALBRAITH. But I do not think, Senator Javits, that this is an on-and-off action. I think we are going to continue to have strong unions, continue to have strong corporations, we are going to have competition that is natural between the unions for the wage increases that they exact. We are going to continue to have the power of the big corporations to pass those wage increases on to the public to export their attentions, in other words, to the society. This is something that has become built into our system. I think we are going to have to continue to deal with it.

Senator JAVITS. Now, leading from that proposition, I noticed that you say that the next step in that approach would be to expand employment:

> The first claim should be funds for pressing urban and welfare requirements. And I would place special stress on public service employment.

Would you say that this would be likely, no matter what we did—and you know I have been the central figure in getting the administration at long last to authorize some public service employment from a bill we passed—but wouldn't you feel that such steps could only contribute marginally?

You are never going to approach the number of jobs really required and a much better bet would be a real productivity drive in this country which would make American business very much more competitive, remembering that its competitive stand is not only in respect to meeting competition in foreign markets where we are being bested right now very badly, but also meeting the competition of imports?

It is my judgment, for example, just to comment on the question, that the erosion of our surplus is heavily attributable to the fact that because of inflation and an erosion of the motivation of the American worker, imports are underselling us at home very much more than they should? Would you be good enough to comment.

Mr. GALBRAITH. Yes, I would agree with that. There is a problem, when one talks about increasing productivity, of how one goes about doing it. And this gets into a wide, varied set of actions, some of which, as in the case of research, development, and education, and so forth, have a very long time horizon. In the meantime, one has the problem of cities and one has the problem of the urban unemployment.

I must confess, Senator Javits, I would be a little bit more optimistic than you about the possibility of making the cities, making the employers, the last resort on a much larger scale than we are doing. I was struck by Mayor Daley's comments about the enormous number of men he could use in Chicago. I think this also should involve a degree of permanence, so one can work with these people into more skilled jobs, work out the permanent arrangements for the urban unions, for bringing them in as additional employees without breaking down the wage structure. It involves provision for more than employment just at the minimum levels. It involves employment of people up the salary scale.

I have thought at times, I must confess, that the whole move into revenue sharing should take this form rather than the more direct grant——

Senator JAVITS. That is services instead of money?

Mr. GALBRAITH. Yes.

Senator JAVITS. However, isn't it a fact, Professor Galbraith, that in those American cities where there has been a real explosion of construction and development, it has rarely been a municipal effort. It has most often been a determined band of local boosters, mainly businessmen, who have combined together to really break through with a major development? That is the history of Philadelphia, for example, Pittsburgh, even Boston, where this kind of a development took place. It is what I find—and you know how much of a native I am—the deficiency in my home city, notwithstanding the fact it is the citadel of American business. What is your experience in that? Isn't that a practical point we must bear in mind here?

Mr. GALBRAITH. I think this is true, Senator Javits, but I do not think a New Yorker should be apologetic about this, because I think the tendency is very much away from this possibility.

The 19th century, and the early part of the 20th century, extending down to our own time, there was in the large American city—this is something I have been writing about recently and I could easily get into a long lecture—a recognizable power structure. This was true of cities such as Atlanta, Pittsburgh, even Philadelphia. But in the very large metropolis, New York, Chicago, Los Angeles, there is a tendency for power to become so diffused and so disintegrated that it ceases to be a force in the community. One cannot beyond a certain size, beyond a certain stage of urban development, rely on it.

It is significant that when one thinks of this, one thinks of Wilmington where there was the Dupont influence, or Pittsburgh, where one had an exceptional concentration of corporate power. Or Atlanta, where one had great basic industry like Coca-Cola.

When one gets to the larger cities, one does lose this degree of concentration.

Senator JAVITS. But would you agree with us on the following, Professor? After all, this committee is really a committee to establish doctrine, it is not a legislative committee. Mr. Blackburn, Senator Proxmire and I belong to many other committees where we can implement the doctrine. would you agree with us, therefore, granted the posture of controls, with which I thoroughly agree—I do not think there is any other way of arresting this combination of economic leukemia, which is weakening us, and at the same time stimulation which is just giving us a fever—but would you agree with us that the choice of means thereafter, whether it should be your means, to wit, a big investment in the public sector, or whether it should be my means, which entails a major drive in the private sector is not as critical as the fact that we will then have a field in which to operate. Presently, we are paralyzed from moving in that direction by the fact that the disease is consuming us constantly?

Mr. GALBRAITH. I would agree with that. I might want, after this stage, to reserve some right to argue as to the recent steps. But I do agree that the first step is to tie this down, the wage-price spiral, and to establish the platform of stability from which one then goes to a variety of policies, certainly.

Senator JAVITS. I am glad to hear you say that because there are other things you stand for that I do not agree with.

I was very interested in your answer to Congressman Blackburn about the antitrust laws for trade unions and I know your position. But don't you think that under existing circumstances at home and abroad, the whole basic premise of the present antitrust laws, for example, that the public interest demands that there be the ultimate or the utmost in competition, no matter how small or inefficient the unit, so long as they are fighting with each other, is obsolete? In light of present conditions, isn't that a rather ultraconservative automatic theory, and wouldn't you agree that what we need is some new formulation of the antitrust laws which would take into account the very things which you mentioned, especially the inability of the antitrust laws, as a contrary philosophy, to accomplish what we ought to be doing with respect to these enormous economic units, both in business and in labor?

Mr. GALBRAITH. You couldn't have stated my position better, Senator Javits. I completely agree. I have long felt, as you know, that the antitrust laws are a diversion, that a certain amount of liberal progressive energy that we need for other purposes is diverted into hopeless efforts to dissolve General Motors' hopeless efforts to break up the trade unions; our task must be to learn to live with these institutions. A man who talks about breaking up General Motors does not talk about the parameters—those concerning the problems of the environment and the problems of safety and the problems of relations with the customer—within which we must require General Motors to live.

It diverts attention from that. And similarly, as I indicated in my interchange with Congressman Blackburn as regards the unions. I do not suggest that the antitrust laws have been wholly unuseful for maintaining a certain decency in trade and between competitors. But I do regard them as basically a diversionary reform.

Chairman PROXMIRE. Mr. Galbraith, I have another question. We have two other witnesses to come. I cannot resist going after one part of your very interesting and very attractive proposal. If it would work, it would certainly be a very logical and appealing solution to the problems that plague the administration and plague the Congress.

What you are saying is we can get inflation under control with a relatively small investment in terms of resources, a few hundred people and by concentrating on the big industries and labor unions. The difficulty is when you look at the statistics—I have been looking at them since I questioned you last—the commodity part of the price structure has not been going up very rapidly. What is produced by the big industries, the big concentrated industries. The price of their product has not been rising very rapidly. They didn't in 1968, 1969, and 1970. They haven't been lately. The big price increase has been in services. As a matter of fact, I think the increase in services overall has been rising at the rate of 8 percent.

And since this, as you say, is characterized by small business and not by a few units whose prices you would control, I just wonder if your solution of controlling prices that are produced by big business firms, whether that would really work.

Mr. GALBRAITH. This is a very important question, a very important amendment to what I said. But one must, I think, go a little bit behind these statistics you cite. In the first place, the service figures are greatly influenced by two facts. First, they are specifically influenced by the very great increase in medical costs. That series includes the explosive increase in medical costs, which is in some degree sui generis, something of an exception which has its own causes associated with the development of medicare and medicaid and the great pressure on medical services.

The second thing one must also, of course, bear in mind, is the services not having any important factor for productivity to catch up with the full extent of the increase in the wage cost.

Notwithstanding, it is the organized section of the country that has led the inflationary movement. It is the persistent, steady increase in industrial prices which went right through the tight money policy the last couple of years. Agricultural prices, for example, subject to market influences, leveled off and even declined.

This was not always reflected in food prices because one has an enormous margin effective there, with the strong unions operating in the food industries.

Chairman PROXMIRE. But don't agricultural prices constitute now such a relatively small sector of our total cost? As I understand it, food represents about 18 percent of the cost of living for the typical American and, as you say, food prices are quite different from agricultural prices. The farmer only gets a third of that, so the agricultural costs would only represent about 6 percent of the overall cost. So this represents a large and rapidly increasing share.

Mr. GALBRAITH. There is a point I must emphasize. My argument depends heavily on this point. Let us exclude medical costs as having their own special cause and effect result. Then I would go on my argument depends on the fact there is no original cost-shove effect in services, that services are part stimulated by the cost-push movement elsewhere in the economy, respond to it, and are in the process of catching up. That the barber shop back in the days when people had haircuts, did not increase its price, except in response to general movement of wages in the community and responded. But since there are no productivity gains in that industry, when it increased, the whole effect came through on the price of haircuts.

Therefore, my argument is right or wrong, depending on whether you agree or do not agree that the organized industries have a leadership role in the movements in the price structure.

Chairman PROXMIRE. In the past 10 years there is a consistently greater increase in prices of services than in prices or commodities.

Mr. GALBRAITH. Yes. I would emphasize as strongly as I can, however, one must not rely on the crude statistics. This is the part of the economy which does not have productivity gains. Therefore, any increase in wages that comes fully through.

So I would still urge that it is the steel, automobile, building trades, that those are the lead industries. That was the theory in the early sixties which caused the economist of that period to seek to tie down those wages. The theory of the guidepost was correct.

Chairman PROXMIRE. Fine. Unfortunately, there is a rollcall going on now. Senator Javits, I presume you will have to go down with me to meet that rollcall.

Congressman Blackburn, do you have any questions?

Congressman BLACKBURN. I have one or two.

Chairman PROXMIRE. You do that and we will be back in a very few minutes. You may call the next witness.

Representative BLACKBURN. Mr. Galbraith, as you were talking to Senator Javits a minute ago, you suggested a great expansion in the public sector, that is making State and local governments the employer of the last resort. To get back to the question I raised earlier about how will we control fiscal and monetary policy if the government itself is irresponsible, if we do go through this great expansion in the public sector, how can we do it without increasing taxes? What do you propose to finance this?

Mr. GALBRAITH. I would use this as the budget stimulus. I would do it by the Federal government and as an added budget stimulus which can be afforded now that we are not relying on budget and monetary policy exclusively as the instruments of controlling inflation. The strategic problem is an interesting one. As long as you are relying on these two inadequate instruments, you have to have more of them.

You have to have a tighter budget and tighter monetary policy and a lot more unemployment than you need to have. Once you no longer are placing that degree of reliance, you can afford to ease up on the budget, you can afford in the present circumstance to run x amount of deficit at full employment levels.

Representative BLACKBURN. Which would then be financed through increased monetary supply?

Mr. GALBRAITH. Or through borrowing, yes.

Representative BLACKBURN. That generally results in increased monetary supply?

Mr. GALBRAITH. Yes. You can offset it, if you want to.

Representative BLACKBURN. If we should go to our major producers—and understand, I have publicly defended "bigness" on occasion. In fact, I was on the radio last week in debate and pointed out that the biggest financial combines in Japan have proven to be very effective in the international market. So we just cannot automatically say because something is big, it is necessarily unproductive. It might well be more productive than a number of small enterprises.

But if we did fix prices and wages for our major producers, then what would be the incentive on those major producers to innovate or to improve their operations, if they were guaranteed a profit by maintaining the status quo in operations, if labor knew that it would earn no more, no matter what the company did, by way of innovation and unique techniques and technology; what would be the incentive on these enterprises to improve their productivity?

Mr. GALBRAITH. I think this is a question which certainly requires an answer. I do not think, however, that this kind of control does destroy the traditional incentives.

One tells the steel corporation that in return for holding wages within the limits set by productivity gains, we would expect them to keep the average of their prices the same. One would not preclude adjustments as between the individual products. (As a matter of fact, this sort of control has been used in the past.) This does not exclude increasing profits from expanding volume. As a matter of fact, if one were to hold the present level of steel prices for a year or two, one would hope that the steel industries would recapture some of the domestic export markets which they have been losing.

As a practical matter, the corporation would expect to get some of the gains from productivity. These, after all, are the basic profit incentives at the present time. So one would not have altered either of the basic incentive structures. The basic incentive to go for improved methods.

Representative BLACKBURN. Mr. Galbraith, I won't take any more of your time. I see we have two more witnesses. I do appreciate your coming and being with us today.

For those we have Mr. Jones and Mr. Modigliani, and we will have Mr. Jones lead off.

Mr. GALBRAITH. Professor Modigliani assures me he will support everything I said.

Representative BLACKBURN. Everybody else here has, so far, but me.

STATEMENT OF HOMER JONES, FORMER VICE PRESIDENT, FEDERAL RESERVE BANK OF ST. LOUIS

Mr. JONES. I possibly may say just a word about my reaction to Professor Galbraith by way of giving some transition to our remarks. At one time I thought I was agreeing with about 65 percent of what Mr. Galbraith was saying. Whether it will appear so to you I don't know. I do not see the cost-push thing exactly as he does. From 1957 to 1965, I think that the economy worked pretty satisfactorily. By the end of 1964, the beginning of 1965, when we were up to what I would consider to be approximately full level employment, the cost-push phenomenon was not dominating the economy.

Then we turn to the period from 1965 to 1969. Here, I think that everybody would agree, as least most people would agree, that the inflation resulted from excess demand, excess total spending, excessive fiscal stimulus, excessive monetary stimulus. So it would seem this cost-push thing as a practical matter was something that only came upon us in this past couple of years, in an extreme way.

Well, this is in a sense true. But I prefer to look upon it as a lagged effect of the excessive total spending of the 1965 to 1969 period, and I think we should have some hesitancy at introducing measures or practices which change the nature of our society.

I think that it is a much more competitive world, much more free market world than Professor Galbraith does. The world changes, it changes in certain respects, but I think that in this matter it has continued in the main to be guided by market forces and competition. These are great forces.

Neither am I too impressed with the big union, big corporation matter. Maybe there are things that need to be done here. I think there are. Most people agree. But after all, Professor Galbraith has himself pointed out on occasion that the total union force in the country is only 23 percent of the labor force, and I think we might roughly divide this in half and say only half of that is exercising extreme power. So I just give this by way of a little background in my view of things before turning to some other matters.

I thought I would not read the prepared statement that I have submitted, but I did submit six charts, which I believe may have some bearing on matters of interest to this committee. The first of these charts concerns interest rates. And, of course, we are not interested in history per se, we are interested in the problem of interest rates now and the problem of interest rates in the future. But I think it is well to look a little at the past.

We had a situation in 1964 and 1965 when at least these interest rates I have plotted here—and they properly represent movements though you may be more interested in some other specific interest rates—were at about a 4.5-percent level; and then they rose, and rose and rose, up to the 8-percent level. And, of course, many of them a year ago, a year and a half ago, were up at the 9- and 10-percent level.

So I think it is worth our while to examine how this happened and why it happened in order to have some background as to what we can expect now.

I conceive of interest rates as a market price, not something that is fixed by Government or fixed by the Federal Reserve. I think the Fed has been tremendously ineffective in this regard and this has of necessity been the case. Interest rates are determined by the supply and demand for loan funds. So during this period, the interest rose more than any other one reason because of the inflation. When people expect inflation of 2 percent, they demand and are willing to pay a 2-percent premium. And when people expect an inflation of 4 percent, they expect and are willing to pay a 4-percent premium. So the rise in interest rates pretty much went along with the inflation and the inflation expectations.

Why did we get the inflation? I will just run through this briefly and maybe come back to it a little later on. We got the inflation because of the excessive total demand, the excessive phenomenal GNP, the excessive total spending, which in turn came from fiscal and monetary policies. We have disagreement as to what extent it was fiscal and what extent monetary, but some combination of these explain the great inflation—the public expenditure growth, the budget deficit, and the excessive monetary expansion.

Let me mention for a moment my view of the role of the Federal Reserve in this connection. I have not seen anybody maintain that the interest rates rose because the Federal Reserve on the whole was restrictive during this period. On the contrary, it was at the very time that as a trend the Federal Reserve was expanding and expanding and expanding. So we came to a new recognition that under some circumstances, and I think basic circumstances, if the Federal Reserve operates in an extremely expansionary way, it increases the demand for everything, it increases the demand for loan funds. Rapid fiscal and monetary expansion causes high interest rates, and not low rates under such circumstances.

So on the whole we have gotten to this high level of interest rates from, and its continuation is very dependent upon, expectations of inflation, which we still have with us.

We had some decline of interest rates last fall and in early winter. One likely cause of the decline was a short-run effect of the Federal Reserve expanding very rapidly. Rapid Federal Reserve expansion does have a somewhat depressing short-run influence on interest rates. Further, we were having some recession, so there were some declines in real demand for loan funds. And to some extent, the decline may have been a technical reaction from interest rates just having run up higher in late 1969 and early 1970 than the basic conditions justified.

Now we have had a rise of interest rates since March and this has been despite very rapid monetary expansion. So to me this is an indication that we are simply in a high interest rate world, unfortunately, which has resulted from the great inflation. I think there will be nothing that will bring the interest rates down again until we dissipate the expectations of inflation. If inflation and expectations of inflation were to rise again for some unfortunate reason from 4 to 5 to 6 to 7 to 8 percent rate a year then we will have a rise in nominal interest rates again from 7 to 8 to 9, to 10. There is very great correlation between the amount of inflation of various countries and the level of their interest rates.

So with respect to cures, the first is to avoid inflation. A second general public policy conducive to low interest rates is any measure which promotes high savings, a basic supply of loan funds large enough to promote low interest rates. One such measure would be a substantial high-employment budget surplus as our general public policy over the years.

Now, there are some false cures that have been talked about and attempted in connection with interest rates. First, is public controls of the regulation Q-type. We have now had some experience with ceilings on interest rates paid by commercial banks and other financial institutions. I believe these controls have been harmful to the public interest. They have not kept down interest rates in general. They have not been helpful to housing. They have not been helpful to the average citizen. Indeed, they have restricted the flow of funds to institutions which finance the small person and businessman. But at the same time, they have made for a relatively greater flow of funds through the open market where the large, and not the small borrower is at home. I alluded to the situation a year or two ago. The regulation Q-types of controls have forced the small saver to bear the brunt of inflation without compensation.

A second ineffective way to avoid high interest rates is rapid monetary expansion. We cannot basically reduce interest rates by monetary expansion. This works to a degree in the short run but the experience in the past 6 years shows that as time goes on, rapid monetary expansion leads to high interest rates, not to low rates.

Regarding the relation of interest rates to changes in the level of general economic activity, I believe that the dominant effect runs from business activity and the demand for loan funds to interest rates and not from interest rates to business activity.

Consequently, I do not agree with the suggestion that if interest rates continue to rise in the next few months, this may abort the recovery. If rates continue to go up, it will be because of an economic recovery taking place or because inflationary expectations are revised upward. The rates would rise largely because of a greater demand for loan funds.

With respect to housing construction, there has recently been a benefit from the moderation of credit conditions since a year ago. Only gradually, as anticipations of inflation may be reduced, can we expect to achieve those basic interest rates which are conducive to a reasonably steady high-level financing of housing. Housing would be most benefited by sound monetary action which would reduce inflation and thereby hold down the price of houses.

There has been a lot of talk about the prime rate, a lot of talk about the discount rate. Most of this discussion is not very much to the point. The prime rate is a market rate. The prime rate, if we had the chart here, moves along with other short-term rates very closely. It is not an arbitrary, managed rate, in my opinion.

With respect to the discount rate, it is terribly overemphasized as an important factor in the economic system. We kept it down at 6 percent for 2 years when market rates went to 9 percent and 10 percent, and I think keeping down the discount rate did nothing whatsoever at keeping the general interest rates down. It simply created a windfall, a bonanza to those banks which were able to borrow.

I think it would be desirable, as do many other people, for the discount rate to either move along with interest rates in general, or to be a rate above the general market rates. It does not effect or control the market rates.

Let's return to the next chart, "Federal Government Expenditures," since one of the issues is whether Government expenditure should be increased. The acceleration of the rate of increase of Government expenditures back in 1965 is one way of looking at what caused the great increase in total demand. From 1958 to 1964, Federal Government expenditures increased at a 5-percent rate and you will see this jumped to a 14-percent rate for the period from mid-1965 to mid-1968. As to the immediate situation, total Government expenditures have increased at about a 10-percent rate in the past four or five quarters. I personally do not see that it would be a sound thing to increase them at a greater rate than this 10 percent rate.

Nondefense expenditures, we may note, have in the last five quarters increased at a 20-percent annual rate. You can see that tremendous spurt. Defense expenditures are going to level out most likely, or according to the budget, increase somewhat, so that if we were to continue increasing the nondefense expenditures at a 20- or 21-percent rate, and the defense expenditures go up at a 7-percent rate, as has been forecast by the budget, we would probably have about a 15-percent rate of increase in total expenditures.

Well, I only use this as a background for considering the question of whether it is good policy to increase Federal expenditures further. In all of this, I would like to emphasize my views that fiscal and monetary policies operate with a lag, and that when we have a long history of taking definite, positive actions at a time when we think we see the need, and that they come into effect at a later time, when they do the greatest harm.

Turning to the next chart, here is a chart which is conceptually used a great deal. There is the surplus and deficit of the high employment budget, and the surplus and deficit of the national income accounts budget. We see how they both went into great deficit in 1966, 1967, 1968, and indirectly, or directly, depending on how one sees things, contributed to the inflation. We can see that the national income accounts budget is in a great deficit at the present time.

As to the high employment budget, there are differences of opinion as to how to measure it and what is happening to it. But as I see it by conventional interpretations, this budget is more simulative than in 1969 and the first half of 1970. I think that we do not know how to manipulate this budget in a useful short-run fine-tuning way. I think we should hesitate at taking steps to throw it into a great deficit most frequently when such action becomes effective, when the results appear, it is just at the wrong time.

Chairman PROXMIRE. In your presentation and your charts, you talk about expenditure policy and then you talk about fiscal measures. You have no chart, no reference here in your remarks, as to taxation and the fiscal measures; is that putting the two together?

Mr. JONES. Yes; that is right.

The full employment budget would represent the net of the two.

Chairman PROXMIRE. What assumptions, then, do you make about the future of tax revenues?

Mr. JONES. They are essentially what was in the budget somewhat adjusted by the things that Mr. McCracken was saying 2 weeks ago when he was here before you.

Chairman PROXMIRE. You assume then no change, in effect?

Mr. JONES. That is right.

Chairman PROXMIRE. In taxes?

Mr. JONES. That is right.

Chairman PROXMIRE. Do you make any assumption about the social security tax increase going into effect January 1?

Mr. JONES. It assumes just what is planned.

Chairman PROXMIRE. I see. Sorry to interrupt. Go ahead.

Mr. JONES. Well, we come to the matter of monetary policy, and, of course, there is great disagreement as how to measure monetary policy. I do not want to make any great brief at this time for this particular measure, but one would get about the same impression if one used Federal Reserve credit, if one used total bank reserves, or if one used the total so-called monetary base.

So, here, I feel that we have a basic explanation of the inflation that we have. Money supply from 1952 to 1964 increased at a 2-percent rate. In 1964–65, it was about a 5-percent rate, and then in 1965 we took off with a 6-percent rate. Inordinately changing the rate of increase of money in 1965 was a major turning point in the inflationary situation. At the end of 1965 or by the beginning of 1966, the Federal Reserve began to take tightening steps. I think that was right.

In my opinion the acceleration of monetary growth in 1965 was done because of a gerat public demand for taking steps to keep interest rates down. This was one of the major illustrations of the past that when monetary policy takes steps to keep interest rates down, it may result in inordinate monetary expansion and inflation.

Again, we had such a situation of course, and a fortiori from late 1966 or early 1967, up to the beginning of 1969, when the money supply increased at a 7-percent rate.

There were some corrections in the excessive monetary expansion made in 1969 and 1970 which, I believe, were moderate. I do not think they are subject to criticism.

Now most recently in the last two quarters, the money supply has increased at a 9-percent annual rate. This seems to me to be excessive, but if it is not continued it is not necessarily going to bring upon us tremendously excessive total spending and tremendous inflationary expectations again. I think it should be tapered off to a 4- or 5-percent annual rate.

The next chart, "Demand and Production," is simply a graphic representation of things that I have been saying. You see that, from 1965 to 1969, total spending went up at about a 9-percent annual rate, which is about twice what is generally supposed to be the rate of increase of our productive potential, and it was in an era of certainly full use of resources, I would say this is to be looked at as the basic transitional link between money and fiscal policy and the price inflation that we got and the interest rate rises that we got.

Now, as to the recent past, I think with the new figures, the annual rate of increase of total spending from the fourth quarter to the second quarter was 10.8 percent. But I recognize that in a sense the fourth quarter was an unusual quarter, and in making some adjustment for that I would say that total spending has been going up at about an 8-percent rate.

This is twice our potential, but may be justified in view of the lack of unused resources. But I would not think it would be good public policy to plan for total spending to go up at more than this 8- or 9-percent rate.

As I interpret what has been happening in the last two quarters, the growth of real product has been at about a 6-percent annual rate. It might be well to adjust this to say it was about a 4-percent rate.

I come, finally, to the "prices" chart which shows the course of the inflation, the inflation that we did get. Whereas, back in 1963 to 1965, the consumer price index was going up at a 1-percent rate; this accelerated to 3 to 4 to 5 and to 6 percent, and built up tremendous inflationary expectations and we have been given excessive promises or talk as to how rapidly this could be cured. It has not been rapidly cured. I think there are no practical ways for a quick cure. It is a slow process.

If you will permit me, I will summarize my remarks by saying, in conclusion, we live with the problems created by past mistakes. Both the inflation and our shortfall of production result from the past gyrations of policy. The best cure is to avoid making more mistakes similar to those of the past. We must be mature enough to recognize that there are no miraculous ways of suddenly curing the inflation and restoring employment. Fiscal and monetary policies that would inflate total demand more rapidly than at present run too much risk of a renewed burst of inflation. Then we would again have to have restraint and more unemployment. Along with steady fiscal and monetary policy, we need to look to changes in law which will increase the efficiencies of the markets for labor and for commodities. These basic steps will give us sound basic lower unemployment and higher production in relation to our potential.

Thank you.

(The prepared statement, with attached charts, of Mr. Jones and his November speech, "Observations on Stabilization Management," follow:)

Prepared Statement of Homer Jones

Views on the Current Economic Situation

Mr. Chairman and members of the committee, I propose to give briefly my views with respect to the current economic situation, with emphasis on interest rate movements and the mix of monetary and fiscal policy.

INTEREST RATES

Recent interest rate history may be considered in three periods: First, the great and unprecedented rise from 1965 to 1970. Second, the decline from the first half of 1970 to March of this year. Finally, the rise of rates since March. (See chart I.)

Interest rates are market prices, resulting from supply and demand forces, like other prices. They change in response to changes in the supply of, and the demand for, loan funds. From 1965 to early 1970, the demand for funds burgeoned. This demand resulted from the great total demand for goods and services, which in turn followed from the expansionary fiscal and monetary actions of 1965 through 1968.

Interest rates rose from 1965 to 1969, in part because of the Federal budget deficit and great financing demands by local governments, and real demands of the general public. But, as time went on, the course of interest rates was dominated more and more by the inflation and by anticipations of inflation. When potential borrowers anticipate inflation, they are willing to pay a higher interest rate and hence they bid rates up; correspondingly, when potential lenders anticipate inflation, they are willing to lend only at interest rates which will compensate for expected inflation. In a rough way, when a 5 per cent inflation rate is anticipated, a 4 per cent basic interest rate means a 9 per cent market rate, and this is what we got by 1969 and early 1970. This experience points up the irony of an activist policy to stabilize stated interest rates, but which resulted in the most volatile actual interest rates ever.

The sharp rise of interest rates from 1965 to 1969 did not result from restrictive monetary actions. In fact, in those years, monetary expansion was particularly rapid. Federal Reserve credit, bank reserves, and money all increased very rapidly. The great increase of interest rates was, in large part, an indirect result of the rapid monetary expansion. Monetary and fiscal developments led to excessive total spending. This, in turn, led to inflation and to the high interest rates. Rapid monetary expansion in 1965–68 resulted from an attempt to keep interest rates down. But the longer-run effect was, instead, the great rise of market interest rates. This brief historical reference helps understanding of recent and prospective developments.

The decline of interest rates in the last half of 1970 and up to March of this year was, in my opinion, mainly a superficial short-run development. It was, in part, a reaction from a run-up above equilibrium rates in early 1970, in part, a short-run effect of renewed rapid monetary expansion in 1970 and early 1971, and, in part, a result of a temporary decline in real demand for loan funds. But the basic forces that pushed up interest rates from 1965 to 1969 have remained in operation. There is no reason to suppose that anticipations of inflation have greatly abated, and so long as this is true we cannot expect a basic reduction of interest rate levels. Consequently, we should not be surprised by the upward reaction of rates since March, and we should also not be surprised if there is further upward movement toward the levels of 1969. Basic reduction of interest rates will be fostered chiefly by public policies which reduce inflation and thereby inflationary anticipations. Low rates could also be fostered by long-run fiscal policies designed to create Federal budget surpluses in times of normal economic conditions.

In my view, therefore, the principal way that public policy can moderate interest rates is to gradually reduce inflation and expectations of inflation. If we perpetuate inflation we will perpetuate high interest rates. If we accelerate inflation we will raise interest rates yet further. But if we reduce the rate of inflation, and consequently anticipations of inflation, we can thereby reduce basic interest rates.

We cannot reduce interest rates by rapid monetary expansion. This may work to a degree in the short-run, but the experience of the past six years shows that as time goes on rapid monetary expansion leads to high interest rates, not to low rates.

Short rates have always been more volatile than long. This has been true in the last half of 1970 and in the first half of 1971. Short rates fell much more than long, as the public undertook to refinance its short-term debt into long-term. Experience of many years seems to show there is little that the monetary authority can do to control the relation between long- and short-term interest rates. Market forces are largely dominant in this connection.

Regarding the relation between interest rate changes and the level of general economic activity, I believe that the dominant effect runs from business activity and the demand for loan funds to interest rates and not from interest rates to business activity. Consequently, I do not agree with the suggestion that if interest rates continue to rise in the next few months this may abort the recovery. If rates continue to go up, it will be because an economic recovery is taking place, or because inflationary expectations are revised upward. Rates will go up largely because of a greater demand for loan funds which accompanies the recovery and the expected inflation.

We have now had some experience with ceilings on interest rates paid by commercial banks and other financial institutions. I believe these controls have been harmful to the public interest. They have not kept down interest rates in general. They have not been helpful to housing. They have not been helpful to the average citizen. Indeed, they have restricted the flow of funds to institutions which finance the small person and businessman. At the same time, they have made for relatively greater flow of funds through the open market where the large, and not the small, borrower is at home. They have forced the small saver to bear the brunt of inflation without compensation.

With respect to housing construction, there has recently been a benefit from the moderation of credit conditions since a year ago. But this development may prove ephemeral. Only gradually, as anticipations of inflation may be reduced, can we expect to achieve those basic interest rate trends which are conducive to a reasonably steady high level financing of housing. Housing would be most benefited by sound monetary action which would reduce inflation and thereby hold down the price of houses.

MIX OF MONETARY AND FISCAL POLICIES

With respect to an appropriate mix of fiscal and monetary policy, I believe policies of the past three years have, on the whole, been reasonable. The fiscal action of June 1968 was three years overdue, but better late than never. Subsequently. Federal expenditures have gone up at a more modest 7 percent annual rate, compared with a 14 per cent rate in 1966–68. (See chart II.) In the past five quarters these expenditures have risen at about a 10 per cent rate, and I should not think that a greater rate would be in the long-run social interest. Total Federal, state and local government expenditures now amount to about 32 per cent of gross national product. Expenditures of Federal and state and local governments combined are increasing at about a 9 percent annual rate.

Growth of Federal expenditures at a 7 per cent annual rate in the last three years has been the net result of military expenditures declining at a 3 per cent rate and of non-defense expenditures growing at a 13 per cent rate. In the last five quarters, nondefense expenditures have risen at about a 20 per cent rate. If military expenditures cease to decline and other expenditures continue their present rate of growth, there will be a sharp upturn in the rate of growth of total Federal expenditures.

Experience seems to indicate that a change in Government expenditure policy would not be effective for solving the employment-inflation problem. Manipulations of Federal expenditures are so cumbersome that they are likely to have their effects at uncertain delayed times when they will generally cause more harm than good. Similarly, with respect to the manipulation of tax rates. The timing of effect of changes in tax rates and tax rules is uncertain and problematic.

Present provisions for Federal Government expenditures and for Federal taxes are such that it is estimated the Federal budget under conditions of high employment would be yielding a slight surplus. (See chart III.) In my opinion, no steps should be taken to raise expenditure growth rates or reduce tax rates to alter this relation. The effect, if such there was, would very likely come at just the wrong time.

With respect to monetary developments, I believe they were on the whole reasonable in 1969 and 1970. The stock of money increased at about 4 per cent rate compared with a 7 per cent rate in 1967 and 1968. (See chart IV.) A move to less expansion was necessary if the excessive growth of total spending were to be limited in order to reduce the rate of inflation, and this move was relatively moderate. It may be that a sharper reduction in monetary growth would have been desirable in order for total spending and inflation to be affected more rapidly.

Looking more closely at the monetary growth of the past two years, we see about 3 per cent growth in 1969, a rate low enough to produce a monetary basis for some correction of excessive total spending and inflation trends. Then from the first quarter of 1970 to the fourth quarter, growth was at a 5.4 per cent rate. In the past two quarters, growth of money has been at 9.4 per cent rate. In my view, monetary growth may already have become excessive in 1970. I feel yet more certain that the 9.4 per cent rate of the past two quarters has been far too much. If the monetary growth of the recent past has been too rapid, it is too early as yet to see the adverse effects. Experience has shown that changes in the rate of growth of money affect total spending with a lag of about two or three quarters, and that prices are affected with a further average lag of another three quarters.

Total spending, that is, nominal GNP, seems to me to have grown at a reasonable rate from mid-1969 to late 1970, namely, at about a 4 per cent rate. (See chart V.) Subsequently, in recent months, spending growth seems to have been at about a 10 per cent annual rate. I am fearful that if we were to continue to increase the money stock at the 9 per cent rate which has prevailed since the fourth quarter of 1970 we would be laying the basis for excessive growth of total spending and a resurgence of inflation.

The recent rates of growth of money may be compared with some observations that this Committee has made on the subject in the past. The Committee has emphasized the desirability of a rather steady growth of money and avoidance of large and sudden policy shifts. For example, in 1968 this Committee suggested money growth be kept within a 3 to 5 per cent per year range. With this view I agree. The great growth of money this year has been inconsistent with such a policy. The lagged effect of this growth of money may give us a burst of total spending just when it is not desirable, thereby leading to accelerated inflation.

While we have learned from experience that monetary actions can be very powerful, we have also learned that we do not have adequate knowledge to manipulate them usefully, in a short-run, fine-tuning way. This feature it has in common with fiscal policy. The best course for both fiscal and monetary policy is to avoid manipulations. A steady high-employment budget balance, a growth of Government expenditures commensurate with expanding needs of a growing society, and a steady growth of the money stock, will give us the best chance for the economy to provide the greatest social welfare.

With respect to a reasonable growth of money for the next half year, we should rather rapidly draw back from the 9 or 10 per cent rate of the past half year. I would suggest that we get back to a 4 or 5 percent rate which would be sustainable for a relatively long period.

We are all very unhappy that there has not been more rapid improvement in the inflation situation, and that employment and production have not improved more rapidly. But, in view of the extreme inflationary trends that developed in 1965–68, subsequent developments have been the unavoidable price to be paid.

INCOMES POLICIES

There have been widespread suggestions that we might correct the inflation more rapidly by some version of incomes policy. These proposals are so multitudinous in nature, and generally so vague, that it would be impossible for me to comment upon them precisely. Let me only say that, in my view, the inflation beginning in 1965 was not caused by administered price and wage rises but by excessive total demand. Prices and wages were bid up by excessive total spending, which in turn resulted from extreme fiscal and monetary policy. Similarly, there is no basic cure for the inflation but restraint on total spending to be fostered by moderation in fiscal and monetary policy. The current inflation is not a cost-push inflation, but rather reflects the lagged effects of a demand-pull inflation.

Experience with incomes policies in this and other countries point up many problems with them. They are virtually impossible to administer, misallocate resources, slow economic growth, reduce consumer welfare, and reduce freedom. Rather, we need enforcement of anti-trust laws with respect to both business and labor and a recasting of labor law. This would be of benefit not only to the inflation and unemployment problems but also to consumer welfare, economic growth, and the balance of payments.

INTEREST RATES OUTLOOK

For the near future, the financial demands of the budget deficit and of an economic recovery, and the demands for loan funds due to anticipations of inflation, seem likely to put considerable upward pressure on interest rates. This is, in a sense, regrettable. But I hope that we will not foolishly attempt to keep interest rates down by the Federal Reserve buying more Government securities than would otherwise be appropriate. To do so would be to repeat the mistakes of 1965–66 and 1967–68, induce another acceleration of inflation, and yet higher interest rates. The only defense against high interest rates is to refrain, over a considerable period of time, from inducing excessive total spending which fuels inflation.

In January and February there were some who thought that the Federal Reserve could successfully and soundly foster continued decline of interest rates, particularly long-term rates. But such has proved not to be the case. Market forces have again provided the dominant elements in the money and capital markets and the practical immediate influence of the monetary authority on interest rates has proved to be minor.

PRIME RATE AND DISCOUNT RATE

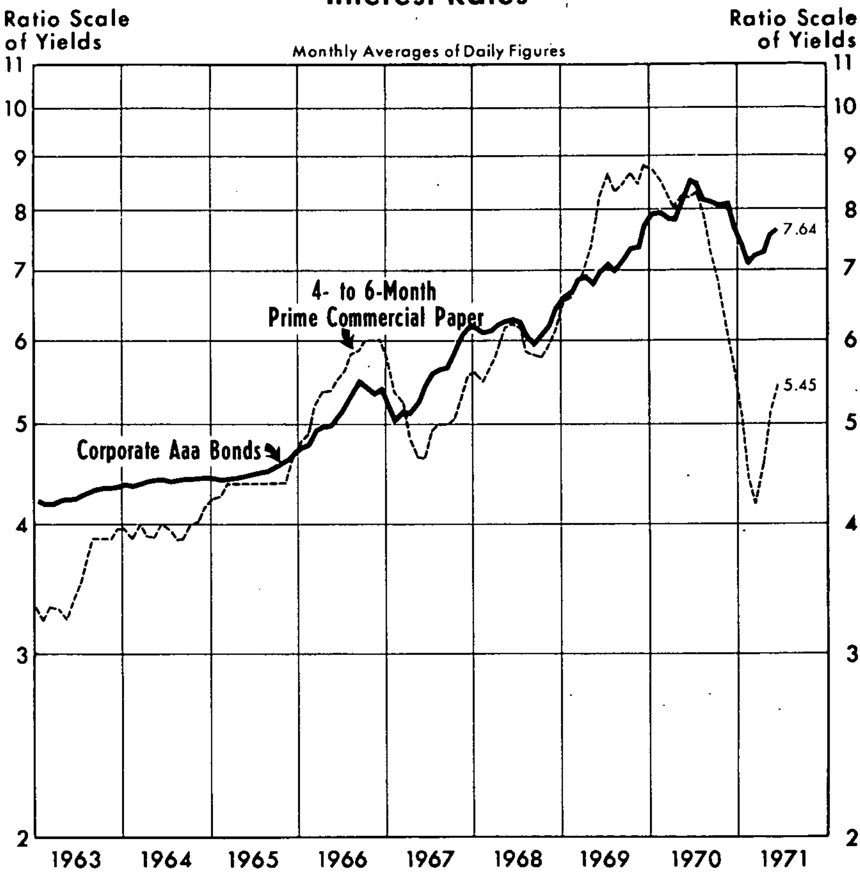
As market interest rates rise in response to supply and demand forces, it is reasonable to expect the rates charged by banks to rise along with the others, as illustrated by the recent move of the prime rate, even as it was reasonable for them to decline when other interest rates were declining. Similarly with respect to the Federal Reserve discount rate. If market interest rates rise, no social benefit would derive from the banks being able to borrow at a preferential rate. Keeping the discount rate far below the commercial paper rate, the prime rate and the Federal Funds rate in 1969 and 1970 did not help to keep down interest rates. Rather, such a policy necessitated rationing of funds by the Federal Reserve and provided a socially undesirable windfall to those banks that did borrow.

CONCLUSION

In conclusion, we live with the problems created by past mistakes. Both the inflation and our short-fall of production result from the past gyrations of policy. The best cure is to avoid making more mistakes similar to those of the past. We must be mature enough to recognize that there are no miraculous ways of suddenly curing the inflation and restoring employment. Fiscal and monetary policies that would inflate total demand more rapidly than at present run too much risk of a renewed burst of inflation. Then we would again resort to restraint with a result of more unemployment. Along with steady fiscal and monetary policy, we need to look to changes in law which will increase the efficiencies of the markets for labor and for commodities. These basic steps will give us a sound lower unemployment and higher production in relation to our potential.

Chart I

Interest Rates



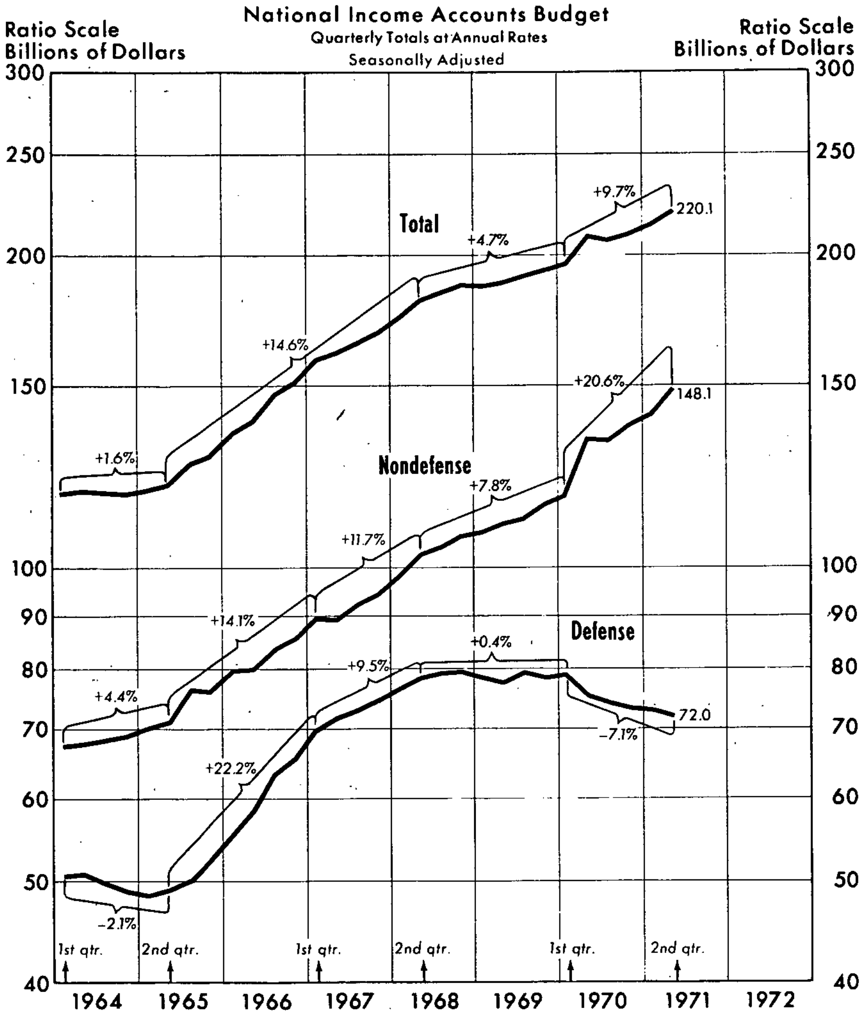
Latest data plotted: June

Prepared by Federal Reserve Bank of St. Louis

Chart II

Federal Government Expenditures

National Income Accounts Budget
Quarterly Totals at Annual Rates
Seasonally Adjusted

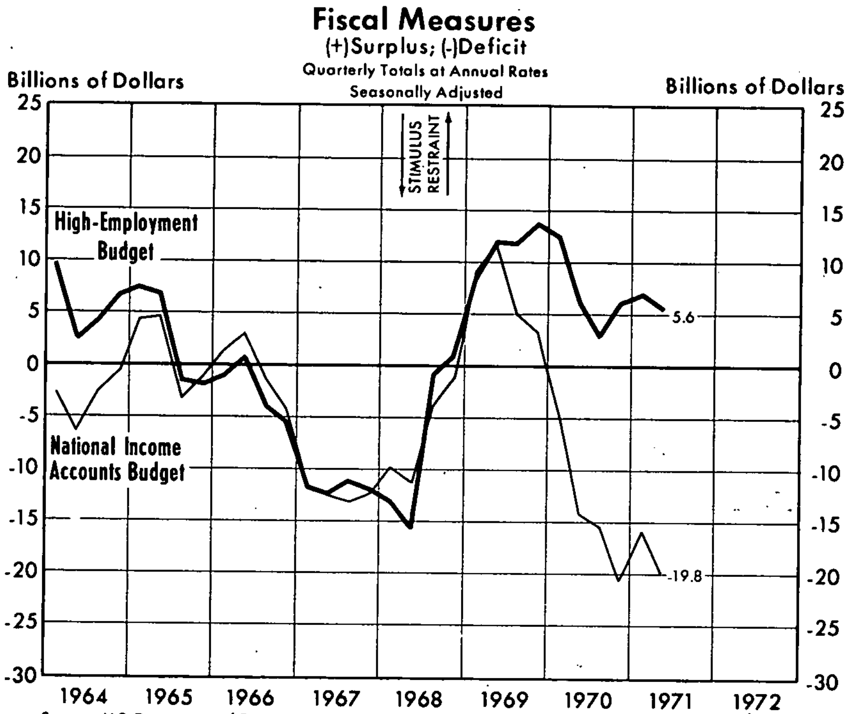


Source: U.S. Department of Commerce

Percentages are annual rates of change for periods indicated.
Latest data plotted: 2nd quarter preliminary

Prepared by Federal Reserve Bank of St. Louis

Chart III

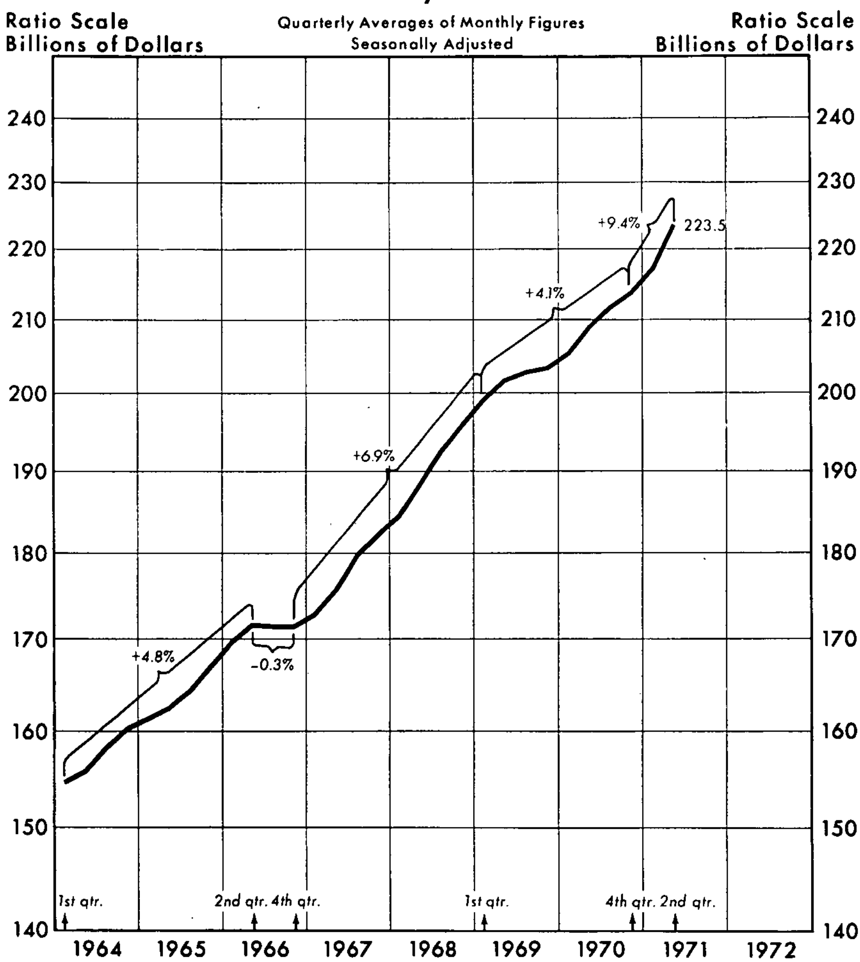


Sources: U.S. Department of Commerce, Council of Economic Advisers, and Federal Reserve Bank of St. Louis
Note: NIA budget for 1971 does not reflect change in depreciation rules.
Latest data plotted: NIA-2nd quarter estimated; HEB-2nd quarter preliminary

Prepared by Federal Reserve Bank of St. Louis

Chart IV

Money Stock



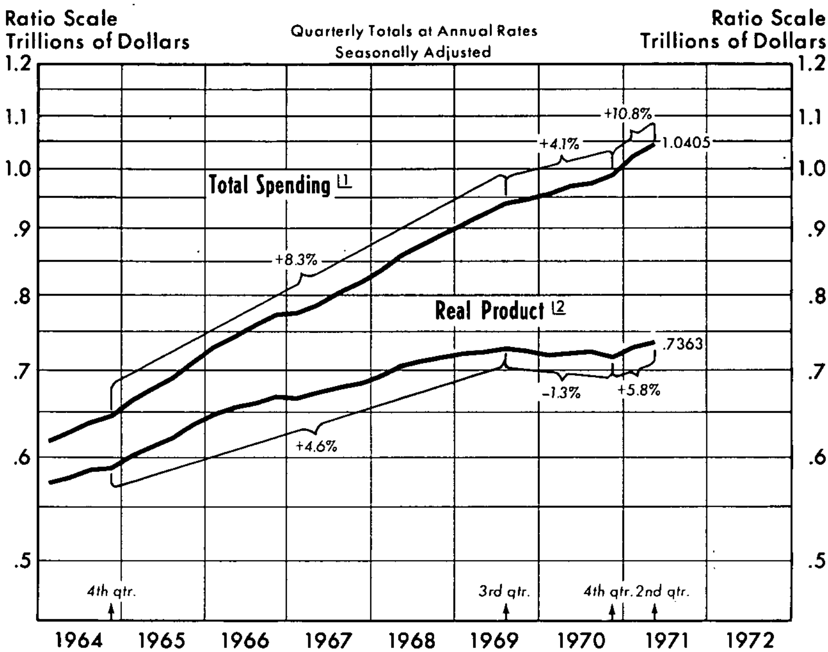
Percentages are annual rates of change for periods indicated.

Latest data plotted: 2nd quarter

Prepared by Federal Reserve Bank of St. Louis

Chart V

Demand and Production



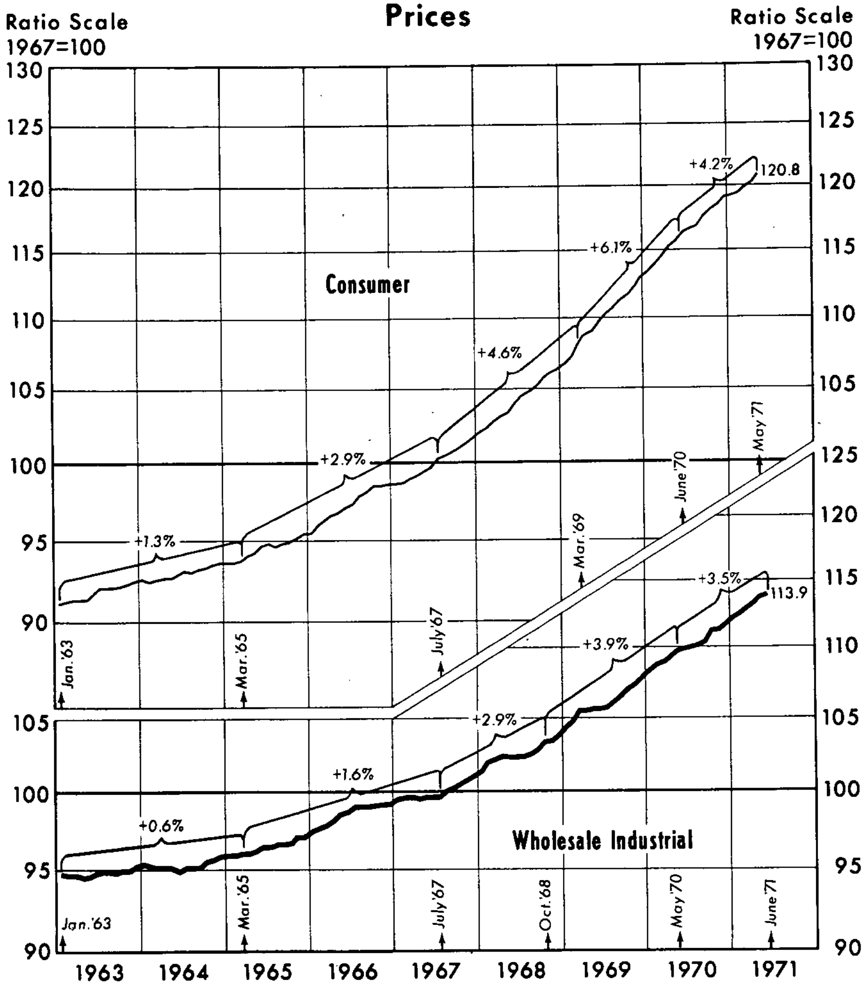
Source: U.S. Department of Commerce

[1] GNP in current dollars.
[2] GNP in 1958 dollars.
Percentages are annual rates of change for periods indicated.
Latest data plotted: 2nd quarter preliminary

Prepared by Federal Reserve Bank of St. Louis

Chart VI

Prices



Source: U.S. Department of Labor

Percentages are annual rates of change for periods indicated.

Latest data plotted: Wholesale-June; Consumer-May

Prepared by Federal Reserve Bank of St. Louis

Reprint Series
Number 65

Observations on Stabilization Management

A Speech by HOMER JONES, Senior Vice President, Federal Reserve Bank of St. Louis, to the Joint Luncheon, Southern Economic Association and Southern Finance Association, Atlanta, Georgia November 13, 1970

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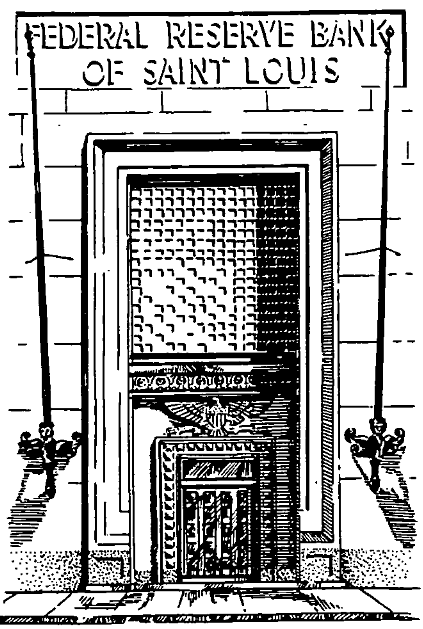

RESEARCH DEPARTMENT
Federal Reserve Bank of St. Louis

Observations on Stabilization Management

A Speech by HOMER JONES, Senior Vice President, Federal Reserve Bank of St. Louis, to the Joint Luncheon, Southern Economic Association and Southern Finance Association, Atlanta, Georgia, November 13, 1970

THERE IS a prevalent idea that dynamic government action is necessary to effectively restrain prices and promote employment. This has been the prevailing view during the past twenty-five years.

I wish to pose two questions: First, is there evidence that active stabilization management has, on the whole, been desirably effective in the last twenty-five years? Second, does that quarter century of experience suggest that active stabilization management can be desirably effective in the future?

We may list five classes of stabilization tools which are most commonly considered as means of achieving more stable high-level non-inflationary growth, namely, fiscal, monetary, investment funds flow control, changes of economic structure, and price and wage controls. I would like to look at each of these tools in turn.

Fiscal Management

Let us first look at fiscal management. In undertaking to judge the record of fiscal management, we are faced with a problem of measurement. There are a variety of possible measures of fiscal action: among these are Federal Government expenditures, high-employment tax receipts, national income accounts tax receipts, high-employment surplus or deficit, and national income accounts surplus or deficit. Scholars are far from agreement as to which of these measures best indicates the influence of fiscal management on total demand, or how they could be amalgamated as a single indicator of fiscal influence. In view of such a confused situation regarding the measurement of fiscal management, it is no wonder that fiscal management has been less than successful in the past twenty-five years.

In any case, no matter how one measures fiscal management, I find no evidence that these magnitudes have followed courses which, in any plausible way, have been related to a desirable course for total spending, for real product, or for prices. In my reading of economic history, I do not find a consistent and predictable relation convincingly demonstrated between any fiscal measure and economic activity. Indeed, I would suggest it is more likely that the fiscal management which we have had has contributed to instability and to limitations on average growth, either directly or indirectly, through its influence on monetary management.

Let me turn to the question of what we now know about whether fiscal management may in the future be able to contribute to stabilization, high employment and growth. That fiscal variations have not on the whole contributed to a successful course of the economy in the past does not necessarily mean that they have not had an effect, or that they could not conceivably have a desirable effect in the future.

Whether fiscal manipulation might be capable of promoting desired economic ends in the future depends on two considerations, the economic and the political. With respect to the economic, we have not been lacking in theories about fiscal influence during the past forty years. Where we stand now about the theories, I shall not attempt to comment. But I shall comment on what research seems to show about a relation of fiscal developments to economic activity. My chief point is that research has not found consistent relations, independent of monetary action, between any of the standard measures of fiscal action and simultaneous or subsequent changes in aggregate economic events. The large models which have dealt with this matter have not successfully disentangled the influence of fiscal from the influence of monetary factors. Casual empiricism of observing the course of fiscal management, together with total spending, real production, and prices, does not yield positive conclusions. Our econometric studies at the St. Louis Federal Reserve Bank have not yielded positive relations between high-employment taxes or the high-employment surplus-deficit, when the monetary factors have been held constant. These studies have yielded some positive results with respect to the influence of Federal expenditures, but they are not very impressive.

Some observers may not be impressed with our results. In response, I can only say that we await either suggestions as to how we can make better tests, or the results of the work of others which find, from experience, plausible useful independent relations between fiscal actions and crucial economic developments.

But, if we were to find significant and stable relations between fiscal actions and economic developments, could we put them to practical use? Successful application of the knowledge would depend upon useful forecasting of other economic variables which would need to be offset or supplemented. Given the general record, I think we cannot be optimistic about the imminent practicality of such forecasting.

Finally, experience with respect to the political implementation of fiscal management is not impressive. I am not sure that the political problem has made past experience any more adverse than it otherwise would have been; but even if economists did know how to actually manage a budget beneficially, the application might very likely be adverse after political manhandling. It may be that the less it is suggested that the budget is something to be manipulated, the less likely politically we are to get adverse budget results.

Monetary Management

Let me now turn to our monetary experience. On the whole, it is similar to the fiscal. As in the case of fiscal management, we are plagued by lack of agreement as to proper magnitudes of measurement. But using any of the common measures, examination of the experience of the past twenty-five, fifteen, or ten years, does not indicate that active monetary management has in fact contributed beneficially to stability and optimum levels of employment, prices, and growth. Here again it seems possible that fluctuations in strategic monetary variables may have contributed more to failure to achieve these objectives.

But, even though active monetary management may not in actuality have contributed desirably, experience suggests that monetary developments have had reasonably predictable effects on total spending, real product, employment and prices. Casual empiricism, the research of others which is persuasive to me, and our own econometric studies at St. Louis, have long indicated strong, roughly predictable, relations between monetary action, intentional or unintentional, and the course of the economy. Here, as with our own studies of fiscal management, I realize that many students of these matters may not be fully impressed, if at all. But, here again, we are open to suggestions as to better means of studying past relations between monetary actions and total spending, real product and prices.

Assuming that we have found relations between monetary actions and the course of strategic economic variables, does this mean that we can expect to engage usefully in active monetary management in the future? Here again, we may question whether active monetary manipulation, any more than fiscal, can be expected to eliminate short-run fluctuations as envisaged by the proponents of fine tuning. Because of lags in the effect of monetary actions, we would have to forecast successfully, many months in advance, the course of other factors to be offset or supplemented, and the forecasting record is very poor. And, while I believe that we have positive results regarding monetary effects, we cannot claim that the timing of results is a very exact matter. I therefore conclude that we cannot in the near future engage intelligently in short-run manipulative monetary management.

Other Stabilization Tools

I now turn briefly to three other social controls which are frequently offered as stabilization tools, though sometimes only as supplements to general fiscal and monetary controls: namely, administrative allocations of the flow of investment funds; structural changes in economic institutions, such as changes in the labor market; and wage and price controls.

Proposed and actual investment fund allocation management really has nothing to do with stabilization management, but rather with providing a general alternative or supplement to allocation by means of market forces. It is frequently said that tight money squeezes especially and unjustly particular fields of real investment. This matter has entered into rationalizations of Regulation Q management. Actually, adverse effects on certain sectors, such as housing, arise not from tight money policy but from great monetary expansion as in the 1965-68 period. A steadier monetary expansion, which would probably be desirable on all counts, would remove much of the alleged need for administrative allocation of investment funds. But if there were still a call for allocation different from that provided by the market, this would have nothing to do with stabilization management but with continuous noncyclical economic policy.

With respect to structural changes such as reducing unemployment through improvements in the labor market, these stand on their own merits and have nothing to do with cyclical stabilization policy.

With respect to labor power and corporation power, and their contributions to inflation, I am inclined to say that possible improvements here have little to do with cyclical stabilization. But I suppose there are two ways in which wage-price controls or guidelines may be brought in. First, proponents suggest that wage-price controls are an instrument that should always be available and would come into play in the boom phase of a cycle and then could be held in abeyance at other times. A second, closely related, suggestion is that wage and price controls will be used continually. In this latter instance fiscal and monetary policy would foster a total demand so high that production, employment, and growth would be maximized while demand would not be dissipated in higher prices.

Experience with wage-price guidelines has not been propitious. The guidelines were instituted at a time when we were not having an inflation problem in 1962-64. Then, as they obviously failed in 1965 and 1966, they were quietly dropped. Now, in a time of recession (I do not consider this an evil word, or that it is evil for anything ever to recede, ever so slightly), those who inaugurated the guidelines in recession and abandoned them in inflationary boom propose their reinauguration as a price panacea. It would appear that wage-price controls, rather than being an instrument to be always in effective operation or to be used in boom and laid aside otherwise, are instead to be abandoned during inflationary boom and at all other times to be actively used. On the contrary, I believe, as Paul Samuelson has recently written, "No mixed economy has been able yet to find a satisfactory incomes policy." (New York *Times*, October 30.)

I personally conclude that experience shows wage-price controls have no semblance of beneficial practicality in any economy which retains any pretence of market determination of the allocation of resources. And we have no evidence that a chronic policy, pressing up inordinately on total spending, will give a higher or steadier employment or production than otherwise, without chronically accelerating inflation. The apparently widespread popular call for administered prices and wages indicates that we have done a poor job teaching economic history and of teaching the role of prices in allocating resources and product.

Historical Background

It may be useful to try to reconstruct why and how we developed the dogma that active fiscal management was necessary and practical to avoid stagnation at and about a low level of activity. I suggest that out of desperation in the 1930's we had to find something that we could do. The desperate and largely wrong panaceas of the Keynes of 1936 resulted because the prescriptions of the Keynes of thirteen years earlier were ignored.

Possibly we now have again an opportunity to profit from the Keynes of the *Tract on Monetary Reform* of 1923. Then, Keynes was fighting to achieve monetary management for sound domestic economic stability, freed from the shackles of fixed exchange rates. But Keynes lost, and so occurred one of the great tragedies of modern economic and political history. England returned to the shibboleth of the fixed exchange rate, and this, in turn, led to the suicidal world monetary policies of 1925-33. Then, in desperation, were created all the elaborate theories that fiscal management could substantially solve the problems of economic instability, and along with this the theory that in the absence of finely-tuned fiscal policy an economy might most likely stabilize at or fluctuate far below optimum employment and production.

Now we should put ourselves back with the Keynes of 1923. We should abandon the chimera that it is either necessary or practical to actively manage a fiscal policy in the interest of stable high-level economic activity. Our experience indicates that, even as in 1923, the main key to a satisfactory operation of the economic system is not to permit a fixed exchange rate system to dictate disastrous monetary contraction, as in 1925-33. The other side of the coin is that, given this freedom, we should equally avoid inordinate monetary expansion.

It may be instructive to consider how much happier we might have been in the last forty years if Keynes had been successful in 1923-25 – if Britain had not hung about her neck the albatross of a $4.87 pound, and the other leading nations of the world had not subsequently been preoccupied with defending their currencies. We would have had a good chance of avoiding 1929-33 and all the troubles which that period brought in train economically, politically, and militarily.

If we have had reasonably good economic performance during the past twenty-five years in this country, and in most other countries, we cannot ascribe it to the success of active manipulation of fiscal and monetary management. Rather, it is due to the inherent strength of what are still, on the whole, free market economies. It has depended upon avoiding, on the whole, shocking monetary and fiscal mismanagement such as in England in 1925, and in the United States in 1929-33 and 1936-37.

Having said so many negative things, let me make a few positive remarks. In the field of fiscal management we should avoid gyrations of the high-employment surplus or deficit. For purposes of promoting national saving, investment and growth, I would prefer a substantial high-employment surplus. But this is less crucial than budget stability. Similarly, in the monetary field, the most important objective for policy is to avoid gyrations. Until we can get better information upon which to base our actions, I believe a steady growth of money gives a better chance of getting a steady growth of total spending, real product and employment, and a tolerable price trend than does any other procedure. In such a fiscal and monetary setting, the market economy has a better chance of following the high stable growth trend which we desire than does any alternative procedure apparent to us at present. But this is not easy. We know from experience that avoiding unintended gyrations in strategic fiscal and monetary variables requires eternal vigilance.

Conclusions

In conclusion, I have two points, one concerning what economists should be teaching, and the other dealing with the problem of current policy.

Economists have spent a generation teaching that there are some magic tools of fiscal policy, and more recently of monetary policy, which, if managed according to some scientific principles, supposed to be well known to the experts, can be used and must be used incessantly and with finesse to give us satisfactory operation of the economy. Will the profession now have enough fortitude to face and teach the facts? We should now, while saving as much face as possible, tell the public that we do not know how to finely manage the economy, and that, the way the fiscal and monetary tools have been used in the last twenty-five years, manipulation has probably done more harm than good. We should inform the public that the best we can do – and it will be a major improvement – is, on the one hand, to avoid mistakes such as the monetary and fiscal excesses of 1965-68 and, on the other hand, to avoid letting monetary expansion be led around by fixed exchange rates and by money market conditions.

Finally, where are we just now and what course shall we follow? Despite my negative remarks about active, positive fiscal and monetary management, bad management can give us massive trend disturbances, as did the monetary collapse of 1929-33, the war inflations, and the inflation of 1965-69.

Such massive disturbances, which could and should have been avoided, not only have their immediate social evils, but they create the problem of what, if anything, fiscal or monetary management can do to restore stability. It is this last problem we have now been struggling with for the past two years.

Let me emphasize that our present not too happy situation derives from gross fiscal and monetary mismanagement in 1965-68, when with shocking suddenness, we accelerated Federal expenditures, turned a high-employment surplus into a great deficit, and accelerated monetary expansion. Having made these grave errors, which brought inflation and expectations of inflation, what to do has been a great problem.

It is sometimes said that we are experiencing the worst of all possible worlds – we continue to have inflation and real product is not growing. But I believe that this situation is the inevitable result of the best possible choice among the three alternatives which were available to us. First, we could have fostered a total spending which would have temporarily better maintained production and employment, but which would have provided accelerating inflation.

Second, we could have achieved a faster reduction of inflation, but that would have involved less real product and more unemployment than we have achieved. Third, we could choose a course between these alternatives, and this we have done.

The course we chose has meant, is meaning, and, if pursued, will continue to mean, only slowly declining inflation, retarded growth of real product, and rising unemployment. If we had not made the gross errors of 1965-68, we would not subsequently have had the painful choice between accelerating inflation and the restricted production and employment which we are now experiencing.

Given our decisions and our present situation, we can now expect that, if we avoid erratic fiscal and monetary action, real product and employment growth will accelerate gradually over the next few years, and the upward trend of prices will end or become nominal. In time we can obviate the results of the 1965-68 mistakes and can achieve a practical optimum of employment, real growth and price trends.

In my judgment, given the errors of 1965-68, subsequent developments have been as good as could be expected. One trouble has been that the economics profession has led the public to believe that there could be miraculous correction of the price trends without pain. That was not possible in 1969-70 and it is not now possible in the immediate future.

We should not pretend to the public that there is some "game plan" which will magically and painlessly avoid the results of the errors of 1965-68 along some time-path of short duration. It is sometimes said that the fiscal and monetary actions since June 1968 or since January 1969 have grossly failed. I do not think they have failed. They have done what was in the nature of the economic universe that they could accomplish. And I cannot see, on a basis of hindsight, that we could have made another choice that would have given us a better pattern of results.

Chairman PROXMIRE. Thank you very much.
Mr. Modigliani, go right ahead.
You have no prepared statement?

STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. MODIGLIANI. Mr. Chairman, I am afraid, as you perhaps know, there was some failure of communication in connection with my appearance and although it had been discussed for some time, I was only firmly notified over the weekend that I would appear today. The pressure of other work has prevented me from writing out a statement. You will have to put up with me, relying on my oral testimony. Nor have I had time to prepare a polished statement and a comprehensive program or policy for you to follow. All I can do is to share with you my concern about the present state of the economy and give you a broad idea of the kind of measures that I feel Congress ought to push, whether or not the administration is asking for these measures.

I would also like to make another statement.

Mr. Chairman, this appearance today marks an important event for me, because, for several years now, I have felt that I could not in good conscience continue to provide advice and counsel to an administration, to a series of administrations, that pursued a policy in Southeast Asia which was leading to bloodshed, and the support of a corrupt government, and I have felt I would not therefore provide advice. I have changed now, because I feel there is a glimmer of hope. I have been very impressed by the Senate reasserting its functions, commencing with the Mansfield amendment, and I am hopeful that, by the time the draft bill is completed, there will be some such statement in that law.

Also, I have really been very much concerned with what has happened to the economy and the administration's program for handling or not handling what is happening, and that is the second reason why I felt that I should come out of retirement, as it were, and tell you what my feelings were about the situation.

Chairman PROXMIRE. This is most encouraging. I will tell Senator Mansfield. I know he will be delighted to hear that one effect of his resolution is that we are going to get better economic advice.

Mr. MODIGLIANI. You are very kind to say so. I am not sure it is better advice.

Chairman PROXMIRE. I am sure it is better.

Mr. MODIGLIANI. Perhaps, it is a good idea to start out by expressing some disagreement with some of the propositions made by my colleague, Mr. Jones. I agree with much of what he said, but I disagree with his diagnosis of the present situation.

The administration seems to tell us that they are very pleased with the remarkable recovery we are making. I submit that, if you will look at the facts, you will find that the recovery is miserable and is nothing to brag about.

In the first quarter of this year, the revised GNP figure, real GNP, seems to be put at $730 billion. That looks like a $14 billion rebound from the previous quarter: but you must realize that the previous quarter was very much depressed by the strike and the first quarter was conversely boosted by the purely transient recouping of the losses of the strike. If you take an average of the two quarters to wash out the effect of the strike, the real GNP was $723 billion; or, below the third quarter of 1970, suggesting that up to the first quarter we had actually brought to a halt and reversed the very sluggish recovery which had begun in the second quarter of 1970.

Now, if you look at the very last figures which have been released—unfortunately, I have not had access to them; I have just seen some reference to them—we are told the real GNP rose by $6 billion, roughly to $736 billion. This is a rate of growth of only about 3.6 percent. That is no more than roughly the long growth potential of the economy and therefore makes no dent whatever in the 6-and-plus percent in the unemployment rate which we now have.

Furthermore, it is generally agreed that the figures for the second quarter were somewhat boosted by another transient effect; namely, accumulation of inventory in view of a likely steel strike in the third quarter. When you allow for this extraordinary boosting effect, I think the growth in the second quarter can only be regarded as dismal and disappointing.

As a matter of fact, you will notice most people expected a larger increase in the second quarter, and the evidence for it, if you need some, is Mr. Jones, himself, gives us a chart in which his figure for the second quarter was $742 billion. That was more or less the modal forecast, an increase of about $10 billion over the previous quarter. And the truth has been just over half as much, $6 billion.

Now, it is disappointing to be told the administration is very pleased with this development of the economy, and to make us swallow the proposition that we ought to be satisfied with it.

What have they done? They have merely scaled down the modest goals they first set up.

So, what they are saying is, "We are doing very well because we are no longer aiming for something which was too high, but we are aiming for something lower."

On top of that, we hear the President's newly appointed official spokesman for economic affairs, tell us that we should forget the 3.8 percent about which the administration spoke in the first report to the Council. As you remember, they spoke of 3.8 percent as the target. You should forget the 4 percent everybody agreed was the sensible target, because we are told by Mr. Connally that 4 percent in this country has never been achieved except in wartime. And, if I may quote him, he said: "The American people are not willing to continue the war to get employment down to 4 percent."

I submit this is one of the most incredible statements one has ever heard, particularly coming from an administration which has the peculiar distinction of having both a war and 6 percent unemployment. For one thing, it is not even factually correct.

Furthermore, Mr. Connally seems to believe that there is indeed a connection between employment and war, that there is only one way for this country to have high employment, and that is to have war. Because he tells us next that the reason why unemployment is high is because the President has been cutting down on defense expenditures.

Does he not know one can replace certain expenditures with others? The administration does not know that there are ways of stimulating the economy; that if the defense expenditure finally goes down there are thousands of things for which we need funds and we can spend money on?

This pretense of satisfaction with the growth of the economy is particularly disturbing in another respect, because it leaves the administration to do nothing in terms of fiscal action, and it also encourages the kind of sharp criticism of the one Agency which has been pursuing a sensible policy; namely, the Federal Reserve. Homer Jones has referred to this so-called rapid growth of the money supply. I would like, at this point, to comment a little on this latest fad that comes to us from Chicago, the fad of what I call the money-supply watchers, watching every wiggle of the series, and who are shouting holy murder if that series for one moment of one day arises above some magic figure, say, 5 percent.

I am afraid I must express at this point, Mr. Chairman, that I think this committee may have some slight responsibility for having encouraged that fad by some pronouncement made in the past. As I have said before this committee, and I will say again, there is no magic figure; just as there is no magic figure which is appropriate for the speed of your car. It is not 40 miles an hour or 50, or 60. It depends on where you are going; it depends on what road you are traveling; it depends on the conditions of the road. The only way of assessing what is an appropriate growth of money supply is to ask yourself: What is the appropriate growth of aggregate demand in a particular period of time? And many wise and respected economists who have asked themselves this question, in the fall of last year, have concluded that for the year 1971, or for most of 1971, the appropriate rate of growth of the money supply can be no less than 8 percent and probably substantially higher.

Now, you can ask: How is that figure reached?

Well, you can reach that figure in two stages. First, you ask yourself how much of a rise is appropriate in money GNP and then how much money growth is needed for that GNP rise.

What do we need in terms of money GNP growth?

First, we need roughly 4 percent which is the long-term trend, but that would not make any dent in the unemployment which we now have.

We have 2 percent unemployment in excess of the original target, and even if we got a modest reduction by 1 percent, let us say from 6 to 5, a reduction of 1 percent in unemployment requires approximately between 2 and 3 percent growth in real output. Four percent and 2 to 3 percent means 6 to 7 percent. Beyond that, you have to recognize that prices are presently rising, and no measure we can take short of creating massive unemployment is going to make the rate of change of prices substantially below 4 percent.

Hence, money income needs to rise by something like 7 plus 4, which makes something like 11 percent which, in effect, is the rate of growth we have had in the last two quarters. And, as I just pointed out, this growth was rather on the sluggish side.

So, money income needs to rise something like 10 or 11 percent.

So, how much must the money supply rise?

If you want velocity to be constant it has to rise as much; but if you are in a period where you need to bring interest rates down from where they were, somewhat lower than they were before, then you need a larger rate of growth of the money supply. Last year, in 1970, the 3-month Treasury bills rates averaged 6.5 percent. I think this year we ought to aim at something like 5 percent; not substantially different from 5 percent. If you are going to bring down the interest rate by that much, you need an additional amount of growth in the money supply.

My conclusion is that nothing would surprise me about a required rate of growth of the money supply in the order of over 10 percent, if we are to move toward the target of not increasing unemployment but rather decreasing it, toward a target of 5 percent by the end of the year.

It is these considerations which lead me to think 10 percent is nothing to be worried about for a while. Mind you, there are conditions in which 2 percent is too much, but at the present time, under the present circumstances, 10 percent is fine.

Where does the 5 percent come from?

From the fact that under normal conditions you will need something like 3.5 percent for growth of real output, something like 2 percent for price growth, or 5.5 percent. And over the past decade we have had another circumstance: Interest rates have been gradually rising, and that allows the money supplies to rise less. Thus 3 to 5 percent was reasonable under the circumstances. Today, the reasonable figure is more like 10 percent, or over.

Let me add another point: You look at the actual rate of change of money supply, and it has been more like 12 percent, and everybody is terribly excited about this. People look at this money supply, they look at its wiggling from week to week as though this money supply had objective existence as though it was something you could touch, that anybody, any fool, could measure.

How many people realize the amount of adjustment and sophistication that goes into producing that series?

One starts out from deposits, makes all kinds of adjustments, makes all kinds of decisions as to how to treat this and that. The latest decision on how to treat the liabilities of Edge Act corporations, for example, is a doubtful conceptual adjustment in order to take care of certain statistical problems. And, on top of that, you multiply the figure by some very substantial number which is called the seasonal adjustment.

Now, I have strong reasons to believe that the seasonal adjustment is significantly in trouble since the recent revision of the series. We will not go into detail here. You will find in a recent release of Salomon Brothers & Hutzler, a comparison of the seasonally adjusted money supply of 1971 with the money supply of 1970, and you will find every wiggle that was there in 1970 is there in 1971—just about every wiggle.

And by the way, in 1970, the money supply in the first half rose appreciably faster than in the second half. I have taken a little more trouble and looked back for the last 6 years, and I am able to report that in every one of the last 6 years this seasonally adjusted money supply rose faster from January to July than from July to January.

Now, anybody that knows anything about seasonal adjustments know that means that, except for a miracle, they are not adjusted correctly; we seem to underestimate the seasonal adjustments for the first half of the year; if so, the money supply in the first months of 1971 has not really been growing as fast as it seems to.

Mind you, I do not want to make too much of possible shortcomings in the seasonal adjustment of the money supply. My hunch may even be wrong. Rather, what I am getting at, is that it is foolish to pay so much attention to the wiggles of the measured money supply, just as it would be foolish to drive your car using as the sole criterion how far your speedometer reading deviates from some magic figure, especially when you know that your speedometer is a pretty erratic gadget. Furthermore, if at some point you find the speedometer is registering 80 miles an hour, before you bawl out the driver, I suggest you ask yourself: Are you crawling or driving like mad? And if you look out the window, you see we are crawling; we are not running like mad. As a matter of fact, I think the money supply grows too fast in the first half to prevent the crazy rides in marketplaces.

I would like to point out in particular how easy it is to misread things. If you look at Mr. Jones, he tells us the rapid expansion of the money supply led to the rapid decreases, recent rapid decrease, in interest rates. If you look at his two charts, the interest rate chart on the first page, and the money supply chart on the money-stock page, you will see that the interest rate fell very much just during the period when the money supply was rising most slowly; and in the period; namely, February, they fell very much, through early February while the money supply rose quite slowly, and they rose very fast since the so-called seasonally adjusted money supply began to rise very fast.

They rose very appreciably, and my interpretation for this is that indeed the increase in the money supply went but some of the way toward accommodating a sporadic increase in demand for money possibly, in part, of a purely seasonal nature. And I feel with all of the shouting against the Federal Reserve for running too fast, we are forcing the Federal Reserve into a restrictive type of policy. They are squeezing the market now and interest rates are going up in a way which is totally unjustified. We ought to settle for a sensible target level of interest rates, subject to adjustment in the light of further developments and not worry so much about the wiggles of the money supply.

Now, this brings me to the next question; namely, can we have a faster expansion of the economy without running into terrible trouble in our fight against inflation?

Here, I think I understand your concern, and I think it is a justified concern. Let me develop a few considerations about it. First of all, I would like to stress that, in terms of my own analysis of the economy, in terms of an extensive analysis of the economy in the postwar period, I have reason to believe that the present rate of change of prices is out of control in the sense that it is not a predicable consequence of the series of events that Mr. Jones described before.

I completely agree with him, that the inflation was generated by excessive Government spending, brought about by the war, and compounded by political considerations which prevented the administration from asking for correct fiscal measures in time, plus some errors in the money-supply policy. But, again, coming back to the money supply, we are told from past experience that wherever the money supply has risen fast there have been horrible consequences, and people point to 1967 and 1968.

Well, now, it just turns out these 2 years are totally different. In 1967, the money supply rose, and thank God for it. It did help us to make that contraction minimal and pull out of it fast. In 1968, on the other hand, the money-supply growth was excessive. But let's not lump them together. There was nothing wrong with the high money growth of early 1967; in view of the slowdown that was a justified policy as it is today.

Essentially, then, we are paying today the delayed price for wrong policies made in the past. It is my view that the inflation is abating, and I think it is evident that it is. You can refer to the chart that Mr. Jones has brought over, to the price chart. You will see that every one of those graphs indicates that the rate of change of prices has been slowly abating, and it is my view it will continue to abate as long as we prevent employment from getting too high. As long as we keep unemployment above the 4.5-percent range, those prices will continue to slow down toward a 2- to 3-percent long-term growth which will tend to accompany a 4- to 4.5-percent unemployment rate.

Essentially, then, if we do that, we can expect to move back to a more moderate rate of price changes. Furthermore, we can bring that unemployment rate below 4.5 percent and still have no greater change of prices, no more than 2.5 to 3 percent, if we are prepared to take a series of manpower measures which have been suggested, which have been researched and on which more work needs to be done. And I hope the research in this area will continue, because I think there is a great deal of work that can be done in terms of reducing the amount of frictional unemployment below which we cannot safely go without creating inflation.

Anyway, I feel one can take the view that one has to be patient, let things take their course, look at real output, try to stimulate the economy, so we move toward a sensible area of unemployment and let prices gradually take care of themselves.

This creates some problems in the balance of payments. Those problems should be handled by a different kind of reform, reform aimed at more flexibility in international exchange rates. And I am presently working on a program in this direction; so, I need not go into this area now.

Of course, the American people are impatient. The Senate is impatient; the Congress is impatient; and they do not like the idea of standing back and waiting for the inflationary spiral to gradually work itself out.

Is there anything we can do to speed things up?

There are three answers. Two of these are answers that the "conventional wisdom" proposes: One answer is: depress the economy and create more unemployment, and, then, maybe prices will stop rising.

The second solution which belongs to the conventional wisdom is the solution Professor Galbraith has just advocated, in some form or another, and has been advocated by other economists; namely, to use some kind of price and wage controls, or some kind of price review board.

Like Mr. Jones, I feel this is a hopeless thing to do. I am not against it because I believe in perfect markets, or in the instant power of monetary and fiscal mix, or anything like that. I do not believe in it, because it will not work at this time. It will be a clumsy system. If it is for 6 months, it will do no good. It will take 6 months to get it going and by then it will be time to disband it.

It is my view that under peacetime conditions in this economy nothing really can be achieved by price and wage controls. Can you imagine Mr. Galbraith deciding what is an appropriate wage settlement in the steel industry, because that is the kind of thing he would have to get into. I cannot see that we are ready, or conditions warrant a measure of this kind.

I would like to quote Professor Samuelson, when he says that, "under some conditions, if used very rarely, these kinds of controls will work." Let's not get them worn out in useless circumstances. Let's keep them aside until they are really needed.

Is there any measure that can be taken?

Yes, there is a third course, and that is the wise course. If you really meant it, if you really wanted to bring inflation in wage and prices quickly under control, the only wise solution is the old and proved incentive system; namely, replace "jawboning" with so-called "backboning." This is an expression which has been introduced by Henry Wallich to refer to tax incentives to resist upward wage pressure. As you know, suggestions have been made, for instance, to increase the tax rate for corporations which grant wage increases above some guidepost agreed figure. I happen to think that this particular approach, though in principle is reasonable, would face a great deal of constitutional problems because it would involve discrimination in taxation. But I would like to suggest an approach which does much the same thing but is much simpler. That is to say, to apply the general principle that the law decides which expenses are deductible for the computation of taxes. I would say that wage increases in excess of some established guidepost are not a deductible expense for the purpose of calculating profits.

If you did that, what would you do?

In effect, any increase in wages granted over and above the agreed guidepost would come entirely out of net tax profits, instead of 50 percent of it being borne by the Treasury as under the present system.

If you like, I could expand on some further devices.

One could think of some more sophisticated kind of taxation on which you would impose an excess profits tax on the increase of profits per dollar sales above some base period and not allowing the deduction of wage in excess of the agreed amount in computing the markup.

With this second device, the corporation would not find it profitable to try to pass on the higher tax burden into higher prices.

These kinds of measures would be applied essentially to the corporate sector, and, indeed, I would not mind their being applied only to corporations above a given size, because, and here I do agree with Professor Galbraith—the problem of wage push nowadays is essentially the problem of big labor. When I said "inflation is abating," I was really referring to this: In the less unionized sector, the rate of change of wages is coming down significantly and will continue to drift down, but union wages are still rising, and this, in part, reflects a kind of a catchup phenomenon. During the period of the rapid inflation of 1965 through 1969 and 1970, it actually did happen that competitive market bidding for labor did push up the nonunion wages faster than the highly unionized wages, and the present endeavor of "big" unions is to reestablish the differential.

I do not have very much sympathy with that particular enterprise, and I would have no great qualms about having tax laws which would make it kind of hard to do that, at least under the present circumstances.

Now, I feel that if you are willing to face up to the task of quickly slowing down inflation, you should consider seriously my tax proposal, though, of course, it would not be a popular measure with big business and big labor. But otherwise let us stop talking about wanting a quick end to inflation, and above all let us stop talking about wanting to stop inflation by a means of prolonging the current high rate of unemployment, which really falls on that part of society which is less able to support the burden.

Let me then come to a summary of my recommendation. I would suggest that the first thing we need to do is to stop giving hell to the Federal Reserve for doing a good job.

It may be sensible to have a less stimulating monetary policy if we do engage in a somewhat more stimulating fiscal policy. Then, indeed, it would be appropriate for the money supply to rise less fast and for interest rates to edge up. I would prefer, looking to the future, a mix of policies which would rely less on monetary policy and more on fiscal policy for a lot of reasons, including the lags involved and including balance-of-payment considerations.

But let's, by all means, try to move ahead; let's get the economy moving, and let's try to get back to a sensible level of unemployment.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, both of you gentlemen, very much. You have been certainly most stimulating and interesting. And that was a fascinating proposal you just made, Mr. Modigliani.

Let me first disabuse you gentlemen of the notion that the Joint Economic Committee had ever argued at anytime that the increase in the money supply should be between 3.5 and 5 or 2 and 6 percent. What we said was that during any quarter in which the Federal Reserve Board varies from those limits, that they explain to us why. Obviously, there are times, such as perhaps the present, when it should vary from that. Then, we want an explanation.

But let me persist with you a bit, Mr. Modigliani, to point out why some of us feel that some policy like this makes sense.

We have seen a number of studies, not only from Mr. Friedman but other studies of the Federal Reserve Board policies, in which we have found over the years—not this Board of course but over many years—that the Federal Reserve Board has often been wrong. In fact, it has been wrong far more often than it has been right. One reason for this is because there is an obvious tendency to respond to the situation that you have statistics on—and that was last month. And then there is a lag between the increase in the money supply, for example, and the stimulus for the economy, or the decrease in money supply's rate of increase and the restraint on the economy. That lag may be for a year; it may be 18 months, and forecasting is still rather primitive. The National Bureau of Economic Research indicates economic forecasting is pretty good for 6 months, and after that you might as well ask your friendly taxi driver what is going to happen. Economists just have not been very good.

So, for these reasons, we are concerned with erratic changes which anticipate the situation 12 or 14 months from now, in which we have found that the economists are just not very good at forecasting.

What is your response to that?

Mr. MODIGLIANI. Well, I agree with you that there are lags. I think again, I am very unhappy when Professor Friedman goes around bandying figures like a 18-month lag. That is really a very inaccurate statement. What is meant——

Chairman PROXMIRE. I am not quoting.

Mr. MODIGLIANI. That goes around as the kind of thing being said.

It is quite true that monetary policy operates with lags, which means that some of its effects are spread over some time. It does not mean it begins to work 18 months from now; it begins to work right now. In fact, much of the effect occurs in the second and third quarter, some spills over into the fourth and fifth.

Now, at the present time, what I am suggesting in order to judge Federal Reserve policy, is first of all to ask what is the needed increase in money GNP. I know I need to provide enough money to transact a larger GNP. Furthermore, if you are talking about the danger of overheating, I think the danger is far away from now. We have a lot of unemployment, and all of the projections I have seen from anybody suggests our present policy, assuming the Federal Reserve goes back to a much tighter policy, reacting to the criticism, is for a very sluggish continued recovery.

Chairman PROXMIRE. Let me interrupt to see if I can get you and Mr. Jones on the same track. I do not know how anybody can deny the fact we are far from a cost-push type of inflation. After all, we have 5.5 million out of work, the largest number in 10 years. Our plant capacity is operating at 75 percent of capacity. We are far below the situation in which a sharp increase in demand should cause any projected shortages. But the argument by Mr. Jones has been quite different. He said the expectation of an increase in the money supply is the thing we have to be concerned about. I think that many people share that view. What is your answer to that?

Mr. MODIGLIANI. My answer to that is it is most unfortunate that the people have been sold a bill of goods, and I do agree that right now the growth of the money supply has become a sensitive issue. In fact, Professor Friedman has had the gall of bragging about the fact that whether or not maintaining a money supply growth within 6 percent is really important, now when everybody believes it, it has become important.

I think we need to educate people to the fact there is no such magic figure, that there are different appropriate figures at anytime—which does not mean the Federal Reserve is right. I agree with you, if you look at their record it is spotty. Generally, it has been a good record. I approve of most of the policies they followed from 1969 and 1970. I think one large error was in 1968. But if I look at the record from 1965 to date, I think, on the whole, it was a good record.

And do not forget, to some extent some of its failures are explained by the fact the administration was keeping everything confidential and secret and was not communicating to anyone the extent of the defense increases.

The Federal Reserve has to have some information to come out with what is appropriate. And if they are not told the facts, then you cannot blame them entirely for having made a mistake.

So, it is true, perhaps, that people are now getting so upset about that, that you have a hard time bringing down interest rates. Inflation is abating; I think the expectations are coming down, but everytime the Fed tries to bring down interest rates, there is a reverse effect because of the expectation that it will increase inflation. Let's try to educate the people to think otherwise, and I think that your committee could be influential in doing this. I think we have to warn people that they have been oversold on this. And this is very unfortunate. It is depriving us of a very valuable tool.

I think, at the present time, in any event, if my proposition about the seasonal adjustment is correct, you will find that in the second half of the year a 6 to 8 percent rate of expansion may prove quite adequate for what I have in mind, because, in fact, it would be larger. It would be smaller than appears in the first half and larger than appears in the second half.

So, I would think that probably something which would be more or less acceptable, 6 to 8, might prove sufficient. But I would not want to venture a very hard guess on this, because it is hard. You know, you have to play by ear to some extent. I am just saying: Let's not get overscared if it takes continued expansion.

Chairman PROXMIRE. Mr. Jones.

Mr. JONES. Well, I said that I thought I agreed with 75 percent of what Mr. Galbraith said, and when Franco Modigliani started out, I thought I agreed with 85—this went to 90, 95, and up to about 99 percent agreement. He is quite right, that in a short term sense, there is too much made of the money supply figures; that we have to think of them as they develop over a considerable period of time.

Chairman PROXMIRE. How about the specific point he makes, 6 to 8 percent increase of money supply for the rest of the year might be desirable?

Mr. JONES. I said 4 to 5. So, I feel he is too generous about the thing. And I think we try to manage these things with too fine a hand.

Both he and I agree about lags and about imprecision of our knowledge, and I agree that things are working out in a gradual way, improving the employment situation. So, I feel that we will best and most reliably get what we want, if we, in effect, sit tight. We are on a reasonable average course, both budget and monetary-wise and we should not think that we can guess with precision what to do.

With respect to the seasonal adjustment matter the experiences we have had indicate Professor Madigliani may be right. It has been very discouraging. Whether he is right now, that the seasonal adjustment is off in a certain way, I don't know. I have never been able to feel we could outguess the seasonal adjusters. We must wait for them to examine new information. So, I think for the time being the figures might be accepted as facts.

Chairman PROXMIRE. Mr. Jones, you seem to advocate pretty much of a sit-tight policy all along. You want to hold down the increase in money supply to 4 or 5 percent. You indicate we should not change fiscal policy, either by tax reductions or expenditure increases that would stimulate the economy. We have close to 6 percent unemployment now. If you recognize the problems with the statistics we have got for the last month, we do not seem to be making any progress with that. Most of the economists seem to agree that unemployment is going to be very high, 5 or 5.5 percent. That does not seem to bother you very much.

Don't you think we have a moral obligation to do something about people, Americans who want to work, especially when reducing the amount of unemployment would not increase demand inflation?

Shouldn't we try to design policies that would both increase demand, putting these people to work, and at the same time restrain whatever kind of expectation, whatever sort of inflation that might bring in?

Mr. JONES. Well, I regret the unemployment as much as anybody, and the hardship as much as anybody, but I think we are oversold on what we can do and how we can do it. You know, to bring up an old subject. I think we were oversold on the effects of fiscal policy in 1968. We were told that it was going to cure everything then in a great hurry, and it did not.

We have popular ideas about how much we can do and about the efficacy of fine tuning which really have no basis in fact. I think the best we can do is to avoid making tremendous mistakes, and we have in the past made tremendous mistakes on both sides. We are, unfortunately, at the present time, paying the price for some of these past mistakes.

Chairman PROXMIRE. I am not talking about so much fine tuning. Here we have a situation where we have a tremendous demand for housing, for example. If we were operating at the 2.6 million housing rate which my amendment put in the Housing Act of 1968, we would have 1.5 million more people at work. That is one area.

We have enormous demands in health.

We have great demands in combating pollution.

We have great need to improve many other areas, including manpower training in a far more imaginative and vigorous way. All these things would make a stronger country.

And you have a general feeling—frankly, I have not shared it; maybe I am beginning to change my mind, but I have not shared the feeling that seems quite common in the public, that we ought to have wage and price controls.

My questionnaire to my State shows that 70 percent of the people in Wisconsin would like to see wage-price controls put into effect, because they feel that we have to combat inflation. We also ought to move ahead and do all the things they want to have done. And yet you seem to advocate holding down in these areas of public expenditure which are necessary if we are going to achieve these things I talk about.

Mr. JONES. Well, I agree human beings have unlimited wants. We have unlimited needs. I never thought, or never belonged to the school of thought, that we had only limited wants or needs and that we have a basic situation of excessive production or productive potential. We have problems which Congress should consider, continually decide about the division of the gross national product between the public sector and the private sector. The total private sector is now amounting to about 32 percent of the GNP, and I am not saying it should not be 40 or 50——

Chairman PROXMIRE. I am very sympathetic with the notion we have to be very careful about moving the public sector too much into the act, because I do not think, by and large, this is as efficient as the private sector is in many areas, at least. But housing would be overwhelmingly the private sector. What concerns me about the policy you advocate—and there is a difference of a 4-percent increase and an 8-percent increase in the money supply. I think a 4-percent increase could be devastating to housing. It could mean higher interest rates. By far the biggest element in the cost of a home is the cost of the money. From the calculations we have, about 60 percent of the total cost of the monthly payments are in interest costs. And if we hold down the supply money, I cannot see any other effect but higher interest rates.

Mr. JONES. We disagree as to how we might get lower interest rates. We had the rise in the interest rates in the last few months, in spite of the most rapid increase in the money supply we have had in the entire post-war period. I think we need low interest rates. I hate a high interest rate world. I think the solution is a greater propensity to save and, shall I say, getting rid of the inflation. We need to look at the problem of what funds are to be available in housing at reasonable terms over the next 10 years and not be misled by the immediate situation and possibly make the situation worse over a longer period.

Mr. MODIGLIANI. Could I make a couple of comments, Mr. Chairman?

Chairman PROXMIRE. Yes.

Mr. MODIGLIANI. First of all, Mr. Jones has referred—as it is popular now—to the tax increase of 1968 as a failure. I would like to recommend to anybody to take a look at the recent study which was published by Brookings which went into a detailed analysis of the 1968 episode and concluded the increase in tax in 1968 had precisely the effect which had been anticipated—if anything, it had effects a little larger than was anticipated. The reason why we had inflation nonetheless was because everybody underestimated the power of other sources of demand. It is not that it did not work; it had its dampening effect, but it was not sufficient in the light of all other circumstances.

The second point I would like to bring out is the following. I have refrained from referring to this point, because it sounds partisan. I want to be clear that I do not belong to any party, and I did not vote for the democratic candidate, but I do feel that I have a certain mistrust with the way the current administration is going about things. What I am concerned with is the following thing, that if we have a slow recovery in 1971, as we seem to have, and we are approaching election time, there will be all kinds of measures taken to stimulate the economy quickly at that time, to be sure we get through the election time with a reasonable level of employment, and then we will be picking exactly the wrong tactic; namely, going slowly when we are far away from the the full employment goal, and running quickly when we get close to the goal, with a large chance to overshooting it.

I would urge now that we have plenty of slack to push demand and be prepared to restrain it later. In this sense I would suggest attention be given to fiscal measures which are quickly reversible. For instance, temporary tax cuts on excise taxes have the correct character in terms of impact and expectational effects.

Also, I would very much like to urge Congress, if you are really concerned with wage increases and price increases—to take a real look at using taxation which is simple, which is in our tradition, which can be enforced easily and not try to set up complicated measures. The public may say they are in favor of price and wage controls. They do not realize what it means to administer them, to put them into effect, and Mr. Galbraith himself knows exactly what miserable experience he had with OPA. During the war there was reasonably good compliance, when the war was over, the thing just broke down. I have no reason to think it would be any better this time. So, I do not think that that is the way to go. Let's think about tax measures.

Chairman PROXMIRE. I understand you are in a particularly good position to talk about controls, because you have been studying that and studying the Phillips curve heavily.

Mr. MODIGLIANI. That is correct.

Chairman PROXMIRE. What do you think about the estimate by Professor Galbraith which was startling to me, that he thinks the whole job could be done, in the first place, by a freeze that would last 6 months and then use only a few hundred people here in Washington with no regional offices, and designing a system that would only control a few hundred corporations—maybe a thousand altogether—that you could get your results of stabilizing prices in spite of a sharp increase in demands?

Mr. MODIGLIANI. Let me say this, to put things in perspective, he did not say "despite large increases in demands." He presupposed that we keep demand under control.

Chairman PROXMIRE. But he did not say it, but I would take it that he would advocate it. He has advocated, consistently, throughout the years a very sharp increase.

Mr. MODIGLIANI. His statement refers explicitly to "a fiscal and monetary policy that maintains a general balance between aggregate demand and supply."

My view is, that in the present situation, I just do not believe that a couple of hundred people in Washington could do anything significant about holding down prices and wages. Except perhaps in one sense: There are millions of prices, as large corporations have thousands upon thousands of products with all kinds of variations and permutations while the wage rates subject to collective bargaining are much fewer. So, perhaps, what in effect would happen is you could sit on wages under the appearance of sitting on everything.

Now, that has some possibility, but I, frankly, do not know how easy it would be to get this kind of a measure through. Yes, it has some possibilities.

Chairman PROXMIRE. It might be a little easier to get through that, however, than your proposal of imposing taxes, although it is a very intriguing and very interesting thing, and I intend to discuss that with other Senators and Members of the House, because I think it has other possibilities.

Has this ever been tried elsewhere?

Mr. MODIGLIANI. I have not searched the literature. It occurred to me independently. I understand that it has been proposed in England by the economists for a while. And I think they may have similar attention from other countries. I will try to investigate this and will communicate with you.

Chairman PROXMIRE. You feel there would be no need of having this kind of restraint on marginal firms whose taxes might be very small?

Mr. MODIGLIANI. You see, I think this could be limited to corporations with assets above a certain size, because I think the problem is there. It is really with the large firms dealing with big labor that the problem lies. And if you can scotch the incentive for them to give wage increases, the increase for the rest of the wages is already coming down; so, I think you would need to concentrate on that sector.

Chairman PROXMIRE. Mr. Jones, when would you say the rapid first half growth of money supply would have an impact on the GNP?

Mr. JONES. Well, I agree with Mr. Modigliani, that this is a distributed lag. When I was at the Federal Reserve Bank in St. Louis, our investigations tended to show effect over a period of about 18 months with possibly concentration of effect in the third quarter. We may distinguish between the effect on GNP and the effect on prices. We have thought that the effect on GNP might average, say, about 9 months, that is three quarters, while the price effect is still later, after a subsequent lag.

Chairman PROXMIRE. I understand the St. Louis model predicts that with a 9 percent greater growth in the money stock we should expect 6 percent real growth sometime toward the end of 1972. The inflation would intensify in 1973. Is that a correct summary?

Mr. JONES. Well, I think Mr. Modigliani would agree that the further out you go with these things the less certain they are.

Mr. MODIGLIANI. 100 percent agreement.

Mr. JONES. Yes; we think that the rapid money growth would mean we would not have a near-term improvement in inflation, but in the near term, say of a year, it would not mean an acceleration of inflation, but we would expect that then to come along at some later time.

Chairman PROXMIRE. What do you foresee if we follow this policy? How do you see unemployment the rest of this year and 1972?

Mr. MODIGLIANI. Are you talking to me?

Chairman PROXMIRE. First, Mr. Jones, and, then, Mr. Modigliani.

Mr. MODIGLIANI. Would you specify, if you follow the current policy of doing nothing, essentially?

Chairman PROXMIRE. First, with respect to fiscal policy, freeze it as Mr. Jones advocates, and then with respect to monetary policy, the 9 percent growth rate followed by 6 percent the rest of the year.

Mr. JONES. I have thought, and I guess researchers at the Federal Reserve have thought—we are not terribly optimistic about how rapidly the unemployment rate would decline. Of course, I have some inclination to disagree with the common ideals in this respect: I do not know how the 4 percent got invented and became an article of faith. I observed that the inflation really took off in 1965, when unemployment declined below 5 percent. Five percent unemployment is bad, and 4 percent unemployment is bad. In a sense, any unemployment is bad.

But given our institutional structures, what our labor markets are like and their imperfections, we have some unemployment, and I am not sure but what 5 percent is a more realistic figure than 4 percent.

Chairman PROXMIRE. Then, you share views of the administration's present economic spokesman that 4 percent is a myth——

Mr. JONES. Yes; it is something people started talking——

Chairman PROXMIRE (continuing). And 5 percent is a more logical figure, if you are going to restrain high prices?

Mr. JONES. I cannot say exactly about this kind of thing. But it is my tendency to feel that way, right.

Chairman PROXMIRE. Mr. Modigliani.

Mr. MODIGLIANI. Well, first about the facts, I have earlier disputed Mr. Connally's assertion about 4 percent rate being achieved only in war periods. I have done some checking, and I found 5 peacetime years in the postwar period in which the unemployment rate has been hovering very close to 4 percent, a little above, a little below. I think it is 1947–48, 1953, and I believe 1956–57. There are five such periods.

Furthermore, I was looking for the figures, but, actually, the rapid rate of change of prices did not begin in 1966 when unemployment, indeed, began to get to 4 percent and below. From the St. Louis publication, "National Economic Trends," I note that in 1965 the growth of the GNP deflator was only 1.7 percent.

I do not believe there is a magic figure. I do believe there is a long-run tradeoff between the rate of change of prices and the rate of unemployment for a given set of labor market institutions. But these institutions can be changed so that the tradeoff can be made more favorable. And I repeat, we need to look more and give more attention and more energy and funds to training programs for increasing the efficiency of placement and variety of programs which can improve the tradeoff.

Mr. JONES. I agree with that.

Mr. MODIGLIANI. So, there is nothing magic. All I am saying is 6 percent is real high.

Chairman PROXMIRE. I do not want you fellows to agree too much. Do you agree with the notion that in the short run we obviously cannot do all of these things that we would like to do to overcome structural unemployment?

Do you think it is practical and feasible to get unemployment down to 4 percent with a simultaneous policy to combat serious inflation?

Mr. MODIGLIANI. No; I will be frank about this. I think something like 4.5 percent is more likely, more sensible, until I see evidence we are doing something about manpower programs.

Chairman PROXMIRE. You have an incentive tax system. If we put that into effect, do you think we can get down to 4 percent?

Mr. MODIGLIANI. Perhaps. But I would like to think of that as a transient measure to cut short the present inflationary spiral.

Chairman PROXMIRE. So, I understand you to say that we should follow policies of getting unemployment down to 4.5 percent, but if we go any further it might be irresponsible?

Mr. MODIGLIANI. It might be too much, unless we have accompanying manpower policies.

Chairman PROXMIRE. Wait a minute. That is a big "unless."

What kind of accompanying manpower policies?

Mr. MODIGLIANI. That would be a long story. We have with us Prof. Charles Holt, who is an expert in this area. He has written and worked in this area. Perhaps, you should ask him sometime to appear before you and tell you about it. He has actually worked out a package. He has spent much time working on this with a team of experts.

The programs he would advocate would include things like retraining programs, subsidies to people who want to move; it includes increasing efficiency of the employment service in a variety of directions, including the incentive not to look at the number of placements but how stable those placements are.

He thinks a program of this kind, which has a sizable cost, I should say—runs in the billions—would be able in some years, in some time, to shift perhaps the minimal unemployment which would go with a 2-percent rate of prices from 4.5, to perhaps 3, or 2.5 percent.

Chairman PROXMIRE. Do you have any idea what effect on the economy it would have if we followed the policy of the House of Representatives, which I think it has started, of providing for a family assistance program, guaranteed annual income of $2,800 to a family of four?

What would that do in keeping other things about as they are?

Mr. MODIGLIANI. First of all, I must say that I am personally not yet convinced those programs will work. I am still very much concerned with the incentive effect of those programs.

This issue is a delicate one, because you have here one issue on which Professor Friedman and Professor Tobin agree and, as you know, they are at the antipodes in many other respects. Here I stand alone and disagree. My view is, at least, we do not yet know the incentive effects of that kind of a proposal, whether the incentive effects are large enough to really create serious problems in terms of the supply of labor and in terms of tax evasion. I am very much concerned about the tax evasion aspect of it.

Chairman PROXMIRE. I agree with that; I have very serious reservations as to any kind of a guaranteed income, but let us assume we put it into effect. Can you give us your conclusions?

Mr. MODIGLIANI. Obviously, that would be an additional stimulus.

Chairman PROXMIRE. A considerable proportion, as I understand it, would be $17 billion, or something like that. I understand that $3,200 would be about $20 billion.

Mr. MODIGLIANI. That I regard as absolutely undefensible. $3,200 strikes me——

Chairman PROXMIRE. I thonght it was $2,800.

Mr. MODIGLIANI. Whatever the figure, the calculation is complicated by the fact that together with that program there are supposed to be savings in other programs. I do not really have in mind a sensible estimate of what the net contribution would be. But, of course, that is equivalent to an increase of fiscal stimulus unless it is offset by high taxes. So, that might be a way to go. But that, of course, is very permanent and not quickly reversible. That is the kind of program that ought to be done in terms of the longrun program rather than in terms of what it takes now to get the economy moving.

Chairman PROXMIRE. Would either of you gentlemen want to comment on the recent Federal Reserve Board discount rate increase, as to whether you think it is justified or not justified?

Mr. MODIGLIANI. I think we probably agree that is a very trivial technical move.

Mr. JONES. Yes; I think when you were absent I made my remark about that, but I think the whole discount rate——

Chairman PROXMIRE. I heard that. I just wondered if you thought this latest one——

Mr. JONES. I think it was appropriate, just lagging behind what happened to market rates and removing what would otherwise be a bonanza to those banks that happen to borrow, and being quite appropriate.

Mr. MODIGLIANI. We happen to be in complete agreement about this angle except one thing, the only thing that may be ominous about it, if it is an indication that from now on we try to tighten—in other words, the rise in the discount rate announces a program of increasing short term market rates, first catching up with them and then increasing them further, if it gives us notice from now on "We are going to squeeze the market and try to nudge the bills rate up to 6," then, I think it is dangerous.

Chairman PROXMIRE. Is there a recent change by the Federal Reserve of changing the discount rate more rapidly so it would not have this psychological effect?

Mr. MODIGLIANI. Right.

Chairman PROXMIRE. Would you agree, Mr. Jones, you have to increase it when you have a situation such as this; otherwise, it would provide a windfall unintentionally?

Mr. JONES. Yes.

Chairman PROXMIRE. Thank you very much, gentlemen. You have been most helpful witnesses and most responsive.

The committee will stand in recess until tomorrow, in room G–308, and we will hear from Professor Dingle, Professor Gordon, Professor Levy, and Professor Shapiro.

(Whereupon, at 12:45 p.m., the committee was recessed, to reconvene at 10 a.m., Wednesday, July 21, 1971.)

THE 1971 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, JULY 21, 1971

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

The committee met, pursuant to call, at 10:10 a.m., in room G-308, New Senate Office Building, Hon. Martha W. Griffiths (member of the committee) presiding.

Present: Representative Griffiths and Senator Proxmire (chairman of the committee).

Also present: John R. Stark, executive director; Courtenay M. Slater, economist; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF REPRESENTATIVE GRIFFITHS

Representative GRIFFITHS. This morning we are continuing our midyear review of the economy. Yesterday we heard extremely interesting testimony from three very distinguished economists. They agreed that the outlook is most gloomy. Unemployment is going to remain high and inflation is not going to abate very much. Yet they disagreed on what should be done.

We heard a very interesting proposal from Mr. Galbraith for price controls and another very interesting proposal from Mr. Modigliani for guidelines backed up by tax penalties. Mr. Jones was not optimistic about the success of either of these approaches.

We also discovered disagreements about the wisdom of additional fiscal stimulants and about the best specific measures to use if more stimulants were desired. Similarly, we heard recommendations for widely varying degrees of monetary growth. So already we have had a wide range of policy alternatives presented.

This morning, and also Thursday and Friday morning, we will continue to explore these alternatives. By the conclusion of these hearings, we hope to have established a basis for building a consensus on what must be done to get the country out of the present economic mess.

This morning we have a panel of four economic experts, Miss Mona E. Dingle, a professor of economics, of the University of Missouri—I am a graduate of that university—a former staff member of the Board of Governors of the Federal Reserve, and an expert on monetary policies; Mr. Robert J. Gordon, a professor of economics at the University of Chicago and author of the recent Brookings study, entitled "Inflation in Recession and Recovery"; Mr. Michael Levy, director of Economic Policy Research for the Conference Board and author of a number of Conference Board publications, including the very cogent and helpful analysis of the President's budget; and Mr. Harold Shapiro, a professor of economics at the University of Michigan, where he helped develop the Michigan forecasting model of the U.S. economy.

We are very grateful to all of you for appearing this morning. Since we do have four witnesses and a lot of questions I would like to ask all of you to limit your statements to 10 or 15 minutes. The full text of your prepared statement will, of course, be printed in the hearing record.

Senator PROXMIRE. Could I just interrupt at that point?

Representative GRIFFITHS. Yes.

Senator PROXMIRE. Mrs. Griffiths, first I want to thank you very, very much for taking over.

Second. I want to apologize to you and the very distinguished members of this panel. I will not be able to be here this morning. Unfortunately, the leadership has decided to take up the Lockheed bailout this morning and we are going to be on that for some time and, therefore, I just have to be on the floor.

I had planned to be here and I have looked forward very enthusiastically to being here. I read your prepared statements which are all excellent and most helpful and I certainly expect to read the responses to the questions by Mrs. Griffiths and by others in the course of the hearing this morning. But I do want to thank you very, very much for coming. Again, I apologize.

Representative GRIFFITHS. Thank you.

Miss Dingle, will you please lead off.

STATEMENT OF MONA E. DINGLE, PROFESSOR OF ECONOMICS, UNIVERSITY OF MISSOURI

Miss DINGLE. It is my understanding my being first is strictly alphabetical and not because I am a woman.

Representative GRIFFITHS. Right.

Miss DINGLE. I think all of you have my prepared statement. I will skip through it and make additional comments along the way. I think my prepared statement makes it clear I am one of the least optimistic about being able to increase employment rapidly, even if we forgo our goal of curbing inflation, and I am also one of the least optimistic about the prospect of purely voluntary prices and wage controls.

Concerned as I am about the level of unemployment, I think that it would be a mistake to carry out excessively expansionary fiscal and monetary policies, not only because of my concern about inflation but also because I doubt the effectiveness of such policies to increase employment at a greatly increased rate in the short run, given the current elasticity of price expectations and the structural problems with which we are faced. We can indeed increase gross national product in current dollars if we expand Government spending and the money supply enough, but it will be little consolation if the increase shows up almost entirely in the form of price inflation.

Inflation has become less unacceptable to many economists in recent years, both because it has been widely believed that within the current institutional framework price increases are likely to be accompanied by a higher level of employment than stable prices and because an increasingly large proportion of the public has been able to take steps to protect itself against the effects of inflation. The more successful the public is in protecting itself against the effects of inflation, however, the less successful price increases are in encouraging or permitting an increase in output.

A striking characteristic of the recent inflation has been the extent to which various groups have become both more aware of the inflation taking place and better able through economic or political means to obtain increases in incomes to compensate for present and expected future increases in prices. To the extent that contracts for wages, interest, and other payments are written to allow for the expected depreciation of the dollar, the stimulative effect of the price increase is reduced, at the same time that the expectation of price increase tends to fulfill itself.

There are, of course, still some groups who have been unable to protect themselves against the effects of price increases—and the plight of these groups has been aggravated by the rapidity with which prices and other incomes have chased each other up. For those persons who expect to have future expenses that are large in relation to expected incomes, inflation may have a perverse effect on expenditures. The classic response to recognition of inflation is to increase expenditures in anticipation of price increases, to draw down assets and increase debts in anticipation of a decline in the value of the dollar. The extent to which expenditures can be meaningfully anticipated is limited, however. Meanwhile fixed value assets tend to depreciate in real value, while stocks and even long term bonds may involve more market risk in the short run than seems appropriate. The high level of saving that has been taking place recently undoubtedly reflects uncertainty about the ability to meet future commitments at rising prices as well as uncertainty about employment prospects in the near future.

Another reason for my unwillingness to see excessively expansionary fiscal and monetary policy pursued in an attempt to minimize unemployment is the structural nature of some of the current unemployment. I have been impressed with the concern of this committee with the necessity for appropriate manpower policy as well as appropriate policy with respect to aggregate demand. It is difficult to estimate how much of the unemployment in a cyclical industry is cyclical in nature and how much reflects longer run forces. It seems unlikely, however, that the demand for aerospace engineers will reach its former peak. The same thing is true of Ph. D.'s in economics and a number of other areas.

Despite the difficulties discussed, aggregate demand and production do seem to be increasing, although at an unsatisfactory rate.

To encourage further expansion without encouraging inflation, fiscal and monetary policies should be moderately expansionary in the near future. I would hope that we could avoid the sharp shifts in the mix between fiscal and monetary policies that have sometimes occurred in the past. Experience has shown that the domestic economy functions most satisfactorily when both sets of policies have similar objectives, with changes in interest rates and in the cash budget both responding to variations in the strength of private demand.

The shortrun balance-of-payments position should not be a major factor in monetary policy determination. A given change in aggregate demand has similar effects on the underlying balance of payments position whether brought about predominantly by fiscal or by monetary policy, and other ways should be devised to take care of shortrun fluctuations brought about by international variations in economic conditions and consequently in interest rates.

It is difficult to make an apriori judgment with respect to a satisfactory change in the money supply in the near future, particularly in the light of the sharp, apparently largely unintentional, expansion in the first half of this year. In any case I do not believe that a precise rate of growth can be specified as appropriate. Among other developments affecting the relationship between money and expenditures in recent years have been the sharp changes in the supply of money substitutes—both savings deposit and shares and money market instruments. Some of these changes have been cyclical; some, although initially in response to cyclical developments, have changed market and portfolio structures for the foreseeable future. Moreover, I do not think one can lose sight of the possibility that a liquidity crisis may develop from sudden shifts in the attitude toward assets or debts and that the central bank should be free to deal with such a development as necessary.

Yet another reason why I am reluctant to set a definite goal for monetary policy over the short run lies in the seasonal adjustment problem. The extent and timing of seasonal changes in money, as in employment, not only vary from year to year but depend in part on the stage of the cycle itself.

If I had to set a goal for changes in the quantity of money for the second half of 1971, I would arrive at a seasonally adjusted annual expansion of 4 to 5 percent. I believe that this, together with the sharp increase early this year, would provide for as large an increase in expenditures as we are likely to obtain without strongly inflationary developments. I would also expect a continuation of the rapid increase in holdings of commercial bank time deposits and savings and loan shares, although probably at somewhat reduced rates.

If the growth of the money supply does not exceed a 4 to 5 percent annual rate, we can probably look forward to a continuation of interest rates close to current levels, with perhaps some further increase in short term rates. I believe that the relatively high rates for a period of unemployment reflect more the continuation of inflationary expectations on the part of both lenders and borrowers than a shortage of available credit.

I would say I do not feel the interest rate level is unimportant in the long run. I think I would probably put more emphasis than most people on the importance of interest rates as a capitalization factor. But I think the recent experience has simply shown the monetary authorities do not know what a given level of nominal interest rates means under present circumstances, with the result that we have had a stop-and-go monetary policy which I think has had unfavorable repercussions.

Concern has been expressed that the increase in interest rates would have a seriously depressing effect on the housing market, which has responded favorably to the increase in credit availability. As I read the history of the postwar housing market, its problems in periods of tight money have reflected not so much the high interest rates as such, but rather a variety of restrictions in the mortgage market that have prevented mortgages from competing with other credit instruments on an interest rate basis for the limited supply of available funds. Mortgage credit seems to be readily available in most parts of the country at the present time. If funds are competed away from the mortgage market at a time when an appropriate overall volume of credit is being made available, it will be because other demands have increased.

If concern is with the supply of housing as such rather than with the effect on aggregate demand, the solution should be sought in changing the structure of the mortgage market, rather than in maintaining artificially low rates of interest generally.

I believe that changes that have already taken place are sufficient to prevent a repetition of the disruptive developments that we saw in 1966 and, in a less acute form, in 1969. The uncompetitively low ceiling on FHA-insured and VA-guaranteed loans should be raised or eliminated.

I think if we do away with the restrictions on the mortgage market, we might find we have much larger movements in overall interest rates—on a real if not a nominal basis—than we have had in the past. But concern with the mortgage market would call for removing further barriers.

I should like to plead against any change that would involve the Federal Reserve directly in the mortgage market either by purchasing mortgages or mortgage-backed securities or by giving such assets a preferred position as collateral for loans. Reserve management is a sufficiently difficult task without giving the Federal Reserve special responsibility for the supply of funds in individual private markets. Moreover, history shows that there is no necessary relationship between assets sold to the Federal Reserve or offered as collateral for loans and the use made of funds acquired in this way.

I am not in favor of introducing public works programs or other temporary expenditure programs as a means of increasing employment. I believe that expenditure programs should be determined on the basis of social priorities, and I do not believe that experience demonstrates the feasibility of turning programs on and off in an attempt to offset changes in private demands.

I welcome the tax cuts that have been made at the Federal level. I deplore the fact that so many State and local governmental units have felt that they had to increase taxes, particularly regressive taxes like sales taxes which are particularly likely to reduce demand. While the increase in the social security tax base was postponed and the previously scheduled rate increase that went into effect was small, I find it difficult to find an economic justification for handling social security taxes separately from the overall tax structure. A further reduction in taxes at this time might fuel inflationary fires both through the psychological effect on the public and through the increase of pressure that the financing problem might create for an excessively expansionary monetary policy. I might say that my feeling that tax reduction should be postponed has been somewhat modified by seeing the savings figure of the second quarter.

I have thus far avoided the question of whether either voluntary or compulsory price and wage controls would make the goals of rapidly increasing employment and curbing price increases less incompatible than they now appear. The advantages that such controls would have if successful are obvious—the immediate stabilization of prices, the wiping out of inflationary psychology, the assurance that any increases achieved in aggregate demand would show up as increases in output. The dangers are almost equally obvious—the tendency to freeze the status quo in price and wage relations at a time when disequilibria in current relations and changes in future demand-supply relations are likely to be particularly great, the temptation to pursue overly expansionary fiscal and monetary policies as long as resulting pressures are partly concealed, the danger of further straining credibility and enhancing the perversity of expectations if too many adjustments prove necessary.

In my opinion, the disadvantages apply equally to voluntary and compulsory controls, but chances for success with voluntary controls would be very limited. I believe that most groups now pressing for wage and price increases feel that they have a real need for relief. In considerable part, of course, this attitude involves a heritage from the inflation we have been experiencing, with the desire to catch up strong on the part of those groups temporarily left behind in the price-wage race. The problem may reflect in part also a longer run conflict in the allocation of economic and political power. The result is that reallocation of real incomes tends to be brought about by inflation, with the incidence shifting among groups and largely unrelated to the intent of our tax policy.

In this environment I would be willing to accept temporarily the additional rigidities involved in price and wage controls if I were convinced that they would work. By benefit of hindsight, I would recommend the imposition of compulsory price and wage controls in late 1969 or early 1970 to convince the public of the seriousness of the intent to combat inflation. I fear, however, that the psychological moment has passed and that the necessity of permitting upward adjustments to take care of even the most obvious distortions would be likely to increase rather than lessen the perversity of expectations.

Thank you.

(The prepared statement of Miss Dingle follows:)

PREPARED STATEMENT OF MONA E. DINGLE

I am very happy to have this opportunity to discuss economic conditions and policies with Members of this Committee.

This is a very difficult period. In recent months we have seen a continuing high rate of inflation while the unemployment rate remained the highest in a decade; an increase in interest rates while the money supply was increasing rapidly in a period of depressed demand; and a currency crisis while interest rate differentials between the United States and Europe were narrowing. Not only have we committed ourselves to a number of objectives which seem to be in conflict under present circumstances—price stability, a high level of employment, economic growth, equilibrium in the balance of payments, the maintenance of free market processes—but we do not know the trade-off among them. Problems inherent in the multiplicity of goals are enhanced at the present time by structural problems and by expectational factors which, while in considerable part a heritage from our inflationary experience, have shown little response to recent changes in fiscal and monetary actions. Under these circumstances it is tempting to concentrate on the one problem most in evidence at the moment, to overestimate the immediate effects of available actions on that measure, and to underestimate the costs in terms of other objectives.

Two years ago we decided to concentrate on curbing inflationary developments. I think that it was probably a necessary decision, although there are details of timing and execution that I would question. The mistake lay in leading the public to expect a much more rapid conquest of inflation and a much smaller increase in unemployment than there was any reason to expect at the time, a position which has strained the credibility of the public and enhanced expectational barriers to effective future action. Now there seems to be a growing willingness to strike out against the unemployment problem with all available means and to let the goal of curbing inflation go by default.

Concerned as I am about the level of unemployment, I think that it would be a mistake to carry out excessively expansionary fiscal and monetary policies, not only because of my concern about inflation but also because I doubt the effectiveness of such policies to increase employment at a greatly increased rate in the short run, given the current elasticity of price expectations and the structural problems with which we are faced. We can indeed increase gross national product in current dollars if we expand government spending and the money supply enough, but it will be little consolation if the increase shows up almost entirely in the form of price inflation.

Inflation has become less unacceptable to many economists in recent years both because it has been widely believed that within the current institutional framework price increases are likely to be accompanied by a higher level of employment than stable prices and because an increasingly large proportion of the public has been able to take steps to protect itself against the effects of inflation. The more successful the public is in protecting itself against the effects of inflation, however, the less successful price increases are in encouraging or permitting an increase in output. Price increases may encourage an increase in output if costs rise less than prices or if more can be produced at a given price-cost relation than otherwise. Costs of productive resources, including labor costs, may rise less rapidly than prices if owners of productive resources identify changes in money income with changes in real income or if they are unable to protect themselves against the changes in real income accompanying price changes. During a considerable part of our history it has probably been true that suppliers of productive resources tended to think in nominal terms, to be deceived by the so-called "money illusion". A striking characteristic of the recent inflation, however, has been the extent to which various groups have become both more aware of the inflation taking place and better able through economic or political means to obtain increases in incomes to compensate for present and expected future increases in prices. To the extent that contracts for wages, interest, and other payments are written to allow for the expected depreciation of the dollar, the stimulative effect of the price increase is reduced, at the same time that the expectation of price increase tends to fulfil itself. The recently published annual report of the Bank for International Settlements shows the so-called "Phillips curves" relating the unemployment rate to percentage increases in wage rates for several European countries as well as the United States; these diagrams demonstrate clearly the tendency for increasingly large wage increases to be associated with given rates of unemployment in recent years, compared with the trade-off relation which formerly seemed to exist.

There are of course still some groups who have been unable to protect themselves against the effects of price increases—and the plight of these groups has been aggravated by the rapidity with which prices and other incomes have chased each other up. These include particularly persons who are relying on assets accumulated in the past or incomes from such assets to finance regular future expenditures or large lumpy payments. Retired persons not entirely dependent on income from Social Security form a particularly important part of this group, but the group includes also parents who are attempting to provide for educational expenses and others. For those persons who expect to have future expenses that are large in relation to expected incomes, inflation may have a perverse effect on expenditures. The classic response to recognition of inflation is to increase expenditures in anticipation of price increases, to draw down assets and increase debts in anticipation of a decline in the value of the dollar. The extent to which expenditures can be meaningfully anticipated is limited, however. Meanwhile, fixed value assets tend to depreciate in real value, while stocks and even long-term bonds may involve more market risk in the short-run than seems appropriate. The high level of saving that has been taking place recently undoubtedly reflects uncertainty about the ability to meet future commitments at rising prices as well as uncertainty about employment prospects in the near future.

Another reason for my unwillingness to see excessively expansionary fiscal and monetary policy pursued in an attempt to minimize unemployment is the structural nature of some of the current unemployment. I have been impressed with the concern of this Committee with the necessity for appropriate manpower policy as well as appropriate policy with respect to aggregate demand. It is difficult to estimate how much of the unemployment in a cyclical industry is cyclical in nature and how much reflects longer run forces. It seems unlikely, however, that the demand for aerospace engineers will reach its former peak. Recent Ph.D.'s in most fields are finding teaching jobs scarce, and the University of Missouri, like many other schools, is being forced to reexamine past policies of encouraging graduate school enrollment. These areas have received particular attention both because of the role of governmental demand or governmental finance in encouraging the earlier expansion and because these are groups that have a heavy investment in specialized training. Among other industries, the domestic steel industry seems unlikely to regain its competitive position in the near future. The long-run increase in the proportion of income which the public wishes to spend for services and the corresponding decline in the proportion which it wishes to spend for total durable and nondurable consumer goods may also have implications for price and wage relationships, both domestic and international, and for the level of aggregate demand, that have not been fully explored.

Despite the difficulties discussed, aggregate demand and production do seem to be increasing, although at an unsatisfactory rate. To encourage further expansion without encouraging inflation, fiscal and monetary policies should be moderately expansionary in the near future. I would hope that we could avoid the sharp shifts in the mix between fiscal and monetary policies that have sometimes occurred in the past. Experience has shown that the domestic economy functions most satisfactorily when both sets of policies have similar objectives, with changes in interest rates and in the cash budget both responding to variations in the strength of private demand. The major problem at the present time is not the appropriate mix between fiscal and monetary policies but rather the amount of stimulus that should be applied to the economy through the combination.

The short-run balance of payments position should not be a major factor in monetary policy determination. A given change in aggregate demand has similar effects on the underlying balance of payments position whether brought about predominantly by fiscal or by monetary policy, and other ways should be devised to take care of short-run fluctuations brought about by international variations in economic conditions and consequently in interest rates. Certain credit markets are of necessity influenced by international interest rate differentials. The Federal Reserve should be free, however, to concentrate on following an appropriate policy in the light of current domestic conditions rather than attempting to influence international rate relationships.

It is difficult to make an *a priori* judgment with respect to a satisfactory change in the money supply in the near future, particularly in the light of the sharp, apparently largely unintentional, expansion in the first half of this year. In any case I do not believe that a precise rate of growth can be specified as appropriate. Among other developments affecting the relationship between money and expenditures in recent years have been the sharp changes in the supply of money substitutes—both savings deposits and shares and money market instruments. Some of these changes have been cyclical; some although initially in response to cyclical developments, have changed market and portfolio structures for the foreseeable future. One cannot solve the problem of money substitutes merely by broadening the definition of money to include an ever-widening array of assets. These assets are never perfect substitutes; and the evaluation of their liquidity by the public may vary depending on recent experience. Moreover, I do not think that one can lose sight of the possibility that a liquidity crisis may develop from sudden shifts in the attitude toward assets or debts and that the central bank should be free to deal with such a development as necessary. I agree with my monetarist friends that both changes in the relative importance of near money and dangers of liquidity crises would be less acute if there had been fewer sharp shifts in the rate of monetary growth in the past. I do not believe that the problems would be entirely absent, however. Furthermore, as I read history, the effects of unwise policy in the early 1930's were still being reflected in the increase in velocity into the early 1960's. At this rate, we may start ignoring the effects of policies in the 1960's by about the year 2000. Yet another reason why I am reluctant to set a definite goal for monetary policy over the short run lies in the seasonal adjustment problem. The extent and timing of seasonal changes in money, as in employemnt, not only vary from year to year but depend in part on the stage of the cycle itself.

If I had to set a goal for changes in the quantity of money for the second half of 1971, I would arrive at a seasonally adjusted annual expansion of 4 to 5 percent. I believe that this, together with the sharp increase early this year, would provide for as large an increase in expenditures as we are likely to obtain without strongly inflationary developments. The actual increase in money would be greater of course because of the seasonal expansion. I would also expect a continuation of the rapid increase in holdings of commercial bank time deposits and savings and loan shares, although perhaps at somewhat reduced rates. The nonbank public would also increase its holdings of U.S. Government securities during this period of deficit finance, while commercial banks would expand holdings of both private and governmental assets.

If the growth in the money supply does not exceed a 4 to 5 percent annual rate, we can probably look forward to a continuation of interest rates close to current levels, with perhaps some further increase in short-term rates. I believe that the relatively high rates for a period of unemployment reflect more the continuation of inflationary expectations on the part of both lenders and borrowers than a shortage of available credit. While high interest costs would undoubtedly be a burden to some borrowers if inflationary expectations should be overcome, many borrowers would be able to refund at reduced rates.

Concern has been expressed that the increase in interest rates would have a seriously depressing effect on the housing market, which has responded favorably to the increase in credit availability. As I read the history of the postwar housing market, its problems in periods of tight money have reflected not so much the high interest rates as such but rather a variety of restrictions in the mortgage market that have prevented mortgages from competing with other credit instruments on an interest rate basis for the limited supply of available funds. Mortgage credit seems to be readily available in most parts of the country at the present time. If funds are competed away from the mortgage market at a time when an appropriate over-all volume of credit is being made available, it will be, because other demands have increased.

If concern is with the supply of housing as such rather than with its effect on aggregate demand, the solution should be sought in changing the structure of the mortgage market—particularly removing barriers still existing but also granting subsidies where appropriate—rather than in maintaining artificially low rates of interest generally. I believe that changes that have already taken place—changes in lending and borrowing practices of the Federal Home Loan Banks, the development of higher-interest, longer-term share certificates by savings and loans associations, the removal or liberalization of various interest rate ceilings on mortgages—are sufficient to prevent a repetition of the disruptive developments that we saw in 1966 and, in a less acute form, in 1969. The uncompetitively low ceiling on FHA-insured and VA-guaranteed loans should be raised or eliminated. I should like to plead against any change that would involve the Federal Reserve directly in the mortgage market either by purchasing mortgages or mortgage-backed securities or by giving such assets a preferred position as collateral for loans. Reserve management is a sufficiently difficult task without giving the Federal Reserve special responsibility for the supply of funds in individual private markets. Moreover, history shows that there is no necessary relationship between assets sold to the Federal Reserve or offered as collateral for loans, and the use made of funds acquired in this way.

I am not in favor of introducing public works programs or other temporary expenditure programs as a means of increasing employment. I believe that expenditure programs should be determined on the basis of social priorities, and I do not believe that experience demonstates the feasibility of turning programs on and off in an attempt to offset changes in private demand. I would hope that military expenditures could be cut back and replaced with programs of a permanent nature should be higher in social priorities.

While I would not be in favor of reducing taxes further at this moment, I welcome the cuts that have been made and would like to feel that additional cuts could be made with little delay at an appropriate time. I deplore the fact that so many state and local governmental units have felt that they had to increase taxes, particularly regressive taxes like sales taxes which are particularly likely to reduce demand. While the increase in the social security tax base was postponed and the previously scheduled rate increase that went into effect was small, I find it difficult to find an economic justification for handling social security taxes separately from the over-all tax structure. A further reduction in taxes at this time might fuel inflationary fires both through the psychological effect on the public and through the increased pressure that the financing problem might create for an excessively expansionary monetary policy. If the rate of inflation should slow down markedly or if production should fail to increase further, scheduled tax reductions should take place in advance of schedule and consideration might be given to additional reductions.

I have thus far avoided the question of whether either voluntary or compulsory price and wage controls would make the goals of rapidly increasing employment and curbing price increases less incompatible than they now appear. The advantages that such controls would have if successful are obvious—the immediate stabilization of prices, the wiping out of inflationary psychology, the assurance that any increases achieved in aggregate demand would show up as increases in output. The dangers are almost equally obvious—the tendency to freeze the status quo in price and wage relations at a time when disequilibria in current relations and changes in future demand-supply relations are likely to be particularly great, the temptation to pursue overly expansionary fiscal and monetary policies as long as resulting pressures are partly concealed, the danger of further straining credibility and enhancing the perversity of expectations if too many adjustments prove necessary.

In my opinion, the disadvantages apply equally to voluntary and compulsory controls, but chances for success with voluntary controls would be very limited. Many features of proposed incomes policies, which would improve the functioning of wage and product markets, have advantages in their own right, irrespective of whether there is administrative action to determine wages and prices directly. As far as such direct administrative action is concerned, however, I consider the so-called voluntary controls to be less equitable and less likely to work than formal compulsory controls. I believe that most groups now pressing for wage and price increases feel that they have a real need for relief. In considerable part, of course, this attitude involves a heritage from the inflation we have been experiencing, with the desire to catch up strong on the part of those groups temporarily left behind in the price-wage race. The problem may reflect in part also a longer run conflict in the allocation of economic and political power. An attempt is being made, either through the Federal budget process or through the strengthening of groups formerly weak in power, to ensure certain groups a larger share of the national product. It is difficult to find other groups willing to acquiesce in a decline in their relative share, however, with the result that each group tends to bargain for income increases that offset any increase in taxes and that are at least equal to the maximum increase obtained by any other group. The result of course is that reallocation of real income tends to be brought about by inflation, with the incidence shifting among groups and largely unrelated to the intent of our tax policy.

In this environment I would be willing to accept temporarily the additional rigidities involved in price and wage controls if I were convinced that they would work. By benefit of hindsight, I would recommend the imposition of compulsory price and wage controls in late 1969 or early 1970 to convince the public of the seriousness of the intent to combat inflation. I fear, however, that the psychological moment has passed and that the necessity of permitting upward adjustments to take care of even the most obvious distortions would be likely to increase rather than lessen the perversity of expectations.

I fear that this leaves me in the position of saying that the best we can do is worry along and accept a slower growth in employment and more limited success in curbing price increases than we should like. I am afraid that is the price we have to pay for our inflationary binge.

Representative GRIFFITHS. Thank you, Miss Dingle.
Mr. Gordon, please proceed.

STATEMENT OF ROBERT J. GORDON, ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO

Mr. GORDON. This should be an interesting morning because I disagree with nine-tenths of what Miss Dingle said, as you will soon see.

After adjustment for the General Motors strike, it has now been 11 consecutive quarters—almost 3 years—that real output growth in the United States has been slower than the minimum needed to keep the unemployment rate constant. If an economic recovery is defined as real output growth fast enough to reduce the unemployment rate, therefore, the recovery has not yet begun. This period of recession and sluggish growth has been deliberately engineered by the administration and the Federal Reserve Board in an attempt to eliminate inflation. Recently, the administration has reaffirmed the need to maintain present policies in order to reduce inflation, even if the result is a continuation of high unemployment. My message today is that this entire effort has been misguided, because the menace of a steady inflation has been exaggerated. The economy would not be damaged if inflation were to continue forever at the 4- or 5-percent rate which we have experienced in the last few years.

The evils of a steady inflation are not serious enough to justify the administration's policy of "enforced misery through gradualism."

One alleged evil is that steady inflation cannot be sustained, but must inevitably explode into a spiral reaching 10, 20, even 50 percent a year. While this could conceivably happen if we were to push unemployment too low, there are many actual examples of moderate inflation rates which have been sustained over long periods. In Japan, for instance, consumer prices have increased at a steady rate of 6 percent for a full decade, and in France at a rate of about 5 percent for more than a decade.

Beyond this fear of an explosion of prices, almost every evil associated with inflation occurs only when it is a surprise, not when it proceeds at a steady rate which everybody expects to continue. Creditors, savers, and retired people suffered from the recent inflation because they did not expect it. Their investments were made at low interest rates which did not compensate them for the inflation which occurred after the investments were made, and exactly offsetting gains were enjoyed by borrowers who obtained loans, including home mortgages, at these low rates. But once interest rates have risen to include a compensation for inflation, as has occurred since 1965, the inequitable redistribution of income from savers to borrowers comes to a halt, as long as inflation continues at a steady rate and does not accelerate further. In fact, the major remaining burden of the current inflation is caused by the Federal Government. Savers and retired people have been prevented from receiving full compensation for inflation through statutory federal interest rate ceilings on time deposits and savings bonds, and through the failure to make automatic cost-of-living adjustments in social security.

A striking conclusion of this reasoning is that, if the current inflation is now fully incorporated into the expectations of savers, borrowers, and workers, the administration's attempt to reduce the rate of inflation is doing more harm than good. Since the major burden of inflation is due to unexpected changes rather than the particular rate which occurs, reducing the inflation rate below what people expect will cause an inequitable redistribution of income from borrowers to savers, just as increasing the rate above what is expected will redistribute income in the opposite direction.

Is there then no burden of a fully anticipated inflation, once interest rates and payments to retired individuals have adjusted for it? The oft-cited balance-of-payments problem creates no obstacle, because the United States cannot control its own exchange rate and must let other nations decide how to adjust to inflation here. If they decide to maintain fixed exchange rates, as most of them have done, they will inflate with us, or if they do not want to import our inflation they can revalue their currencies.

Economic analysis has pointed to one rather subtle burden of a fully anticipated inflation . . . the extra time which people waste attempting to economize their holdings of currency and demand deposits, on which they earn no interest, in order to increase their holdings of securities paying interest rates which compensate them for inflation. But even this burden of inflation can be minimized by freeing banks to pay a competitive interest rate on demand deposits.

Because a steady inflation at or slightly above the recent rate is not a major menace, there is no need to consider the imposition of wage and price controls, as some have recently recommended. If these controls are temporary, they will have little effect because everyone will expect a resumption of inflation after they are terminated. We saw this in Great Britain in 1967. If on the other hand, they are permanent, resources will be wasted and misallocated, because the signals of changing relative prices would be absent, unless an elaborate central planning bureaucracy is introduced to decide which prices should be changed.

If the actual rate of inflation does not matter much, as long as it is steady and accurately anticipated, which rate of inflation should we choose? Most statistical research for the United States indicates that the lower the unemployment rate, the higher will be the rate of inflation associated with it if that unemployment rate is maintained forever. If, for example, the unemployment we have experienced in the first half of 1971 were maintained forever, the inflation rate would eventually slow down from its present 4 percent to a steady rate of about 2 percent, or perhaps lower. The alternative choice of lower unemployment, say the 4-percent target which used to be called "full employment"—before Secretary Connally declared this concept obsolete—would eventually be associated with a steady rate of inflation somewhat higher than what we have now, about 5 percent, according to the latest statistical research. This "trade-off," the amount of inflation which in the long run will be associated with any given unemployment rate, is not immutable. In fact, it is worse now than it was in the midfifties. Congress can help to improve it by encouraging more and better manpower training and relocation programs to allow those who are still unemployed at "full employment" to qualify for available vacancies.

The possibility of maintaining "full employment" with a steady inflation of only 5 percent calls into question the basic premise of the administration's economic policy. Instead of deliberately producing the recession of 1970–71, policymakers could have allowed the economy to grow steadily beginning in mid-1969 at a rate sufficient to keep the unemployment rate constant at 4 percent. The cost of this policy would have been a rate of inflation which would have remained at or a bit above 5 percent, instead of beginning to slow down (as has occurred recently). But in comparison, the benefits of this alternative full employment policy would have been enormous, not only for those who would not have been made unemployed by the recession, but for those who would not have been forced to quit the labor force after failing to find jobs, for those who would not have suffered a reduction in overtime pay, and ultimately for everyone, since the slow productivity growth caused by the recession would not have squeezed wages, profits, and stock prices. State and local governments would have avoided much of their present financial squeeze, and the unemployment and poverty problem of minority groups would have been less widespread because firms would have been more willing to hire and train unskilled and minority workers. Even if the recession is cut short by a rapid return to full employment by election day 1972, I calculate that it will have cost about $100 billion in lost output, or about $1,600 per American family. If the return to full employment is delayed further, say to 1975, by a policy of gradualism, the total cost of economic slack in the end will have been $270 billion, or $4,100 per family.

Unfortunately, the recession has been allowed to occur. What should be done now? I recommend abandoning the administration's policy of gradualism in order to expand the economy rapidly, with an interim target of 4.5 percent unemployment by late 1972. After that the expansion should be moderated to prevent the economy from overshooting the final target of 4 percent. Statistical research cannot be used to predict what would happen if unemployment were pushed below 4 percent, because there are too few historical precedents, so it would be safer to stop at 4 percent in order to test the terrain before proceeding further.

To summarize to this point, the primary goal of economic policy should be stable growth of output and prices. The administration has deliberately caused instability in output in a misguided attempt to eliminate inflation, when, in fact, a steady rate of inflation does little harm. However, we cannot begin a regime of steady output growth from our present position because too many men and machines are unemployed. Instead we must aim for steady growth in output after an interim period of rapid expansion to make up for the ground we have lost.

Why do administration officials and some economists oppose a policy of rapid growth? The most common reason is an exaggerated estimate of the extra inflation which would accompany faster growth, over and above the inflation which is inevitable even with today's high unemployment. I estimate that rapid expansion now is a good bargain, because we can obtain the benefits of lower unemployment at the cost

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of only slightly more inflation this year and next than would occur if we were to stand still.

There are three important reasons for this favorable trade-off between inflation and unemployment over the next 2 years:

First, the major cause of current inflation is the legacy of excess demand in the late 1960's. Workers and unions are demanding high wage increases both to catch up for real income losses caused by inflation which has already occurred and to anticipate future inflation which they expect will be as rapid as in the recent past. We cannot rid ourselves of this legacy, whether we stand still now or grow rapidly.

Second, while a rapid economic expansion may increase inflationary pressures when it begins from a base of full employment, as occurred in 1967–68, we are now starting from the base of a sluggish economy with an abundant excess supply of labor in most areas of the country.

Third, although rapid expansion will push up the prices of a few goods which are in short supply, the fast productivity growth accompanying rapid expansion will reduce the impact of already negotiated wage increases on labor costs. This will allow employers to pay these wage increases with fewer price hikes.

Of these reasons the first, the legacy of the past, is the most important. To say that a rapid drop in unemployment will not make much differences to the inflation rate in the short run is the exact converse of the fact, which we have already witnessed, that a rapid increase in unemployment in 1970 has not yet made much difference to the inflation rate.

What should Congress do to encourage rapid expansion? One answer frequently given by monetarists, like Milton Freedman, is that nothing needs to be done by Congress. Rapid growth in the money supply in the past 6 months assures a "vigorous recovery", and the Federal Reserve should return monetary growth to a slower, more sedate rate. In a supplement to this statement which I have prepared for the record—and remind me to give this to you—I show that the statistical equations on which the monetarists base this recommendation have been seriously in error so far this year. In fact, if these errors continue, 1971 may develop into as much of a debacle for the monetarists as the late 1968 tax surcharge period was for the fiscalists. The monetarists' policy recommendation is unlikely to cause a vigorous recovery, if that means bringing the unemployment rate much below 6 percent in the next year or two. The Federal Reserve should not listen to the monetarists, but instead should continue the rapid monetary growth of early 1971 for at least another year. I quantify this recommendation more precisely in my supplementary statement.

However, since the money supply is not under the direct control of Congress, and the Federal Reserve is apparently trying to reduce the rate of monetary growth, what fiscal measures should be taken to promote rapid economic expansion? Increases in spending should be designed to help the unemployed directly while minimizing the extra inflationary pressures. Job training and relocation programs should be emphasized, for instance, not public works projects which will further fatten the purses of construction workers. Tax cuts are desirable, not only because they will reduce unemployment somewhat, but also because they temporarily reduce the rate of inflation associated with any given unemployment rate by raising workers' after-tax incomes and making them satisfied with smaller wage demands. In my statistical research, I have isolated increases in the social security tax as an important cause of the inflation which occurred in the late 1960's. There is no more constructive step which could be taken by Congress to reduce both inflation and unemployment in this session than to cut social security tax rates, or, better yet, to junk the whole regressive social security tax structure and finance benefits instead out of general revenue.

Finally, any stimulative fiscal measures will tend to raise interest rates and moderate the present housing recovery unless the Federal Reserve can be convinced to maintain the rate of monetary growth, but this effect on housing will be moderated if Congress eliminates legal interest rate ceilings on savings deposits.

(Mr. Gordon later submitted the following supplemental statement for the record:)

Supplemental Statement of Robert J. Gordon

The Monetarist Prediction: but Who Knows by How Much?

INTRODUCTION

In the past several years "monetarist" or "St. Louis-type" equations, which estimate a statistical relationship between the growth of income and money during some previous historical period, have gained widespread popularity as a forecasting device. Success has been gained through the accurate prediction of the timing of major swings in the economy since the first St. Louis equation was published in November 1968. The continued momentum of spending growth after the 1968 tax surcharge, the beginning of the 1970 recession, and the subsequent 1970–71 recovery were all predicted in advance to occur when in fact they did. Just as important, the retrospective use of the equations can explain why the long advance of the economy in the 1960s paused in late 1962 and early 1967, both of which were periods which followed a declaration in monetary growth but were not predicted accurately at the time.

The problem of economic forecasters in mid-1971, however, is not to divine the direction in which nominal income is going to change in the next year. Almost everyone agrees that the direction is up, and at a rate which is relatively rapid by historical standards. Rather the crucial question is to anticipate the *magnitude* of the advance. On the one hand the annual rate of growth of nominal income might be in the 8.0–8.5 percent range, which is just sufficient to create jobs for new workers in the labor force and those displaced by productivity advance, plus the higher prices caused by an inflation largely inherited from the past, but is not enough to reduce the unemployment rate significantly during 1971–72. On the other hand, growth might be as fast as 10–11 percent, in which case the unemployment rate would be close to 4.5 percent by late 1972. Whether policymakers are aiming at the first or second growth path, or a path halfway between, they need to know within a fairly narrow margin what rate of monetary expansion would generate that path in income.

This paper attempts to show that, whatever their virtues in predicting timing relationships, alternative monetarist equations not only provide conflicting predictions of the magnitude of future expansion for the rest of 1971 and 1972, but in addition have *already* generated sizeable errors in the first half of 1971. Some speculation on possible causes is provided after the basic problem is illustrated, but the main aim of the paper is to provoke discussion rather than to suggest final answers.

PRELIMINARY ASSUMPTIONS AND DEFINITIONS

The alternative monetarist equations examined here differ from each other (a) in the definition of the exogenous monetary variable and (b) in the sample period of statistical fit. Predictions are shown to depend heavily on the choice of

(a) and (b). All the equations follow the current St. Louis practice of including government spending as an additional explanatory variable; no attempt is made to examine the fiscal coefficients or to explain why, in almost all equations, changes in government spending have only a short-lived positive impact on income growth.[1] The definitions of money concepts are the usual:

M1=currency plus demand deposits.

M2=M1 plus time deposits net of large CDs.

M3=M2 plus deposits of mutual savings banks and savings and loan associations.

Predictions of future income growth depend both on past and future monetary growth. Past events have included:

(1) Average growth in the four quarters of 1970 of 5.0 percent in M1, 7.5 percent in M2, and 7.3 percent in M3;

(2) Much faster average growth in the first two quarters of 1971 of 9.3 percent in M1, 14.6 percent in M2, and 16.3 percent in M3.

Most economists identified with the "monetarist school" are currently urging the Federal Reserve to end the "monetary explosion" of (2) and return monetary growth to rates closer to (1). In order to evaluate the degree to which alternative monetarist equations agree on the consequences of this policy recommendation, future monetary expansion beginning in 1971:3 is assumed to proceed at a rate of 6.0 percent for M1 and 8.0 percent for M2 and M3.[2]

INCOME PREDICTIONS

Nine separate monetarist equations were estimated for the purpose of the prediction test, one for each of the three monetary definitions, and one for each of three sample periods ending in 1971:1. The first and longest of these spans eighteen years, beginning in 1953:1. Shorter alternatives begin in 1960:1 and 1965:1. Predictions are obtained when the fitted coefficients are applied to the actual values of monetary change through 1971:2 and the assumed values beginning in 1971:3.[3]

The top line of Table 1 shows the actual growth of nominal income in the first two quarters of 1971 after adjustment is made for the GM strike. Subsequent lines illustrate predictions from the nine equations for each quarter of 1971 and for 1972:4, as well as the errors for the first two quarters of 1971. The average 1971 error tends to be larger for the M2 and M3 equations and the long-sample M1 equation than for the two shorter-sample M1 equations. Further, the average error grows much faster from 1971:1 to 1971:2 for the M2 and M3 equations than for M1. The long-sample equations for M2 and M3 (equations 2a and 3a) are most seriously in error, predicting about 80 percent more spending growth in 1971:2 than actually occurred. The most accurate equation (1b) predicts that GNP should have grown by 1971:2 to $1050 billion, instead of the actual $1040 billion.

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[1] For some preliminary hypotheses, see my "Notes on Money, Income, and Gramlich," *Journal of Money, Credit, and Banking* (May 1971, part II), 3:533–45. The monetarist equations differ from current St. Louis practice in the following respects: (1) all variables are percentage rather than absolute changes; (2) only Federal Government spending on goods and services is included in the fiscal variable, rather than all Federal Government spending; (3) strikes are handled by *ad hoc* adjustments to income growth in 1959:3, 1959:4, 1964:4, and 1970:4, rather than an explicit strike variable; and (4) the Almon lag distribution is constrained to lie along a fourth degree polynomial spanning eight

[2] Roughly a 2-percentage-point spread between the growth rates of M1, on the one hand, and M2 and M3, on the other, occurred in 1967–68 during the most recent previous period of relatively rapid monetary growth combined with rising interest rates. During the eight quarters of 1967 and 1968, the respective rates of growth of the three money concepts were 6.8, 9.0, and 8.6 percent.

[3] Government spending on goods and services is assumed to rise gradually by 5.2 percent between 1971:1 and 1972:4. This is a slower rate than assumed by St. Louis, since the most rapid growth in Federal spending over the next year will occur in transfers and grants-in-aid. In any case, the coefficients on changes in Government spending are so small that alternative assumptions would have little effect on the results.

TABLE 1.—GROWTH IN CURRENT-DOLLAR GNP PREDICTED BY ALTERNATIVE MONETARY EQUATIONS[1]

[Quarterly percent change at annual rate]

Equation number	Money concept	Sample period of equation	1971:1	1971:2	1971:3	1971:4	[1972:4]	Error (Actual—Predicted) 1971:1	1971:2	Average
Actual			[2]7.5	7.7						
1a	M1	1953:1–71:1	9.8	12.1	12.5	11.2	7.9	−2.3	−4.4	−3.4
1b	M1	1960:1–71:1	8.4	9.4	10.8	10.4	7.4	−.9	−1.7	−1.3
1c	M1	1965:1–71:1	8.9	10.0	11.3	10.3	7.3	−1.3	−2.3	−1.8
2a	M2	1953:1–71:1	11.1	13.8	15.3	13.6	8.6	−3.6	−6.1	−4.9
2b	M2	1960:1–71:1	9.4	11.9	13.8	12.9	8.4	−1.9	−4.2	−3.1
2c	M2	1965:1–71:1	9.6	12.0	13.1	12.3	8.5	−2.1	−4.3	−3.2
3a	M3	1953:1–71:1	9.8	14.1	16.7	15.4	8.5	−2.3	−6.4	−4.4
3b	M3	1960:1–71:1	7.6	11.0	13.9	13.4	8.0	−.1	−3.3	−1.7
3c	M3	1965:1–71:1	9.1	12.3	14.5	13.8	8.6	−1.6	−4.6	−3.1

[1] Beginning in 1971:3, growth of 6 percent per annum assumed for M1, and 8 percent for M2 and M3.
[2] Actual GNP in 1970:4 raised $12,000,000,000 to correct for GM strike.

The equations which overpredict the most in early 1971 also predict the most buoyant growth for late 1971. The *increase* in spending growth from the actual 1971:2 rate to 1971:3 spans a wide range from 3.0 percentage points (equation 1b) to 9.0 percentage points (equation 3a). The GNP growth for the last half of 1971 predicted by the *average* of all six M2 and M3 equations is a superheated $38 billion for the third quarter and $36 billion for the fourth quarter, implying a 1971 average GNP of $1064 billion.

IMPLICATIONS FOR THE UNEMPLOYMENT RATE

Which equations are likely to be most accurate for late 1971? The smallest average errors in the first half are made by (1b), (1c), and (3b), but the latter is undesirable because its error grows so much from 1971:1 to 1971:2 and may grow further. The former two equations are used in Table 2 to generate a prediction of the unemployment rate in 1972:4, based on the assumptions that (a) potential output is growing at 4.5 percent per annum and (b) inflation over the period will average 3.5 percent. The result is a reduction in the unemployment rate from an assumed starting point of 6.2 percent to 5.7 percent if monetary growth proceeds at 6 percent, and to 4.7 percent if monetary growth is at a faster 9 percent pace.

TABLE 2.—CONSEQUENCES FOR UNEMPLOYMENT RATE OF ALTERNATIVE PATHS OF MONETARY EXPANSION

[Quarterly percent change at annual rate]

	6-percent monetary growth, equation— 1b	1c	9-percent monetary growth, equation— 1b	1c
Growth in GNP:				
1971:3	10.8	11.3	11.1	12.0
1971:4	10.3	10.3	11.8	12.0
1972:1	9.3	9.6	11.7	12.0
1972:2	8.2	8.2	11.0	10.7
1972:3	7.4	7.3	10.2	9.7
1972:4	7.4	7.3	9.9	9.3
Average growth in GNP	8.9	9.0	10.9	10.9
Minus assumed inflation	3.5	3.5	3.5	3.5
Equals average growth in real GNP (g_Q)	5.4	5.5	7.4	7.4
Implies unemployment rate in 1972:4[1]	5.7	5.7	4.7	4.7

[1] Calculated by formula: $V=6.2-(\frac{1}{3})(3\frac{1}{2})(g_Q-4.5)$.

Table 2, of course, assumes that the specified monetarist equations predict accurately. If the overprediction of GNP growth which occurred in the first half of 1971 were to continue, the minimal drop in unemployment forecast with 6 percent growth in M1 would be even smaller or might disappear altogether.

SOURCES OF ERRORS

Are there underlying factors which explain the differing predictions of Table 1 and allow us to make a "best guess" of the future relation between income and and money? Table 3 presents a selection of information about the estimated equations and provides a few hints. Three extra sample periods are included for each money concept to aid in the interpretation.

TABLE 3.—REGRESSIONS OF CHANGE IN GNP ON CHANGES IN MONEY AND GOVERNMENT SPENDING

Equation	Money concept	Sample period	Constant	Sum of money coefficients	Standard error	Implied change[1] in velocity with money growth of		
						3 percent	6 percent	9 percent
1a	M1	1953:1-71:1	0.0349	0.853	0.0257	3.05	2.61	2.17
1b	M1	1960:1-71:1	.0397	.665	.0187	2.96	1.95	.96
1c	M1	1965:1-71:1	.0504	.491	.0169	3.51	1.99	.47
1d	M1	1953:1-62:4	.0227	1.707	.0317	3.39	6.48	8.58
1e	M1	1953:1-66:4	.0281	1.259	.0279	3.59	4.36	5.16
1f	M1	1960:1-66:4	.0311	1.096	.0195	3.39	3.67	3.96
2a	M2	1953:1-71:1	.0149	.967	.0284	1.33	1.23	1.11
2b	M2	1960:1-71:1	.0124	.885	.0184	.67	.33	.09
2c	M2	1965:1-71:1	.0183	.887	.0174	1.22	.86	.43
2d	M2	1953:1-62:4	−.001	1.489	.0336	2.44	3.89	5.38
2e	M2	1953:1-66:4	.0152	.949	.0302	1.26	1.11	.94
2f	M2	1960:1-66:4	.0175	.911	.0184	1.20	1.04	.76
3a	M3	1953:1-71:1	−.0193	1.324	.0293	−.40	.67	1.65
3b	M3	1960:1-71:1	−.004	1.049	.0199	.24	.39	.48
3c	M3	1965:1-71:1	.0167	.912	.0167	1.23	.96	.69
3d	M3	1953:1-62:4	−.0478	1.848	.0327	−.54	1.98	4.52
3e	M3	1953:1-66:4	−.0206	1.289	.0301	−.62	.34	1.12
3f	M3	1960:1-66:4	−.0225	1.254	.0177	−.98	−.22	.55

[1] Money growth assumed 2 percentage points higher for M2 and M3. Coefficients on government spending ignored.

First, which money concept fits best? Although the standard error of the M1 equation is best for the entire 1953–71 period (equations a), this victory is entirely due to the first half of the period (1953–62, see equations d). During both the early (equations f) and late (equations c) 1960s, the standard error of the M3 equation is the lowest, although M2 fits best for the 1960s as a whole (equations b). These differences are small and in many cases statistically insignificant, so there is little to be gained by a close study of differences between the residuals of the various equations.

A more important problem is the cause of the differing predictions for 1971 illustrated above in Table 1. One common feature of the equations in Table 3 is that the sum of the coefficients on the monetary variable tends to be considerably higher when the 1953–59 interval is included in the sample period. The "b" and "c" equations, which exclude 1953–59, uniformly have smaller sums of coefficients on money than the "a" equations which include the early interval. The contrast is even more dramatic between the "d" equations, in which the 1953–59 period dominates, and the others.

If monetary growth is projected to continue at a steady rate in the future, the basic task of the monetarist equations is to predict the future change in the velocity of money. The last three columns in Table 3 demonstrate that the alternative equations have different implications for velocity change, and differences among them depend on the particular steady rate at which money is expected to grow. The velocity implication of the equations for a given money concept and different sample periods are reasonably close together when money growth is 3 percent, but diverge widely at 6 and particularly at 9 percent money growth. The velocity projection for M1 at 9 percent money growth varies from 8.6 percent growth for the equation covering the earliest subperiod (equation 1d) to only 0.5 percent for that covering the latest (equation 1c).

Particularly, for M1 the increasing divergence of the velocity predictions at high rates of monetary growth reflects the fact that the constant terms in the alternative equations are more similar than the sum of the coefficients on money. Since the sum of coefficients is much higher on those equations which include 1953–59, projected velocity change is much higher with rapid money growth than for equations which exclude 1953–59. These high velocity projections for the early equations are caused by the fact that GNP fluctuations in 1953–59, and to some extent in 1960–61, were much wider in amplitude than after 1961. The equations explain the very rapid recovery in 1955, and the very sharp turnaround from a steep decline in GNP in early 1958 to a steep rise in late 1958, as attributable to a high elasticity of income change to money change. But the greater the share of 1962–70 in the sample period, and the less the role of 1953–61, the less dramatic the observed swings in GNP and the less accurate the high elasticity estimates.

Did the "true" elasticity of income growth to money growth change after 1961? More probable is the changing role of a "left-out variable," the determinants of sharp fluctuations in inventory accumulation. To the extent that these "left-out" determinants are nonmonetary factors which are positively correlated in timing with monetary growth, their exclusion biases upward the estimated elasticity of income to money, and a reduction in their importance over time is reflected in a reduction in the upward bias in equations for the later sample period, and hence a reduction in the estimated elasticity if the underlying "true" elasticity remains unchanged.

An additional, much more straightforward reason for the smaller velocity growth projected by the M1 equations for later sample periods is that the *actual* growth in the velocity of M1 has slowed in recent years. The velocity of M1 grew at an annual average rate of 3.5 percent per annum between 1953 and 1966, but only at an average of 1.6 percent in the 12 quarters of 1967–69. To the extent that the rapid increase in velocity in the earlier period was due to the substitution out of M1 into savings deposits, the slowdown in velocity growth after 1966 has doubtless been due to the virtual cessation of growth in the yields on savings deposits in the 1967–70 period. Since these yields will probably not grow appreciably over the next year, monetary projections based on M1 should probably be made using an equation with a sample period which covers mainly the recent years of slow yield growth and should not rely on evidence from the earlier period of rapid increases in savings deposit yields. This reasoning points to the use of equation (1c) above in Table 2 as the M1 equation likely to be the most reliable in the near future.

What do changing yield relationships imply about the velocity predictions of the M2 and M3 equations? The opportunity cost of savings deposits, the yields on short-term market securities, rose relative to deposit yields during 1967–69. This was reflected in faster velocity growth for M3 (0.7 percent in 1967–69 versus —0.3 percent in 1961–66). M2 velocity growth was little changed (0.4 percent in 1967–69 versus 0.6 percent in 1961–66), probably because in 1967–68 time deposits were still growing rapidly in response to the narrowing of yield differentials between S & L and time deposits which occurred in 1964–66.

If changing yield differentials are the major determinants of the sensitivity of velocity predictions to the choice of sample period, then predictions of M2 and M3 equations may be particularly unreliable in 1971. There is no precedent in any of the alternative sample periods for the extent of the sharp reduction in the yields of market securities relative to savings deposits which occurred from the average level of 1969–70 to the average level in the first half of 1971. If savers take several quarters to adjust to the increased attractiveness of savings deposits, 1971 may be a period of an unprecedented decline in the velocity of M2 and M3. The closest previous historical parallel in the postwar years was the drop of market interest rates in early 1960. This was followed by income growth substantially slower than the fitted values of the M2 and M3 equations (2a, 2b, 3a, 3b) in the second half of 1960 and the first half of 1961.

PREDICTIONS IN PREVIOUS EPISODES OF MONETARY EXPANSION

The preceding section suggests that income growth in late 1971 will be overpredicted by all the equations except (1c), which uses the M1 monetary concept for the most recent sample period. While we must wait at least two more quarters to find out if these conjectures are correct, one test of their plausibility is an application to past periods. What are the predictions of the (d) set of equations, which end in 1962:4, for the three years of monetary expansion 1963–65? And what do the (f) set of equations, which end in 1966: 4, predict for the expansive 1967–69 period?

Actual average income growth in 1963–65 was 7.2 percent, but is uniformly overpredicted by all three (d) equations; growth rates of 8.8, 9.6, and 12.2 percent are predicted by the three respective monetary concepts. In all three cases, the high elasticity of income to monetary change in the 1953–62 sample period, due to the severity of inventory fluctuations, proved to be an overestimate of the economy's response to rapid monetary growth in 1963–65.

The (f) set of equations, with a sample period of 1960–66, do a mixed job in predicting 1967–69. The M1 equation overpredicts substantially that the 1967–69 expansion should proceed at a 10.1 percent average annual rate, as compared to the actual observed rate of 7.1 percent. This reflects the slowdown in the growth of savings deposit yields after 1966. On the other hand, the M2 and M3 equations are much more accurate, with predictions of 7.6 and 6.1 percent, respectively. This success, however, is probably not a good indication of the likely performance of M2 and M3 equations in 1971–72, because the drop in market rates in 1967 was much smaller and shorter than has occurred in 1971, and hence the decline in the velocity of M2 and M3 this year is likely to be much more marked.

CONCLUSIONS

Among the conclusions and implications of this paper are:

(1) Most monetarist equations have already made substantial overpredictions of GNP growth in 1971.

(2) Further overpredictions are likely during the remainder of 1971.

(3) Because of (2), monetarists exaggerate the increase in spending and reduction in unemployment which would occur in 1971–72 if the Federal Reserve slows growth in M1 to 6.0 percent per annum from now on. Such a policy is unlikely to lead to an appreciable reduction in unemployment.

(4) The major cause of errors is probably the omission from monetarist equations of changing interest rate differentials which cause substitutions in and out of different financial assets, and hence cause changes in the velocity of money.

(5) Equations based on M1 are likely to be most accurate in 1971–72 because the major substitute for M1 is savings deposits, on which yields have not changed much recently and are not likely to change appreciably in the near future.

(6) However, M1 equations will lead to overpredictions of GNP growth if the sample period includes too much of the pre-1967 era of rising savings deposits yields, particularly if the 1950s are included.

(7) The overprediction of GNP growth in 1971 generated by the Laffer model is fundamentally due to (6), since his sample period covers the entire 1948-70 period.

(8) The St. Louis equations are likely to be more accurate, even though they include the late 1950s in their sample period, because the expression of variables as absolute rather than relative changes gives relatively heavy weight to the last half of the 1960s.

Representative GRIFFITHS. Thank you very much, Mr. Gordon. I would like to tell you, I have to dispose of the four people ahead of me before I become the chairman of the Ways and Means Committee, before I can junk the Social Security Act.

Mr. Levy, please proceed.

STATEMENT OF MICHAEL E. LEVY, DIRECTOR, ECONOMIC POLICY RESEARCH, THE CONFERENCE BOARD

Mr. LEVY. I have a prepared statement and supplementary material but I would like to summarize my prepared statement.

In the prepared statement, I indicate that the economy has just emerged from the fifth postwar recession and has completed the first two quarters of its recovery. I compare this recession and the first stages of the recovery with previous postwar experience, particularly in chart 1 of my prepared statement. The evidence shows that this was a rather mild recession, probably the mildest one we have had in the postwar period, but the economy so far, during the first half year of the recovery, has been modest—one might even say sluggish—in comparison with previous postwar records.

I also draw some comparisons between the record of the last 3½ years and the experience of the second half of the 1950's. In both instances, the major problem was the fight against inflation. The policies used largely were restrictive fiscal and monetary policy. In both instances, these policies brought on, or contributed to bringing on, the recession.

During the 1957–58 recession, prices continued to rise and the inflation was not stopped until the very end of the recession or the early recovery, and there was a strong cost-push element in the inflation. During the present period, inflation has continued right through the recession and into the early stages of the recovery, but we have had a longer preceding period of inflation and a more deeply intrenched inflation.

During the late 1950's, there was a very strong debate going on whether so-called cost-push inflation could at all be effectively fought with additional fiscal and monetary policies. The debate dissolved when the subsequent period produced 6 years of extreme price stability by almost any measure or definition. It would suggest to us that, indeed, cost-push inflation could be fought by traditional measures. That is not the entire story. As we view the second half of the 1950's, we cannot be sure that inflation would not have been revived had we not turned again to restrictive fiscal and monetary policies after the very initial phases of the expansion, long before the economy had recovered. The result of these restrictive policies was that the recovery of 1958–60 was a sluggish one, unemployment rates were high by historical standards, stayed high, and the loss of potential output was substantial.

I have made some computations which indicate that the unemployment rate during that recovery, 1958 through 1960, averaged 5.9 percent. The loss of potential output per quarter averaged over 6 percent. The unemployment rate never came down during any quarter to 5 percent or below, and the loss of potential output during any given quarter of that recovery was never less than 4 percent.

Moreover, as a result of these policies, we moved into the 1960–61 recession long before full employment was obtained, and had during 1958–60 the shortest and most incomplete postwar expansion.

Now, there may be some important lessons to be learned from this period, because it seems to me this period is relevant to our current policy considerations.

A long period of high unemployment rates and large losses of real potential output will restore reasonable price stability. Yet the economic costs are high in terms of unemployment and they are likely to be higher in terms of unemployment this time around than they were in the late 1950's. There is statistical evidence that we would have to keep unemployment rates at even higher levels now to achieve the same effect of reducing price inflation than was the case in the late 1950's.

In my prepared statement, I review briefly the likely projectory of the economy for the second half of this year and the first half of next year, summarizing this in terms of the likely performance for calendar year 1971 and for fiscal year 1972. In doing so, I provide a table which summarizes seven sets of major economic projections from a variety of sources and using a variety of methods, but all highly regarded projections. Five of these are derived from econometric models which, by the way, include the Michigan model, about which Professor Shapiro will have more to say.

Included also is what is probably the best known so-called "money-supply model," that of the Federal Reserve Bank of St. Louis; they gave me updated figures, the latest updated figures that are available.

Also included is a summary by the American Statistical Association and the National Bureau of Economic Research, derived from a large number of forecasts of professional economists who forecast regularly and many of whom used judgmental methods. So judgemental methods, econometric methods, and a money supply model are all represented here and yet, if one compares figures, there is considerable agreement and some major conclusions emerge.

First of all, these projections, if they are to be trusted, suggest that we are not likely to come close to the famous $1,065 billion GNP target submitted by the Council of Economic Advisers in February of this year. We are not likely to come close to this target, despite the fact that we have had more fiscal stimulation and more monetary stimulation so far than the Council of Economic Advisers considered necessary at the time they made these projections in order to attain this target.

Particularly important is an analysis of the components of this shortfall. If you look at the inflation part of it and the real growth part of it, you find that the shortfall is largely due to the fact that most projections envision sluggish growth for the calendar year in real terms. In other words, the expansion in output of the economy for calendar year 1971 is likely to be so modest in comparison with other first year recoveries, that it will not come close to this target at all.

Most models project some reduction in inflation during the course of this year and some further reduction over the fiscal year 1972 period which extends through the middle of next year. The reductions envisaged are significant—and I provide some figures in the table—but they are modest. They are not likely to get us the degree of price stability generally talked about or envisioned as the key to stability, where we have no longer a problem of fighting inflation, unless we accept Professor Gordon's thesis that inflation is not a matter of concern in the first place, and not all people might agree with that thesis. Inflation will moderate some but not a great deal.

Now, the question is what are the costs of obtaining this moderation in inflation, if these models end projections are to be trusted at all; there we find the costs will indeed be high. Most models project for calendar year 1971 a real growth rate of less than 3 percent. The highest projection suggest real growth rate of 3.6 percent for the calendar year, which would be substantially below the 4.2 percent growth rate which was the growth rate of the slowest previous postwar economic recovery for a comparable period. The fastest or most vigorous recovery had a real growth rate during the first year of 9.6 percent.

Growth is likely to improve somewhat during fiscal year 1972, but even then, three projections suggest a real growth rate of 4 percent or less. The highest single projection suggests for fiscal year 1972 a real growth rate of 5 percent. During previous comparable stages of the recovery, the slowest real growth rate was 6.4 percent and the fastest, 11.3 percent. This gives you an indication of the degree of sluggishness of this recovery.

These figures can be placed into some perspective by what I call the "break-even growth rate," that is, the real growth rate that would be required in order to prevent unemployment from deteriorating. I have estimated that, over the next fiscal year, this break-even growth rate would be about 4.75 to 5 percent in real terms which means that, unless we can move the economy ahead at a substantially faster real rate than that, we cannot expect any noticeable improvement in the unemployment rate.

Mind you, the highest projection envisioned a real growth rate for fiscal year 1972 of 5 percent. This suggests we cannot envision any significant improvement in unemployment from its recent level through the middle of next year and indeed, if you look at the independent estimates of unemployment rates in these various projections, you find they cluster pretty much at the current level or, at best, a trifle below the current level, which after going through a year and a half of recovery would certainly be high in terms of most targets that are set presently. I think it would be disturbingly high.

In brief, the performance of the U.S. economy over the next year as projected by some of the best forecasts currently available would include a modest reduction in the rate of inflation, but at the cost of sluggish real growth in terms of the first year and a half of a recovery, and high unemployment rates at, or near, their current level. Such an economic performance would resemble in important ways the experience of the late 1950's.

At present, the premise is widely accepted that the Federal Reserve Board is in the process of reducing the rate of growth of the money supply well below its earlier hectic pace; moreover, the administration has asserted that no further fiscal stimulation should be expected in the foreseeable future.

The sluggish recovery and the high unemployment rates experienced so far—and envisioned for the coming year by all seven projections reviewed here—are likely to invite efforts to provide additional economic stimulation. Yet it is argued by some, not entirely without merit, that the economy has already received strong stimulation, particularly from a highly expansionary monetary policy, and that the full response is likely to show up only after a time lag. There is, however, some danger here of overrating the degree and effectiveness of recent economic stimulation, particularly in an environment where decisionmaking is still adversely affected by inflationary expectations, as well as by sluggish growth and high unemployment. The recent fiscal stimulation has been relatively modest (at least in terms of such simple and inadequate measures as the full-employment budget surplus as a percent of potential GNP); and the effect of the strong monetary stimulus may well be reduced, at least for the time being, by the desire of business to rebuild liquidity as a hedge against future monetary reversals and by high savings rates that reflect the consumer's malaise caused by continuing high rates of inflation and unemployment.

At this time, the merit of additional economic stimulation must be balanced against the real danger that it may largely spill over into wage, cost, and price increases while producing only modest further gains in real output and employment. If this were to happen, the recent recession—with its ensuing loss of potential output and employment—would have bought, at best, a small temporary slackening of the high rate of inflation.

In summary, fighting the present inflation with traditional fiscal and monetary policies may subject the economy to a trajectory of sluggish real growth, high unemployment, and large losses of potential output. If so, the mandate of the 1946 Employment Act would seem to require that we modify our policy mix in ways that hold out the promise of a higher growth trajectory for the economy while containing inflation.

Thank you.

Representative GRIFFITHS. Thank you.

(The prepared statement and supplementary material of Mr. Levy follow:)

PREPARED STATEMENT OF MICHAEL E. LEVY [1]

The U.S. economy, after emerging from its fifth postwar recession, has just completed the first two quarters of its recovery. In duration, this was the second longest postwar recession—yet it appears to have been the mildest one in amplitude.[2] The initial two quarters of the recovery have extended the "saucer shape" of the recession; compared with all previous postwar recoveries, the latest one has been at best modest, if not sluggish (see Chart 1).

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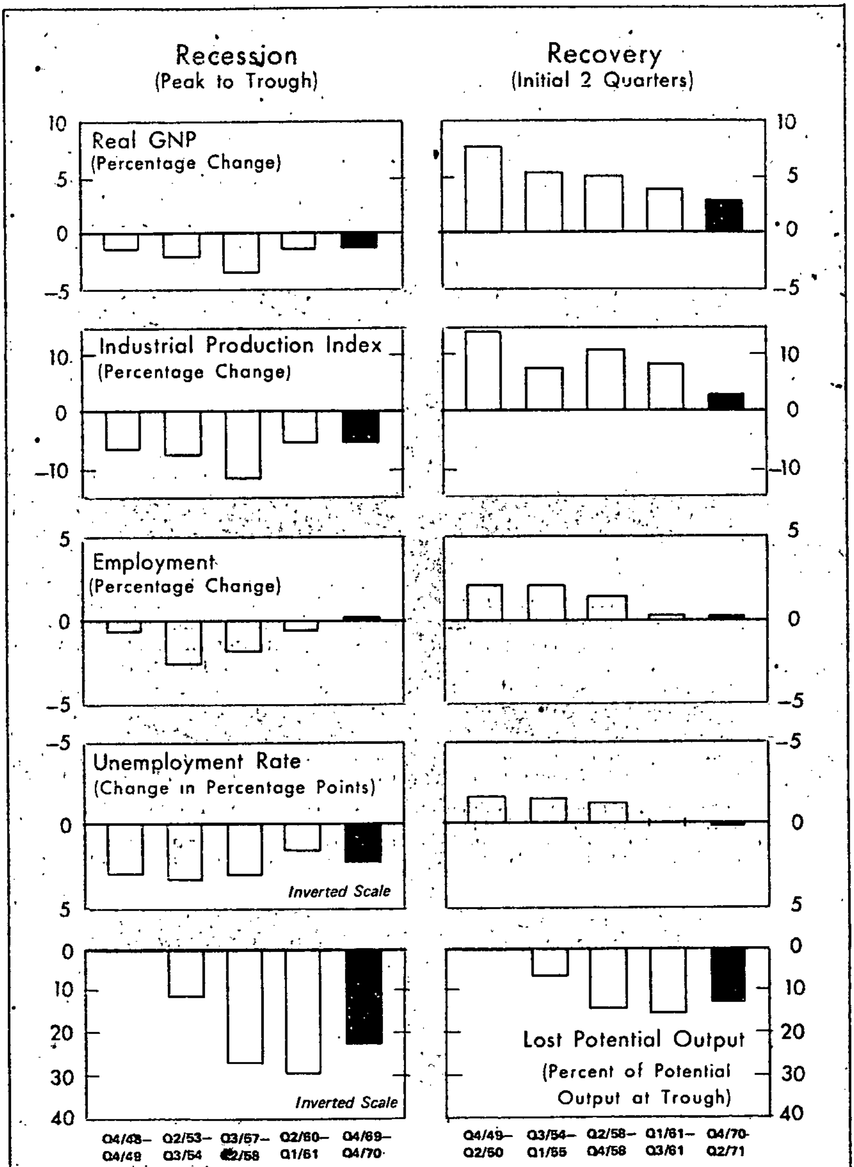
[1] The views expressed in this statement do not necessarily represent the views of the institutions with which the author is currently affiliated.

[2] The recession has been dated tentatively from November 1969 through November 1970 (see Solomon Fabricant, *Recent Economic Changes and the Agenda of Business-Cycle Research*, National Bureau of Economic Research, Inc., New York: May 1971).

Chart 1:

Mild Recession-Sluggish Recovery, 1969-1971



Sources: Department of Commerce; Federal Reserve Board; Department of Labor; CEA; The Conference Board

The 1969–1970 recession was induced to a large extent by the conscious application of fiscal and monetary restraint designed to brake the inflationary spiral and to restore price stability. Of course, this so-called Game Plan 1 did not include an actual recession; it aimed at a gradual slowing of the economy, followed by several quarters of virtually no real growth (but without any decline in real output or sharp rise in unemployment—the classical signs of a recession) in order to choke off the inflation.[3] This policy of "planning without dipping" called for a degree of fine tuning which is presently well beyond the state of the art; therefore, it was likely either to lead to a recession, or to fail to control the inflation—or both.

The economic scenario of 1968–1971 bears a close resemblance to the experience during the second half of the 1950's: accelerating inflation with strong "wage-cost-push" elements fought by fiscal and monetary restraint which resulted in a recession. (Elsewhere, I have reviewed the present and previous postwar inflations and the policies used to cope with these inflations. This analysis bears on the current economic situation; therefore, with the permission of the Chairman and the members of this Committee, I would like to make it available for the record.)[4] A comparison of these two periods is timely, because it may help us avoid a repetition of the experience of 1958–1961, when an incomplete economic recovery was chocked off prematurely by renewed fiscal and monetary restraint, resulting in an economic decline in 1960–1961 long before the economy had attained its full potential.

LESSONS OF THE SECOND HALF OF THE 1950'S

The accompanying chart (Chart 2) presents a few economic series that seem to me particularly pertinent for a comparison of the second half of the 1950's with the most recent economic experience. The number one problem in both instances was an excessively high and accelerating rate of inflation. In both instances prices increased at unacceptably fast rates well into the recession; most recently, the *acceleration* of price inflation appears to have been stopped, but the *rate* of inflation has continued nearly unabated through the recession into the first two quarters of the recovery. From the very outset, the 1956–1958 inflation included strong so-called wage-cost-push elements; the latest inflation has been subject to strong cost-push pressures only during the last two years. In the 1950's as well as most recently, economic policy relied mainly on the traditional weapons of fiscal and monetary restraint to fight the inflation;[5] in both instances these tools were applied forcefully.

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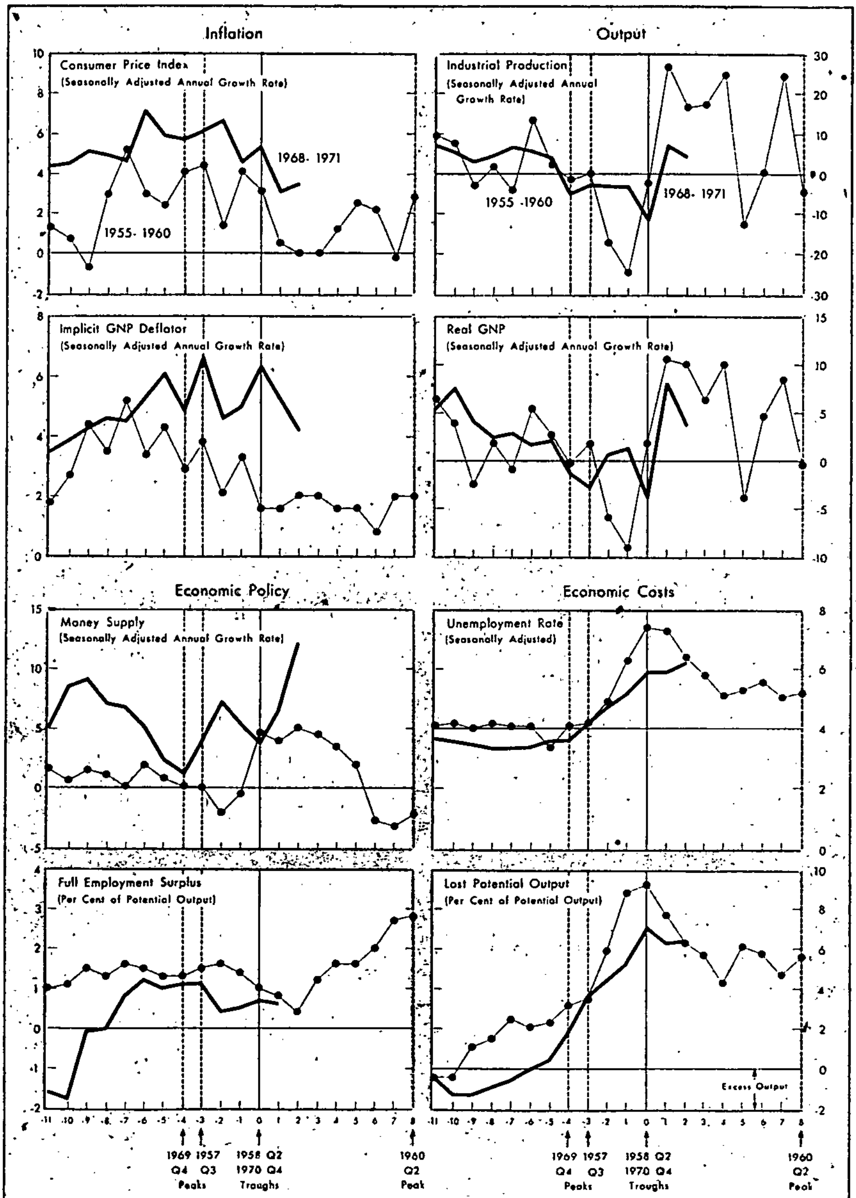
[3] In this connection, note the *February 1970 Economic Report of the President* (especially pp. 7–8) and *The Budget Message of the Present for Fiscal Year 1971* (especially pp. 11–12).

[4] "U.S. Inflation and Wage-Price Guideposts: Past Lessons and Prospects," *The Conference Board Record*, June 1971, pp. 5–11.

[5] However, for a review of recent supplementary measures to restrain wage and price advances, see "U.S. Inflation and Wage-Price Guideposts: Past Lessons and Prospects," *loc. cit.*

Chart 2:

The Fight Against Inflation: Economic Policies and Costs
(A Comparison of 1955-1960 with 1968-1971)



Sources: Department of Commerce; Department of Labor; Federal Reserve Board; CEA; Federal Reserve Bank of St. Louis; The Conference Board

The 1956–1958 inflation (which was far less deep-seated than the present one) was arrested only gradually toward the very end of the recession and the early stages of the recovery. Moreover, it would be difficult to ascertain whether the inflationary flames might not have been rekindled if, after the brief initial recovery, fiscal and monetary policy had not become thoroughly restrictive again, forcing the economy onto a slow growth path and into the premature 1960–1961 recession.

During the second half of the 1950's, economic policy debates centered on the question whether traditional fiscal and monetary policies were effective and adequate in coping with so-called cost-push inflation. The six years of virtual price stability which followed the 1956–1958 inflation seemed to dissolve this issue. To me, the lesson of the late 1950's is clear: traditional fiscal and monetary policies *can* effectively cope with inflations of the kind we have recently experienced—but the real economic costs are high: prolonged sluggish real growth of economy, a very large loss in potential real output, and continuing high unemployment rates well in excess of what would be considered "full employment" even in terms of the most conservative definition.[6] (Evidence to this effect is displayed in the right-hand panel of Chart 2.)

During the 1958–1960 expansion, the unemployment rate averaged 5.9% and never receded to 5% in any single quarter; the quarterly loss of real potential output averaged 6.2% and was never less than 4.3%. The premature 1960–1961 recession resulted in a sharp deterioration in unemployment as well as in potential output lost, and the improvements during the early phases of the subsequent expansion were slow and gradual.

To me, the evidence is convincing and the lesson is clear. A long period of high unemployment rates and large losses of real potential output will restore reasonable price stability. Yet, the economic costs are high—in terms of unemployment they are likely to be even higher this time around than they were in the late 1950's (if recent research on this subject is to be trusted).[7]

Recent policy statements by the Administration suggest, and some of the most prestigious economic projections (discussed subsequently) tend to confirm, that the economy can be expected to continue on a growth path which relies on large potential output losses and high unemployment rates to gradually cure the present inflation. I shall now turn to a review of this economic outlook and consider briefly the real costs and the alternatives.

ECONOMIC PROJECTIONS FOR CALENDAR 1971 AND FISCAL 1972

In the accompanying table, I have put together—on an internally consistent basis—seven sets of economic projections; these comprise some of the best forecasts available outside the Federal government, derived from a multiplicity of alternative and competitive methods and sources. Five of these projections come from fairly detailed econometric models; a sixth set represents the average of projections by a large number of professional economists who prepare regular economic forecasts; projections by a well-known "Money-supply Model"—that of the Federal Reserve Bank of St. Louis—are also shown. The data summarized here include GNP (in current dollars), the real growth rate, the rate of inflation (as measured by the implicit GNP deflator), and the unemployment rate; information is provided for the next four quarters, as well as for the calendar year 1971 and the fiscal year 1972.

Significantly, with one exception, all current-dollar GNP projections for 1971 are substantially lower than the $1,065 billion "target" projected by the CEA last February.[8] Even now this target appears to be out of reach despite the fact

[6] Moreover, recent research by Robert J. Gordon suggests that such a "cure" may be effective only for relatively short periods, up to about 5 or, at most, 7 years (see his "Inflation in Recession and Recovery," *Brookings Papers on ECONOMIC ACTIVITY*, 1971, No. 1, especially pp. 140–42).

[7] What is implied here is a deterioration in the so-called "Phillips Curve." Recent evidence is contained in George L. Perry, "Changing Labor Markets and Inflation," *Brookings Papers on ECONOMIC ACTIVITY*, 1970, No. 3, especially pp. 431–33; also Robert J. Gordon, *loc. cit.*, especially p. 123. This author concluded as early as 1966 that the U.S. Phillips Curve trade-off had deteriorated (see Michael E. Levy, "Full Employment and Inflation: A 'Trade-Off' Analysis," *The Conference Board RECORD*, December 1966, pp. 17–27).

[8] The only projection that comes close to this target figure is that of the Federal Reserve Bank of St. Louis, prepared in July 1971. This model relies heavily on the rates of growth of the money supply for its projections. Its latest results reflect the exceedingly high rate of growth of the money supply during the first half of 1971.

that the economy received stronger fiscal and monetary stimulation during the first half of 1971 than had been proposed by the CEA as a prerequisite for attaining this target. The short fall in GNP—according to the projections reviewed here—would be due to sluggish real growth rather than to a moderation in the rate of inflation.

All but one of the seven projections of the rate of inflation for 1971 are in excess of 4½% ; four models project the rate of inflation at 5% or more.

ECONOMIC PROJECTIONS OF GNP, REAL GROWTH, INFLATION, AND UNEMPLOYMENT, 1971-72

[Seasonally adjusted annual rates]

Series	Actual		Projections						
	1970	1971 1st half	Source and date	1971 III	1971 IV	1972 I	1972 II	Calendar 1971	Fiscal 1972
(GNP billions, of dollars)	974	1,031	A	1,055	1,078	1,103	1,128	1,049	1,091
			B	1,060	1,088	1,113	1,136	1,053	1,099
			C	1,066	1,084	1,109	1,129	1,056	1,097
			D	1,075	1,102	1,124	1,143	1,061	1,111
			E	1,056	1,078	1,108	1,135	1,049	1,094
			F	1,061	1,081	1,109	1,134	1,050	1,096
			G	1,059	1,081	1,106	1,128	1,050	1,095
Real growth rate (percent)	−.6	3.8	A	2.7	4.9	6.0	5.9	2.6	3.6
			B	2.2	6.7	4.8	4.8	2.7	4.1
			C	1.7	3.5	4.3	4.1	3.6	5.0
			D	6.2	5.3	3.2	2.1	3.3	4.7
			E	.3	3.8	6.8	6.1	2.1	3.2
			F	2.7	3.4	7.2	5.9	2.5	4.0
			G	4.5	5.3	5.7	5.2	2.8	4.8
Rate of inflation of implicit GNP deflator (percent).	5.5	5.3	A	3.2	3.7	3.7	3.1	4.6	3.8
			B	3.8	4.0	4.4	3.5	5.0	4.5
			C	3.8	3.7	3.9	3.3	4.2	3.7
			D	4.9	5.1	4.8	4.7	5.2	5.1
			E	5.3	4.5	4.5	3.5	5.2	5.0
			F	4.9	5.0	4.2	4.6	5.0	4.5
			G	3.7	3.0	3.7	2.7	4.6	3.8
Unemployment rate (percent)	4.9	6.0	A	5.8	5.7	5.6	5.4	5.8	5.6
			B	5.9	5.7	5.7	5.6	5.9	5.7
			C	6.1	6.1	6.2	6.2	6.1	6.2
			D	5.7	5.6	5.6	5.7	5.8	5.7
			E	6.2	6.3	6.1	5.9	6.2	6.1
			F	5.9	6.1	6.0	5.9	5.8	6.0
			G	6.2	6.1	5.9	5.7	6.1	6.0

Note: Computations for fiscal 1972 were derived by the author from the quarterly data.

Sources: A—Joint American Statistical Association/National Bureau of Economic Research survey of economists who prepare regular economic forecasts (June 1971); B—Wharton Econometric Model (May 1971); C—Michigan Econometric Model (March 1971); D—Federal Reserve Bank of St. Louis "Money Supply Model" (July 1971); E—Chase Economic Associates, Inc. (June 1971); F—Data Resources, Inc. (July 1971); G—Fair Econometric Model (April 1971).

Looking one year ahead, a modest, but significant reduction in the rate of inflation is envisioned by five projections; but only the three lowest one track the increase in the GNP deflator for fiscal 1972 at a little less than 4%.

If these projections are to be trusted, this rather modest reduction in the rate of inflation will be bought at the price of relatively sluggish real growth and continuing high unemployment rates during the first year-and-a-half of the present recovery. For 1971 as a whole, five of the seven projections envision a real growth rate of less than 3%. (By comparison, real growth during the first year of the previous postwar recoveries ranged from a low of 4.2% to a high of 9.6%). Even according to the highest among the seven projections, the real growth rate for 1971 would be only 3.6%, well below the 4.2% rate of the slowest previous postwar recovery.

Improved real growth is projected for the end of this year and early 1972. But even for fiscal 1972, as many as three projections list real growth rates of 4% or less, and only one single model projects a real growth rate as high as 5%. (At this cyclical stage in previous postwar recoveries, the real growth rate ranged from a low of 6.4% to a high of 11.3%.)

One way of placing these growth rates in perspective is by comparing them to the "break-even" growth rate that is required in order to prevent the unemployment rate from rising. (Real growth rates in excess of this break-even rate would be necessary in order to reduce the unemployment rate.) According to my own rough estimate, this break-even real growth rate is likely to be in the range of 4¾% to 5% for fiscal 1972. This would imply that little, if any, improvement in the unemployment rate could be expected during fiscal 1972, even with the highest real growth rate projected by the models reviewed here.

In fact, the unemployment rates of all seven projections cluster narrowly around the 6% rate recorded during the first half of 1971—well above the 4.9% average for 1970—with little improvement projected for the first half of 1972.

In brief, the performance of the U.S. economy over the next year, as projected by some of the best forecasts currently available, would include a modest reduction in the rate of inflation, bought at the cost of sluggish real growth (in terms of the first year-and-a-half of a recovery) and high unemployment rates at or near their current level. Such an economic performance would resemble in important ways the experience of the late 1950's.

At present, the premise is widely accepted that the Federal Reserve Board is in the process of reducing the rate of growth of the money supply well below its earlier hectic pace; moreover, the Administration has asserted that no further fiscal stimulation should be expected in the foreseeable future. In this connection, it seems appropriate to bear in mind that a sharp shift to fiscal and monetary restraint after the initial phase of the 1958–1960 expansion (see Chart 2) contributed to the economic decline of 1960–1961, which occurred before the economy had regained full-employment.

THE POLICY DILEMMA

The sluggish recovery and the high unemployment rates experienced so far—and envisioned for the coming year by all seven projections reviewed here—are likely to invite efforts to provide additional economic stimulation. Yet it is argued by some, not entirely without merit, that the economy has already received strong stimulation, particularly from a highly expansionary monetary policy, and that the full response is likely to show up only after a time lag. There is, however, some danger here of overrating the degree and effectiveness of recent economic stimulation, particularly in an environment where decision making is still adversely affected by inflationary expectations, as well as by sluggish growth and high unemployment. The recent fiscal stimulation has been relatively modest (at least in terms of such simple and inadequate measures as the full-employment budget surplus as a percent of potential GNP); and the effect of the strong monetary stimulus may well be reduced, at least for the time being, by the desire of business to rebuild liquidity as a hedge against future monetary reversals and by high savings rates that reflect the consumer's malaise caused by continuing high rates of inflation and unemployment.

At this stage, the merit of additional economic stimulation must be balanced against the real danger that it may largely spill over into wage, cost and price increases while producing only modest further gains in real output and employment. If this were to happen, the recent recession—with its ensuing loss of potential output and employment—would have bought, at best, a small temporary slackening of the high rate of inflation.

In summary, fighting the present inflation with traditional fiscal and monetary policies may subject the economy to a trajectory of sluggish real growth, high unemployment, and large losses of potential output. If so, the mandate of the 1946 Employment Act would seem to require that we modify our policy mix in ways that hold out the promise of a higher growth trajectory for the economy while containing inflation.

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U.S. INFLATION AND WAGE-PRICE GUIDEPOSTS

Michael E. Levy
CB Economic Policy Research

A REPRINT

U.S. Inflation and Wage-Price Guideposts

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Past lessons and prospects

During the last two decades the U.S. economy has suffered from three bouts of inflation; the first two were followed by several years of virtual price stability, whereas the most recent one—which dates back to the mid-1960's—has not yet come under control.

The question is being raised now whether traditional fiscal and monetary policies can control the most recent inflation without an exorbitant price of prolonged sluggish growth and high unemployment. Voices outside—and even within—the Administration are raised in favor of some form of "wage-price guideposts" or "incomes policies."

A review of the three U.S. postwar inflations of the last two decades sheds new light on this issue by placing it in historical perspective.

1950-1952 inflation: Korea

The first inflation of the 1950's was closely associated with the Korean War (even though prices had begun to rise moderately during the first half of 1950). The entire Korean inflation ran its course within less than two years, from around mid-1950 through early 1952. Moreover, the main thrust of the inflation was sharper and much more short-lived—from around mid-1950 through early 1951. The consumer price index, which had risen by 9.4% between May 1950 and May 1951, continued to rise by only 1.9% from May 1951 to May 1952; thereafter, it advanced at an average annual rate of merely 0.5% between May 1952 and May 1956.

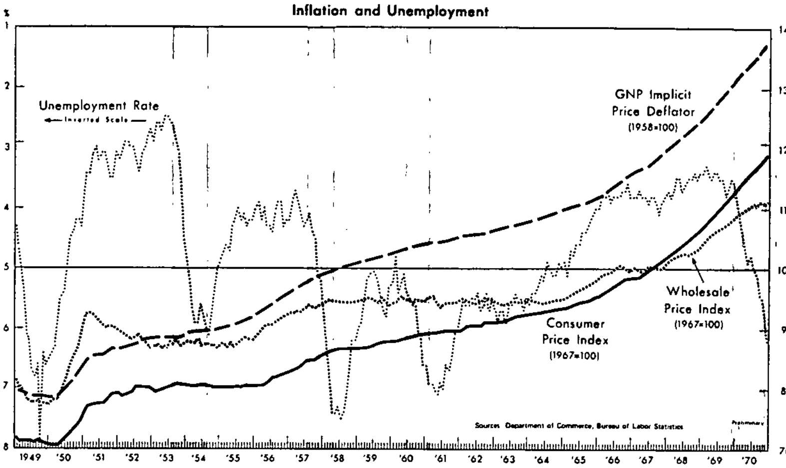
The sharp initial price thrusts were only partially attributable to expanding demand or to supply shortages; they reflected to a large extent expectational forces. In part, the increase in raw material prices anticipated future shortages and price controls; consumers stepped up their buying in anticipation of scarcities. This anticipatory consumer buying—triggered by World War II memories of scarcities of durable goods, and by real fears of a near-defeat after the entry of Red China into the war—differed dramatically from the pattern of consumer buying during subsequent postwar inflations.[1]

Economic policy responded promptly and effectively. Tighter credit controls on purchases of consumer durables and on mortgage credit were imposed by the Federal Reserve Board through its Regulations W and X. Increases in personal and corporate income taxes and the Defense Production Act of 1950 were enacted in quick succession. Selective price and wage controls of late 1950 gave way to a general price freeze under the General Ceiling Price Regulation imposed by the Office of Price Stabilization on January 25, 1951, and to general wage regulations by the Wage Stabilization Board. These concerted policies were largely responsible for undercutting the inflationary thrust and restoring price stability long before the end of the Korean War.

This rapid restoration of price stability in the face of the continuing war effort was all the more impressive because of the very low prevailing unemployment. The unemployment rate—which had declined rapidly from 6.5% in January 1950 to 3.7% in January 1951—continued to decline to 3.2% in January 1952 and to 2.9% in January 1953. By mid-1953, when the unemployment rate reached its postwar low of 2.5%, price controls had been terminated by President Eisenhower (in March 1953), yet the previous record of price stability was preserved. The consumer price index rose by 1.1% from March 1953 to March 1954 at about the same pace as during the preceding year. Moreover, the rise in the implicit price deflator of GNP slowed from 2% between the first quarter of

[1] During the following two U.S. inflations, consumers did not engage in "hedge buying" to beat price inflation. In this connection, see George Katona, "The Impact of Inflation on Consumer Attitudes and Behavior," *The RECORD*, March 1971.

Inflation and Unemployment



Sources: U.S. Department of Commerce; Bureau of Labor Statistics

1952 and the first quarter of 1953 to only 1.2% from the first quarter of 1953 to the first quarter of 1954. In fact, in terms of the implicit price deflator, a high degree of price stability was preserved through 1955; the stability of the consumer price index extended well into 1956.

In reviewing the Korean and post-Korean experience, some economists have concluded that the combination of sharply increased taxation and selective credit, price, and wage controls can effect a favorable combination of low unemployment and relative price stability even under adverse conditions, especially if applied early and forcefully.

1956-1958 inflation and its aftermath

The causes of the 1956-1958 inflation, as well as the remedial economic policies, differed substantially from the Korean War period. The major causes included an investment boom in 1956, sharply rising food prices because of unfavorable supply conditions, and advances in labor costs well in excess of productivity gains which resulted in pronounced increases in unit labor cost. (Other cost increases, such as petroleum price hikes in the wake of the Suez crisis, were also contributing factors.)

Remedial action consisted largely of the gradual application of more restrictive fiscal and monetary policies. These policies contributed to the economic slowdown and the 1957-1958 recession. Yet, price advances were not quickly choked off even by the recession; they continued into late 1957 and early 1958.

This unusually "sticky" price behavior reflected to some extent the normal time lags in the adjustments of wages and prices; but it also led to a revival of earlier theories of "administered pricing" and gave rise to heated discussions of so-called cost-push inflation. (Essentially, proponents of the cost-push view maintained that wage claims in excess of productivity gains, as well as other cost increases, were producing inflationary price increases even at times when there was no excess demand and when the economy was operating well below full employment. This view often stressed monopolistic power of labor unions and of "big business" as the real forces behind cost-push inflation.) Questions were raised whether traditional fiscal and monetary policies could cope effectively with an inflation that was said to have been induced, or at least extended, through the application of monopolistic powers by large corporations and powerful labor unions, and by other postwar rigidities. More fundamentally, the basic issue was whether Western industrial society might have embedded in its economic structure elements of cost and price adjustments that would tend to impart a consistently inflationary bias to the economy.

In its *January 1959 Annual Report*, the Council of Economic Advisers stated the issue in even more basic terms that have remained relevant up to the present:

> Clearly, severe reductions in the price level during a brief and moderate recession are not to be expected and would not be a proper objective of national economic policy. Indeed, such reductions might impede early recovery of the economy. Rather, the problem is how to achieve a reasonable stability of prices when economic activity is advancing and output and employment are high. The limited downward flexibility of prices in a moderate recession, and the upward movement even then of certain key prices and costs, highlight and emphasize the need for public and private policies that will produce the desired price stability at all times. (p. 20)

The concern with cost-push inflation abated gradually during the following seven years as the U.S. economy experienced one of its longest periods of virtually stable prices. It is not, however, without significance that this seven-year stretch of price stability was associated with unemployment rates that were consistently high by historical standards, at least for periods comprising mainly the expansionary phases of the business cycle. During the economic expansion of 1958-1960 the unemployment rate dipped below 5% only once, in February 1960, when it reached its low of 4.8%. It rose rapidly during the 1960-1961 recession, reaching a cyclical peak of 7.1% in May 1961. Even though the unemployment rate receded gradually during the subsequent economic recovery and expansion, it had not yet declined below 5% by the end of 1964 (with the brief exception of two isolated months). Unemployment finally retreated below 5% in March 1965, and below 4½% in July 1965; by that time the seven-year stretch of price stability was giving way to the onsetting "Vietnam inflation."

Thus, while the 1956-1958 inflation was followed by about seven years of virtual price stability, the crucial issue was never resolved whether the U.S. economy could operate without inflation at full-employment—usually defined in terms of a 4% unemployment rate—without having recourse to price and wage controls. "guideposts," or some form of "incomes policy." In fact, the 1962 *Annual Report* of the Council of Economic Advisers established a set of *voluntary* "guideposts for noninflationary wage and price behavior" which first gained prominence during the April 1962 "steel conflict."[2] Subsequently, these "guideposts" were refined, modified, and supplemented by off-the-record "consultations."[3] But they faded away gradually during the 1965-1967 inflationary spiral and received their death-blow in the 5% wage and fringe settlement of August 19, 1967, which ended the strike of the International Association of Machinists.[4]

Vietnam Inflation, 1965 —

The latest inflationary bout was triggered by the rapidly accelerating military demands for the Vietnam War after mid-1965 which coincided, in the early stages, with an investment boom in the private sector of the economy. Moreover, because of the government's commitment to "guns and butter," many civilian programs continued to expand rapidly despite the escalating war costs. Unlike the Korean experience, no direct controls were imposed on consumer credit, wages, or prices. When a modest 10% surcharge on personal and corporate income taxes was finally enacted in 1968, it was clearly labeled a temporary measure of short duration. Not until early 1969 were both fiscal and monetary policies closely aligned in a coordinated effort of economic restraint.

The unemployment rate—which at last declined to 4% in December of 1965—stayed below 4% from February 1966 through January 1970 (with the single exception of May 1967). Moreover, between April 1968 and late 1969 the unemployment rate hovered around 3.5%—a relatively low level by historical standards. (Yet, during the Korean War, unemployment rates of 3% or less prevailed through most of 1952 and 1953 while prices remained remarkably stable.) These low unemployment rates were accompanied by a troublesome and accelerating price inflation. The consumer price index—which had risen at an average annual rate of only 1.3% during the six-year interval from January 1958 to January 1964—ad-

[2] For the initial statement of the "guideposts," see *January 1962 Economic Report of the President*, pp. 185-190.

[3] For subsequent modifications by the CEA, see especially the *January 1965 Economic Report of the President*, pp. 108-110. A good example of the "consultation" approach was the roll back of molybdenum prices in July 1966 (see *The New York Times*, July 15, 1966).

[4] For empirical testing of the relative effectiveness of the guidepost policy 1962-1966, see George L. Perry, "Wages and the Guidepost," *American Economic Review*, September 1967, pp. 897-904.

vanced at an average annual rate of 3.4% during the following six years, from January 1964 to January 1970. The implicit price deflator of GNP rose at an average rate of 3.4% during the latter period, as compared with 1.4% during 1958-1964; and the wholesale price index rose at an average of 2.3% per annum from the beginning of 1964 to early 1970 after remaining virtually stable during the previous six years.

During the 1969-1970 recession, which was induced to an extent by restrictive fiscal and monetary policies, the unemployment rate gradually rose from 3.5% in November 1969 to 6.2% in December 1970; yet there were few indications of slower price advances and a return towards price stability. (From January 1970 to January 1971 the consumer price index rose by 5.2% and the wholesale price index by 2.3%.)

Why "incomes policies?"

It is in this setting that the issues of monopoly power, administered prices, wage- and cost-push of the late 1950's were revived. New to the discussion of the late 1960's was the increased emphasis on the so-called Phillips Curve trade-off between unemployment and inflation. The crucial question was whether unemployment rates of 4% or less are compatible with reasonable price stability, given the present structure of the U.S. economy.[5] Closely related to this question is the current debate whether selective economic policies may be desirable, or even essential, in order to improve the existing unemployment-inflation trade-off (*i.e.*, in order to achieve high employment with less inflation than would be possible without such policies). In this connection, attention has focused specifically on various forms of "wage-price guideposts," or more generally on all types of "incomes policies." Advocacy of some form of "incomes policy" has frequently been combined with recommendations for structural reforms designed to increase competition and reduce rigidities in various labor and product markets.

Most economists who favor at present the use of some form of "wage-price guideposts" or "incomes policies" believe that the current inflation is deeply embedded in the fiber of the economy and could be fully throttled by traditional fiscal and monetary policies only at the cost of prolonged sluggish growth and high unemployment. To some, additional controls would seem necessary only during the transition from inflation to price stability; others believe that the U.S. economy has become inherently more inflation prone and will require virtually permanent "incomes policies."

Is the U.S. more inflation-prone?

Have there been basic structural, institutional, or policy changes which would tend to impart a greater inflationary bias to the U.S. economy in the 1970's? Those economists who answer this question in the affirmative have compiled an impressive list of factors. Some of these have been documented more extensively and convincingly than others. Among the major factors usually listed are the following:[6]

- A potential shortage of savings and of capital.
- A less-favorable composition of the labor force, with a larger proportion of young workers and women (who have lower productivity and higher unemployment rates than adult male workers).
- Greater relaxation of balance-of-payments constraints, because Western Europe now faces similar problems of inflation.
- A consumption mix that continues to shift more toward services (which normally show lower productivity gains and larger price advances than goods).
- Greater expectations that the U.S. economy will never again suffer a serious depression because of greater economic knowledge and better application of stabilization policies.
- Difficulties in providing both the quantity and quality of skilled workers that will be demanded.
- Large and growing demands from the public sector which tend to result in full-employment budget deficits for years to come, unless great restraint is exercised by the Federal Government.
- An unwillingness of the government, as well as the public, to make hard choices among meritorious competing goals which cannot all be satisfied simultaneously with the existing resource endowment.

The need for structural reform

Not surprisingly, those economists who discern an increasing inflationary bias in the U.S. economy and who, therefore, view traditional fiscal and monetary

[5] For a review of this issue and conclusions, see Michael E. Levy, "Full Employment and Inflation: A 'Trade-Off' Analysis," *The RECORD*, December 1966; also "Full Employment Without Inflation: An Analysis of the U.S. 'Phillips Curves' and 'Target' Unemployment Rates," *ibid.*, November 1967.

[6] Each of these is mentioned at least by one contributor—and some are listed by several contributors—to *Containing Inflation in the Environment of the 1970's*, Michael E. Levy, ed., The Conference Board, 1971.

policies as insufficient, favor some form of "wage-price guideposts" or "incomes policies." Whether they advocate such supplementary policy tools merely for a "transition period," or more permanently, they tend to stress almost invariably the need for supplementing an incomes policy with basic structural reforms designed to reduce rigidities and to increase competition within the economy. On this latter score, most proponents and opponents of incomes policies are in full agreement.

Proposals for structural reform often include the following recommendations:

- Repeal of the Davis-Bacon Act (which essentially sets wage scales in Federal and Federally-assisted construction), and of the Jones Act (which requires construction in U.S. shipyards of all vessels engaged in domestic transportation or fishing).
- Removal of import quotas and their replacement, where necessary, by a tariff system.
- Elimination of the "Buy American" policy.
- Repeal of the resale price maintenance laws.
- Reexamination of union monopolies and improvements in the functioning of labor markets and in labor mobility.
- Removal of competitive restrictions on banking and financial institutions.
- Reevaluation of government programs that tend to raise prices or introduce rigidities in certain markets (*e.g.*, the farm price support program).
- Elimination of minimum wage legislation, at least for young people with low skills.
- Revisions of antiquated local building codes in order to permit the use of new materials and of factory-built housing.

Needless to say, not all economists would favor each and every one of these structural reforms, and most proposals on this list would be bound to encounter political difficulties.

Opposition to income policies

Opponents of guideposts and incomes policies comprise two distinct but overlapping camps: those who see no need for any new tools because they believe that traditional fiscal and monetary policies can do the job well; and those who recognize certain limitations of the traditional policy tools, but believe that guideposts and incomes policies simply do not work.[7]

Dominant among those economists who consider new policy tools unnecessary—even if they could be made to function—are some well-known monetarists. They consider inflation primarily a "monetary phenomenon," the offspring of "bad" monetary policy (*i.e.*, excessive financing through the "printing press"). Consequently, their proposed remedy is a simple one: avoid large fluctuations in the money supply and provide stable and moderate monetary growth over a long enough period to eliminate inflation.[8] However, this policy approach shows little concern over the crucial question whether its prescribed remedy might not now entail too long a period of sluggish growth and high unemployment to be socially and politically acceptable; or else it presumes that none of the other policy alternatives can succeed in restoring price stability.

In a slightly different formulation, this latter view has many more adherents who believe that incomes policies tamper with the market mechanism and distort resource allocation without achieving worthwhile restraint on wages and prices. But this group usually favors a more flexible and pragmatic approach; it does not rule out, altogether, selective measures designed to enhance wage and price competition, or to restrain wage and price advances that may be attributable to "monopolistic market power" and to other "market imperfections."

So far, the position of the Nixon Administration has combined the diverse elements of opposition-in-principle to tampering with the free market mechanism and scepticism as to ultimate effectiveness with the pragmatism of selective measures.[9] President Nixon stated the Administration's approach succintly in his *Economic Report* in February 1971:

[7] Much scepticism as to the workability and effectiveness of such policies was contained in a conference transcript, *Guidelines, Informal Controls, and the Market Place,* George P. Shultz and Robert Z. Aliber, eds. (Chicago, The University of Chicago Press, 1966).

[8] Sometimes complementary fiscal restraint is also recommended (*e.g.*, James Meigs, "A Less Inflationary Environment," *The RECORD,* March 1971).

[9] It is worth noting that the Administration's position on this issue has by no means been monolithic. George Shultz, Director of the Office of Management and Budget, has been on record as a staunch opponent of any form of guideposts or incomes policies. Members of the Council of Economic Advisers, while intrinsically opposing such policies, have generally adopted a more flexible and pragmatic stance. Among high ranking officials favoring at least serious consideration of new policy measures are Murray Weidenbaum, Assistant Secretary of the Treasury for Economic Policy; Maurice Mann, a former Assistant Director of the Office of Management and Budget; and Paul Volcker, Under Secretary of the Treasury for Monetary Affairs. Recently, Arthur F. Burns, Chairman of the Federal Reserve Board, has also given serious thought to the desirability of the *temporary* use of some form of incomes policies.

> Free prices and wages are the heart of our economic system; we should not stop them from working even to cure an inflationary fever. I do not intend to impose wage and price controls which would substitute new, growing and more vexatious problems for the problems of inflation. Neither do I intend to rely upon an elaborate facade that seems to be wage and price control but is not. Instead, I intend to use all the effective and legitimate powers of Government to unleash and strengthen those forces of the free market that hold prices down. This is a policy of action, but not a policy of action for action's sake. (p. 7)

The President went on to summarize past and impending actions on the wage-price front as follows:

> Actions were taken to augment the supply of lumber, and to deal with domestic copper prices that were out of line with world markets. To restrain increases in the price cf crude oil, this Administration took steps to permit greater production on Federal offshore leases and to increase oil imports. Faced with inflationary price increases for some steel products, I have ordered a review of the conditions which permit or cause such increases, and threaten jobs in steel-using industries. We have been particularly concerned with increases in the costs of construction. It is now more critical than ever to check inflationary wage and price increases in an industry where unemployment is high. (p. 8)

Toward a selective "guidepost policy?"

A review of the Administration's selective anti-inflationary measures of the last nine months indicates an expansion in scope as well as in intensity. If this trend continues, the distinction between a policy of *ad hoc* specific measures and a more general, but selective, "guidepost policy" may become more and more blurred.

Except for two isolated instances of review and pressures designed to achieve price restraint in softwood lumber and plywood, and in copper in 1969, the recent selective anti-inflationary policies got slowly under way in mid-1970, first with a Presidential Commission, then reviews and exhortations, and finally with outright action. On June 17, 1970 President Nixon announced the appointment of a National Commission on Productivity, a 23-man group headed by George Shultz, Director of the Office of Management and Budget. While the Commission's main focus may be on longer-term measures to enhance productivity, its activities are not unrelated to the present fight against inflation.

On August 7, 1970 the Council of Economic Advisers issued its first "Inflation Alert" which summarized the historical relationship of wages, prices, and productivity and reviewed changes in the major wage and price indexes during the first half of 1970. The second "Inflation Alert," issued on December 11, 1970, was more strongly worded and criticized outsized union wage settlements, especially in the construction trades, and some recent price increases, especially in oil and gas. Subject to strong criticism also was the wage settlement between General Motors and the United Auto Workers. The third "Inflation Alert," issued on April 13, 1971, went one step further. It contained not only a critical review of past developments and general rules for desirable wage and price behavior in the future, but it also focused sharply on forthcoming wage-price decisions and emerging market problems, with particular emphasis on the steel wage negotiations that are due later this year.

Beyond these Inflation Alerts, the Administration exerted pressure and took actions affecting the oil industry, the steel industry, and the construction industry. In a speech on December 4, 1970 President Nixon announced a plan to permit greater production on Federal offshore leases and to increase oil imports in order to offset recent oil price increases.[10] On January 12, 1970 the President denounced a 12% across-the-board steel price increase proposed by Bethlehem Steel and several days later, under Administration pressure, a roll back to about 8% was obtained from the industry. On January 8, 1971 the President called on the Construction Industry Collective Bargaining Commission to develop a voluntary stabilization plan in order to contain outsized wage, cost, and price advances in this industry. When labor leaders were unable to commit their membership, President Nixon suspended the 1931 Davis-Bacon Act on February 23, 1971. Subsequently, labor and industry representatives accepted the President's proposal of a 12-man Construction Industry Stabilization Committee, headed by Professor John Dunlop, and consisting of four industry, four construction union, and four public representatives. The Committee met for the first time on April 6, and the provisions of the Davis-Bacon Act were restored by the Administration.

There can be no doubt as to the Administration's great reluctance to intervene in the wage-price process; nonetheless the most recent history reveals a crescendo of exhortations and selective measures and pressures.

[10] Address to the National Association of Manufacturers in New York City.

The coming year could well bring a further expansion of *ad hoc* provisions (even to the point where their consolidation into a more comprehensive "guidelines approach" may become unavoidable)—or else, stand-off and their gradual dismantling. The choice between these two opposite paths may be decided not so much by economic convictions, but by economic performance. If rapid economic gains during the coming year induce a good-sized reduction in the recent 6% unemployment rate with further progress towards price stability, the entire "guidelines" issue would probably be obliterated. But if the forthcoming economic advance yields only modest reductions in unemployment without making substantial inroads on inflation, then pressures for intensified wage-price controls could well become irresistible.

Representative GRIFFITH. Mr. Shapiro, please proceed.

STATEMENT OF HAROLD T. SHAPIRO, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. SHAPIRO. I would like to summarize some of the highlights of my prepared statement before I turn to the details. In summary, my own forecast of the economic outlook, is very much in line with what has been mentioned by the previous speakers; namely, slow growth, very modest improvements in the employment rate, and very modest reductions in the rate of inflation.

On the policy side of things, I come down very much in favor of tax cuts in order to further stimulate the expansion with Federal expenditures as an alternative source of stimulation, although my own preference would be for tax reduction. On the side of monetary policy, I think if the Federal Reserve succeeds in maintaining the rate of growth of money supply in the neighborhood of 4, 5, 6, or 7 percent, it is likely to raise interest rates to undesirably high levels. Given the nature of the forecasted expansion we have going, a rate of growth of the money supply in the area of 10 percent seems more appropriate.

I would like now to return to the details for a few moments to explain how I have reached these conclusions.

The forecast of economic activity which I will present today is based largely on the University of Michigan's quarterly econometric model of the U.S. economy developed originally by staff members of the Council of Economic Advisers and subsequently by my colleague Prof. Saul H. Hymans and myself at the research seminar in quantitative economics at the University of Michigan.

I shall try to present the highlights. Additional details are available in the tables of my prepared statement as well as the prepared statement and I will answer any questions you might have.

As has already been noted here this morning, the economy is slowly recovering from the 1969–70 recession. Both the recession itself and the initial stages of the recovery have proved especially troublesome, I think, in at least two respects.

First, the rate of inflation was higher in the recession year than in the last year of the expansion. This is unique amongst postwar recessions. Further, despite rising unemployment rates, inflation has remained a difficult problem during the early stages of the current recovery. Second, the rate of recovery, at least in these initial stages, has been disappointing. Given the evidence now available we can characterize the first 6 months of 1971 as ones of slow expansion in real output—especially if we adjust for the "catch up" production in the auto industry—rising unemployment rates and continuing substantial rates of inflation. If we ignore the special effects created by the auto strike, the only sector of the economy showing considerable strength is the residential construction sector which has responded well to easier monetary conditions.

The outlook for the coming 18 months is, of course, critically dependent on the stance of fiscal and monetary policy. We have, therefore, undertaken a careful analysis of the Federal budget and other pending legislation which could have important effects on economic activity over the next six quarters. The assumptions I am operating under, regarding Federal and State and local expenditure, are presented to you in tables 1 and 2 of my prepared statement. To summarize our own projections about the Federal budget, for example, we are now basing our forecast on a projection of Federal expenditures which are approximately $6 billion higher for fiscal 1972 than presented in the January budget.

I guess it is very much in line with at least what the administration is saying right now, judging by Mr. McCracken's testimony before this committee last week or so.

Regarding the second half of 1972, we have no official budget documents to go on, but we have projected increases in Federal expenditures for the last two quarters of 1972 in a manner which appears reasonable to us. I would like to mention our projections, assume that the social security benefits proposed under H.R. 1, in fact, become law and that they will become effective as of the middle of 1972. I think it is important because the benefits there are very substantial and will certainly add to consumer income at that time.

On the revenue side, we have allowed for the increase in social security taxes, effective January 1, 1972, which is already scheduled, as well as the continuing phasing in of the provisions of the 1969 Tax Reform Act.

On the issue of monetary policy, we expect some tightening of monetary conditions over the next 18 months. We are projecting a slow rise in short term interest rates throughout this period. Long term interest rates will also show some modest rise from current levels. I would like to return to a further discussion of the role of monetary policy after I have presented our basic forecast.

Consistent with our views, concerning monetary policy and Federal grants-in-aid, we have projected an increase in State and local government expenditures of approximately 13 percent for both calendar 1971 and calendar 1972, as shown in table 2 of my prepared statement.

These are the broad outlines of the policy assumptions on which we are basing our forecast. As you know, any forecast of economic activities over the next 18 months is critically dependent on what one assumes in this area.

The broad sweep of our forecast for 1971 and 1972 is contained in table 3 of my prepared statement, which displays the forecasted changes of several key macro-economic variables. Tables 4 to 6 in my prepared statement provide full quarterly detail of our forecast for a broader range of aggregates. Based on the input assumptions previously discussed we forecast current dollar GNP to increase by about $78 billion for the year 1971 and $104 billion for the year 1972. This increase amounts to approximately 8 percent and 10 percent, respectively, compared to the increase in 1970 of 4.6 percent. For 1971 the 8 percent rise in current dollar GNP is composed of a rise in the volume of output (constant dollar GNP) of just under 3 percent and a rate of price increase totalling just over 5 percent. For 1972 the figures are 4.9 percent and 4.8 percent, respectively. The decrease in the rate of inflation we are projecting is very modest, and I take it this is roughly the same view presented by the other witnesses testifying here this morning.

Although the 3 percent rate of growth of output predicted for 1971 is a substantial improvement over 1970, it is not rapid enough to prevent a further rise in the unemployment rate for the year as a whole and we forecast unemployment rates to reach their peak in the current quarter.

Beginning with the fouth quarter of 1971, however, the increase rate of growth of real output will finally begin to lower the unemployment rate. For 1972 we forecast the rate of unemployment to decline slowly, but continuously, to a level of under 5.7 percent by the fourth quarter. The decline forecasted in the overall rate of inflation during these 2 years is also quite modest.

Both consumer incomes and corporate profits are forecasted to register substantial gains in current dollar in 1971 and 1972. We now estimate increases of 16 percent and 4.2 percent in pretax corporate profits for 1971 and 1972 respectively. By the fourth quarter of 1972 profit before taxes should be running at a rate close to $95 billion per year. Personal disposable income is expected to rise by 8.4 percent and 9.5 percent in 1971 and 1972 respectively.

Turning to the private nonfarm sector of the economy we forecast increases in wage rates—compensation per man-hour—of 8.2 and 7.7 percent for 1971 and 1972 respectively. While increases in the unemployment rate such as those recently experienced might be expected to dampen the rate of wage increases, we expect much of this effect to be offset by the recent wage patterns established by the negotiations in the auto and other industries. In this sector of the economy—private nonfarm—however, we are forecasting a more significant decline in the rate of inflation during 1972. For the years as a whole we are forecasting an increase in prices in the private nonfarm sector of 4 percent down from the 4.9 percent now projected for 1971. The principal reason for this forecasted decline in the rate of inflation is the substantial increase predicted for the growth in output per man-hour for 1972 as shown in table 3 of my prepared statement.

Thus although we forecast a significant rise in the rate of growth of real output in the coming year and a half—especially in the period following the termination of the projected steel strike—the improvement is not rapid enough to generate what I would consider adequate declines in the unemployment rate. Our forecast embodies provisions for a 4-week steel strike. Should there be no work stoppage in the steel industry, this would not affect our overall forecast in the next 18 months very significantly. There would be some shifting around of the aggregates, but I do not think the general picture for the next 18 months would be very much affected.

While this period marks a definite turn toward the full-employment path, by the end of 1972 we forecast overall unemployment rates to remain at the relatively high level of 5.6 to 5.7 percent. Unemployment, therefore, will continue to be a problem throughout this period, and continued growth at 1972 rates will be needed to bring us anywhere close to full employment by late 1973.

On the more positive side, a careful look at the movements in the components of real aggregate demand, as displayed in table 5 of my prepared statement, reveals a generally well-balanced growth process over the next 18 months. This is potentially important as balanced growth can make an important contribution to the maintenance of greater price stability, by greatly easing the task of generating an orderly move to full employment. Of the various principal components of aggregate demand only business expenditures for plant and equipment are forecasted to play a rather weak role in the expansion. The 4.9 percent growth in real output (GNP) during calendar 1972 is composed of increases, in real terms, of (1) 5.1 percent in consumer durables; (2) 4.5 percent in consumer nondurables and services; (3) 1.9 percent in business fixed investment; (4) 3.8 percent in residential construction; and (5) 4.9 percent in Government purchases.

However, given the recent cuts in corporate taxes and the new depreciation rules announced recently by the Treasury, there does remain some uncertainty in my own mind about the future course of business investment. Although I see little chance of any sharp change during 1971, a more rapid pickup than currently forecasted, beginning in the second quarter of next year remains a distinct possibility. I will discuss this alternative possibility in more detail below.

Another notable feature of our forecast is the continued high savings rate maintained by consumers. Consumer expenditures are forecasted to grow very much in step with the growth in personal income, but not any faster—leaving savings rates at their current rather high levels. We see no evidence at the moment of any strong new surge in household expenditures.

While I believe the forecast I have just presented (RSQE (1)) describes the most likely path of economic activity through 1972, given our assumptions regarding economic policy, other possibilities are certainly highly worthy of consideration in the current economic environment. One alternative is to assume a more expansionary stance for Federal Government expenditures in the coming 18 months. Table 1 of my prepared statement gives the details of an alternative Federal budget for fiscal 1972 embodying a rather rapid increase in Federal expenditures. The increase is $5.750 billion for fiscal 1972 and $8 billion for calendar 1972. A second alternative allows for an acceleration of business expenditures in plant and equipment—beginning in the second quarter of 1972. Table 7 of my prepared statement contains summary data comparing the path of economic growth in 1971 and 1972 implied by the RSQE "control" forecast (RSQE(1)) and these two principal alternatives.

I guess table 7 of my prepared statement is the most relevant one of the tables I have presented for consideration, since it gives, I think, what are the critical parameters implied by our forecast and the various alternatives one could look at.

As expected, a more expansionary fiscal policy raises the rate of real growth and lowers unemployment levels. The rate of growth of real output rises to 5.7 percent for the year 1972 as a whole and the unemployment rate falls to a level of 5.5 percent for the year. By yearend the unemployment rate is close to 5.3 percent. That is under the policy of the more expansionary Federal budget.

On the other side of the issue a more expansionary policy does begin to raise unit labor cost by the end of 1972, but the size of this increase does not seem critical in view of the sharp gains made in employment. This seems to be a policy worthy of strong consideration.

Turning our attention to alternative No. 2 we can note that a stronger revival of private demand—for example, business fixed investment expenditures—in 1972 also makes a significant additional contribution to the expansion. Although I have not presented the results here the same can be said of a drop in personal income taxes. It is true, of course, that almost any increase in aggregate demand from the public or private sectors generates some potential pressure on prices. However, the economy is currently characterized by low utilization rates of both labor and capital as well as certain institutional rigidities which should insulate prices somewhat from the pressures of rising aggregate demand. In this respect I consider our own price forecasts to be on the pessimistic side. Given the current levels of unemployment, the nonunionized sector of the labor force may not quite follow the pattern set in recent wage negotiations, and thus permit somewhat better performance on unit labor costs and prices for the economy as a whole.

Finally a word about monetary policy. As I have noted above, we have projected a slow rise in interest rates for the next six quarters. Given our projected expansion in real output and prices, such a modest rise in interest rates can only be sustained by a fairly rapid rate of growth in the money supply. Given the 5.0 percent increase in real output and the 4.7 to 4.8 percent increase in prices forecast for 1972, a 6 percent rate of growth in the money supply would imply a far higher rise in interest rates than we have allowed for. Since I view a more rapid rise in interest rates as undesirable, I would not favor any attempt to restrain the rate of growth of the money supply, to a figure in the range of 6 percent.

(The prepared statement of Mr. Shapiro follows:)

Prepared Statement of Harold T. Shapiro[1]

The Economic Outlook for 1971, 1972

I. Introduction

The forecast of economic activity which I will present today is based largely on the University of Michigan's quarterly econometric model of the U.S. economy developed originally by staff members of the Council of Economic Advisors and subsequently by my colleague Professor Saul H. Hymans and myself at the Research Seminar in Quantitative Economics at the University of Michigan. I should mention that an econometric model is simply a statistical procedure that attempts to depict in a set of equations, the essential quantitative relationships that determine the behavior of such important macroeconomic variables as output, income, employment and prices. Needless to say, the generation of an actual forecast is not a purely mechanical procedure, but requires considerable "judgemental" input. I will present to you this morning what I believe to be the highlights of our forecast of economic activity for the coming 18 months. Additional detail is available in the tables I have provided, and I will endeavor to answer any further questions you might have.

II. The Current State of the Economy

At the present time the economy is slowly recovering from the 1969–1970 recession. Both the recession itself and the initial stages of the recovery now underway have been quite troublesome in at least two respects. First, the rate of inflation

[1] I would like to acknowledge the assistance of Professors Warren Smith and Gardner Ackley, and R. Hokenson in the preparation of this statement. I especially wish to acknowledge the assistance of my colleague Prof. Saul H. Hymans; since the forecast presented here is based largely on the research we have done together in the Research Seminar in Quantitative Economics (RSQE) at the University of Michigan. The RSQE is financed, in part, by a grant from the National Science Foundation. None of the above persons, however, take any responsibility for the statement presented.

was higher in the recession year than in the last year of the expansion. This is unique amongst postwar recessions. Further, despite rising unemployment rates, inflation has remained a difficult problem during the early stages of the current recovery. Second, the rate of recovery, at least in these initial stages, has been disappointing. Given the evidence now available we can characterize the first six months of 1971 as ones of slow expansion in real output (especially if we adjust for the "catch up" production in the auto industry), rising unemployment rates and continuing substantial rates of inflation. If we ignore the special effects created by the auto-strike, the only sector of the economy showing considerable strength is the residential construction sector which has responded well to easier monetary conditions. Inventory investment (despite the building of steel stocks) and plant and equipment expenditures have failed to make any significant contribution to the recovery so far.

More specifically, based on the preliminary estimates released by the Department of Commerce last Friday, Gross National Product for the second quarter registered a gain of about $20 billion (at annual rates) which represents a gain of approximately 8.0% over the first quarter. This increase was composed of a 3.7% gain in real output and a 4.3% rise in prices—again at annual rates. Unemployment as we know, is still running very close to 6% for the quarter as a whole. Corporate profits, although showing little change from their substantial gain in the first quarter are running sharply higher than last year and very close to their late 1969 levels.

III. POLICY PARAMETERS FOR 1971 AND 1972

The outlook for the coming eighteen months is, of course, critically dependent on the stance of fiscal and monetary policy. We have, therefore, undertaken a careful analysis of the Federal Budget and other pending legislation which could have important effects on economic activity over the next six quarters. Table 1 contains a breakdown of Federal Expenditures on a National Income Accounts basis for Fiscal 1971 and Fiscal 1972, as shown in the January Budget and as revised by the RSQE for use in our forecast. For Fiscal 1972 we present two alternatives. RSQE (1) reflects our current projections; while RSQE (2) allows for a more expansionary stance of Fiscal policy. Our budget inputs (RSQE (1)) for Fiscal 1972 allows for an increase of about $6 billion in expenditures in excess of the President's estimates. This discrepancy is approximately evenly divided between increases in defense and nondefense purchases. We also allow for the scheduled military pay increase to be advanced into the fourth quarter of 1971.

TABLE 1.—FEDERAL GOVERNMENT EXPENDITURES, FISCAL 1971 AND FISCAL 1972

[Billions of current dollars]

	Fiscal 1971		Fiscal 1972		
	January 1971 budget	RSQE(1)	January 1972 budget	RSQE(1)	RSQE(2)
Federal Government expenditures	215.0	213.6	230.1	236.3	242.1
Purchase of goods and services	97.9	96.2	102.2	105.5	111.3
National defense	74.1	73.1	74.0	76.1	79.0
Other	23.8	23.1	28.2	29.4	32.3
Transfer payments	69.2	70.1	75.0	76.5	76.5
To persons	67.0	67.9	72.5	74.0	74.0
To foreigners	2.2	2.2	2.5	2.5	2.5
Grants-in-aid	27.0	26.8	34.4	35.0	35.0
Net interest	14.6	14.5	14.3	14.3	14.3
Subsidies less current surplus of Government enterprise	6.2	6.0	4.2	5.0	5.0
Estimated surplus of receipts over revenues	−15.0	[1] −18.0	−4.2	[2] −20.9	[2] −23.0

[1] Department of Commerce preliminary estimates.

[2] RSQE estimates. These estimates are based on RSQE forecast of economic activity for 1971 and 1972 together with the assumption that State and local governments will have (in the aggregate) balanced budgets.

For the last two quarters of 1972 we have no budget documents to go on and have simply projected what we believe to be reasonable estimates of increases in Federal expenditures. Our projections assume that the increase in Social Security and Medicaid benefits proposed in H.R. 1 ($4.4 billion per year) will become effective in the third quarter of 1972. We also allow for a pay increase for civilian government employees ($1 billion) in the fourth quarter of that year. Finally, we made provision for increased Federal expenditures in the second half of 1972 that might be called for under Welfare Reform legislation.

On the revenue side we have allowed for the increase in Social Security taxes (effective January 1, 1972) which is already scheduled (PL92-5), as well as the continued phasing in of the provisions of the 1969 Tax Reform Act. The new rules regarding depreciation "write-offs" recently announced by the Treasury are assumed to cut corporate tax liabilities by $1 billion in 1971 and $2 billion in 1972.

On the issue of monetary policy we expect some tightening of monetary conditions over the next 18 months. We are projecting a slow rise in short-term interest rates throughout this period. Long-term interest rates will also show some modest rise from current levels. I would like to return to a further discussion of the role of monetary policy after I have presented our basic forecast.

Consistent with our views concerning monetary policy and federal Grants-In-Aid we have projected an increase in State and Local Government Expenditures of approximately 13% for both calendar 1971 and calendar 1972 (see Table 2).

TABLE 2.—STATE AND LOCAL GOVERNMENT EXPENDITURES, CALENDAR 1971, 1972, RSQE ESTIMATES

[Billions of current dollars]

	1971	Percent of change 1970–71	1972	Percent of change 1971–72
Purchase of goods and services	136.5	11.7	153.2	12.2
Transfers to persons	17.0	22.3	19.8	16.8
Net interest	.3		.3	
Subsidies less current suprlus of Government enterprise	−3.9		−3.9	
Total expenditure	149.9	12.8	169.4	13.0
Surplus (NIA basis)	0		0	

Finally, the possibility of a steel strike and an East-Coast dock strike will also influence the pattern of economic activity in 1971. With respect to the possible steel strike some of the effects have already been felt in the forward building of steel inventories. Our current forecast (RSQE(1)) assumes a 4-week strike in the steel industry, the primary effect of which falls upon business inventory investment. Whether or not we experience a work stoppage in the steel industry. the economy should have fully adjusted by year-end providing the strike lasts no longer than four weeks. We have also assumed an East-Coast dock strike beginning sometime in December 1971 and lasting about four weeks. The primary effect here is to alter the pattern of both imports and exports in the period surrounding the end of 1971 and beginning of 1972.

IV. THE FORECAST FOR THE YEARS 1971, 1972

The broad sweep of our forecast for 1971 and 1972 is contained in Table 3 which displays the forecasted changes of several key macro-economic variables. Tables 4–6 provide full quarterly detail of our forecast for a broader range of aggregates. Based on the input assumptions previously discussed we forecast current dollar GNP to increase by about $78 billion for the year 1971 and $104 billion for the year 1972. These increases amount to approximately 8% and 10% respectively, compared to the increase in 1970 of 4.6%. For 1971 the 8% rise in current dollar GNP is composed of a rise in the volume of output (constant dollar GNP) of just under 3% and a rate of price increase totalling just over 5%. For 1972 the figures are 4.9% and 4.8% respectively. Although the 3% rate of growth of output predicted for 1971 is a substantial improvement over 1970, it is not rapid enough to prevent a further rise in the unemployment rate for the year as a whole and we forecast unemployment rates to reach their peak in the current quarter. Beginning with the 4th quarter of 1971, however, the increased rate of growth of real output finally begins to lower the unemployment rate. For 1972 we forecast the rate of unemployment to decline slowly, but continuously, to a level of under 5.7% by the 4th quarter. The decline forecasted in the overall rate of inflation during these two years is also quite modest.

TABLE 3.—ECONOMIC FORECAST FOR 1971, 1972 SELECTED INDICATORS OF CHANGE (RSQE (1))

	1970 level	Change 1970–1	Change 1971–2	Percent change 1970–1	Percent change 1971–2	Percent change 1972.2–1972.4
Gross national product:						
Billions of current dollars	974.1	78.5	103.9	8.1	9.9	10.9
Billions of 1958 dollars	720.0	19.6	36.0	2.7	4.9	6.0
Personal consumption expenditures (billions of 1958 dollars)	475.9	16.4	22.6	3.4	4.6	5.6
Business fixed investment (billions of 1958 dollars)	78.6	−.3	1.5	−.4	1.9	.1
Prices:						
Gross national product, deflator (1958=100)	135.3	7.0	6.8	5.2	4.8	4.7
Personal consumption, deflator (1958=100)	129.4	5.7	5.7	4.4	4.2	4.3
Unemployment rates:						
Aggregate (percent)	5.0	1.0	−.2			
Male 20 and over (percent)	3.4	.9	−.3			
Corporate profits before tax (billions of current dollars)	75.4	12.0	3.7	15.9	4.2	6.5
Disposable income (billions of current dollars)	687.7	58.2	70.6	8.4	9.5	5.3
Savings rate (percent)	7.8	8.7				
Private nonfarm sector:						
Compensation per man-hour (1957–59=100)	179.3	14.7	15.0	8.2	7.7	8.3
Output per man-hour (1957–59=100)	135.3	4.8	6.7	3.5	4.8	4.9
Unit labor cost (1957–59=100)	132.5	5.9	3.9	4.4	2.8	3.1
Private nonfarm deflator (1958=100)	129.4	6.3	5.4	4.9	4.0	4.0
Interest rates (percent):						
Commercial paper rate (4–6 month)	7.71	−2.76	+1.10			
Moody's Triple A bond rate	8.04	−.64	+.06			

TABLE 4.—ECONOMIC FORECAST FOR 1971 GROSS NATIONAL PRODUCT IN CURRENT DOLLARS (BILLIONS OF CURRENT DOLLARS, SEASONALLY ADJUSTED AT ANNUAL RATES) RSQE(1)[1]

	1971				1972				Calendar year		Percent change	
	I	II	III	IV	I	II	III	IV	1971	1972	1970–71	1971–72
Gross national product	1,020.8	1,040.5	1,060.0	1,088.9	1,118.1	1,139.4	1,168.6	1,200.0	1,052.6	1,156.5	8.1	9.9
Personal consumption expenditures	644.6	659.9	670.6	684.5	700.7	715.8	733.1	751.0	664.9	725.2	8.0	9.1
Automobiles and parts	44.1	45.2	45.0	44.8	45.6	47.1	47.5	49.3	44.8	47.4	20.7	5.8
Other consumption	600.5	614.7	625.6	639.6	655.1	668.6	685.6	701.7	620.1	677.8	7.2	9.3
Gross private domestic investment	143.8	150.2	147.9	155.5	159.7	162.5	165.8	169.4	149.3	164.3	10.4	10.0
Business fixed investment	104.2	106.2	107.4	109.8	111.8	112.9	114.0	115.4	106.9	113.5	4.7	6.2
Residential construction	36.4	39.3	4 .5	41.6	42.1	42.8	43.6	44.4	39.4	43.2	30.0	9.6
Inventory investment	3.2	4.7	—.1	4.1	5.8	6.8	8.2	9.6	3.0	7.6		
Net exports	4.3	.2	2.5	2.4	4.3	1.2	2.5	3.1	2.3	2.8		
Government purchases of goods and services	228.2	230.2	239.0	246.5	253.4	259.9	267.2	276.5	236.0	264.3	7.6	12.0
Federal defense	73.0	72.0	73.6	76.1	76.7	77.9	78.9	79.9	73.7	78.4	—2.2	6.4
Other Federal purchases	23.7	24.0	27.2	28.2	30.5	31.8	33.1	35.4	25.8	32.7	17.8	26.7
State and local purchases	131.5	134.2	138.2	142.2	146.2	150.2	155.2	161.2	136.5	153.2	11.7	12.2
Gross national product deflator (1958=100)	139.9	141.3	143.1	144.9	146.6	148.2	149.8	151.7	142.3	149.1	5.2	4.8
Aggregate unemployment rate (percent)	5.9	6.1	6.1	6.0	5.9	5.8	5.8	5.7	6.0	5.8		
Consolidated Government surplus (NIA basis)	—17.3	—19.3	—21.7	—20.6	—20.1	—21.0	—25.1	—24.3	—19.7	—22.6		

[1] Some totals may not be quite consistent with their components due to small rounding errors.

TABLE 5.—ECONOMIC FORECAST FOR 1971 GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS (BILLIONS OF 1958 DOLLARS, SEASONALLY ADJUSTED AT ANNUAL RATES) RSQE (1) [1]

	1971				1972				Calendar year		Percent change	
	I	II	III	IV	I	II	III	IV	1971	1972	1970–71	1971–72
Gross national product	729.7	736.3	741.0	751.4	762.8	768.6	779.8	719.3	739.6	775.6	2.7	4.9
Personal consumption expenditures	484.8	491.5	494.2	498.8	505.4	511.1	518.0	525.1	492.3	514.9	3.4	4.6
Automobiles and parts	38.6	39.3	38.8	38.1	38.6	39.8	39.8	41.0	38.7	39.8	12.6	2.8
Other durable goods	48.2	49.2	49.4	50.3	51.4	51.9	53.2	54.2	49.3	52.7	4.8	6.9
Nondurables and services	398.0	402.9	406.0	410.4	415.4	419.4	425.0	429.9	404.3	422.4	2.5	4.5
Gross private domestic investment	104.7	108.3	104.8	109.5	111.5	112.5	113.8	115.3	106.8	113.3	4.5	6.1
Business fixed investment	77.5	78.2	78.3	79.2	79.8	79.8	79.7	79.9	78.3	79.8	−.4	1.9
Residential construction	24.6	26.1	26.6	26.9	26.8	27.0	27.1	27.2	26.0	27.0	22.2	3.8
Inventory investment	2.6	4.0	−.1	3.5	4.9	5.8	7.0	8.2	2.5	6.5		
Net exports	2.6	−.7	1.9	1.6	3.1	.4	1.3	1.5	1.4	1.6		
Government purchases of goods and services	137.6	137.2	140.1	141.4	142.8	144.6	146.7	149.4	139.1	145.9	−.3	4.9
Gross national product deflator (1958=100)	139.9	141.3	143.1	144.9	146.6	148.2	149.8	151.7	142.3	149.1	5.2	4.8
Aggregate unemployment rate (percent)	5.9	6.1	6.1	6.0	5.9	5.8	5.8	5.7	6.0	5.8		

[1] Some totals may not be quite consistent with their components due to small rounding errors.

TABLE 6.—ECONOMIC FORECAST FOR 1971; SUPPLEMENTARY DATA (SEASONALLY ADJUSTED AT ANNUAL RATES WHERE APPLICABLE) RSQE(1)

	1971				1972				Calendar year		Percent change	
	I	II	III	IV	I	II	III	IV	1971	1972	1970–71	1971–72
Income:												
Personal income [1]	834.7	855.0	866.7	887.8	908.9	926.9	952.7	976.8	861.0	941.3	7.1	9.3
Disposable income [1]	722.0	741.1	751.3	769.0	788.9	803.6	826.9	846.6	745.9	816.5	8.4	9.5
Personal savings rate (percent)	8.1	8.4	8.2	8.5	8.7	8.4	8.9	8.8	8.4	8.7		
Corporate profits plus IVA [1]	79.0	80.5	81.0	83.8	85.8	85.4	88.4	91.7	81.1	87.8	14.5	8.3
Prices, wages, productivity:												
Gross national product deflator [2]	139.9	141.3	143.1	144.9	146.6	148.2	149.9	151.7	142.3	149.1	5.2	4.8
Personal consumption deflator [2]	133.0	134.3	135.7	137.2	138.6	140.1	141.5	143.0	135.1	140.8	4.4	4.2
Private nonfarm sector:												
Private nonfarm GNP deflator [2]	133.7	135.0	136.3	137.8	139.1	140.4	141.8	143.2	135.7	141.1	4.9	4.0
Compensation per man-hour [3]	188.0	192.2	196.0	199.6	203.4	206.5	211.0	214.9	194.0	209.0	8.2	7.7
Output per man-hour [3]	136.9	139.2	141.3	142.9	144.9	145.7	147.5	149.2	140.1	146.8	3.5	4.8
Unit labor cost [3]	137.3	138.0	138.6	139.7	140.4	141.8	143.0	144.0	138.4	142.3	4.4	2.8
Manufacturing sector:												
Manufacturing index of industrial production [3]	163.0	164.5	166.3	167.1	170.0	169.7	172.0	174.3	165.2	171.5	−1.3	3.8
Capacity utilization rate (percent)	73.2	73.1	73.3	73.0	73.6	72.8	73.2	73.6	73.1	73.3		
Unemployment rates:												
Aggregate (percent)	5.9	6.1	6.1	6.0	5.9	5.8	5.8	5.7	6.0	5.8		
Male, over 20 (percent)	4.3	4.4	4.4	4.3	4.1	4.1	4.0	3.8	4.3	4.0		
Financial sector: Commercial paper rate (4–6 months) (percent)	4.59	5.02	5.65	5.85	6.05	6.25	6.45	6.75	5.28	6.38		
Moody's Triple A long-term corporate bond rate (percent)	7.22	7.46	7.50	7.40	7.40	7.43	7.47	7.55	7.40	7.46		

[1] Billions of current dollars. [2] 1958 equals 100. [3] 1957–59 equals 100.

Both consumer incomes and corporate profits are forecasted to register substantial gains in current dollars in 1971 and 1972. We now estimate increases of 16% and 4.2% in Pre-tax Corporate Profits for 1971 and 1972 respectively. By the fourth quarter of 1972 profit before taxes should be running at a rate close to $95 billion per year. Personal disposable income is expected to rise by 8.4% and 9.5% in 1971 and 1972 respectively.

Turning to the Private Nonfarm sector of the economy we forecast increases in wage rate (Compensation per Manhour) of 8.2% and 7.7% for 1971 and 1972 respectively. While increases in the unemployment rate such as those recently experienced might be expected to dampen the rate of wage increase, we fully expect this effect to be more than offset by recent patterns of wage increase established by the negotiations in the auto and other industries. In this sector of the economy (Private Nonfarm), however, we are forecasting a more significant decline in the rate of inflation during 1972. For the year as a whole we are forecasting an increase in prices in the private non-farm sector of 40% down from the 4.9% now projected for 1971. The principal reason for this forecasted decline in the rate of inflation is the substantial increase predicted for the growth in output per manhour for 1972 (see Table 3).

Thus although we forecast a significant rise in the rate of growth of real output in the coming year and a half (especially in the period following the termination of the steel strike), the improvement is not rapid enough to generate what I would consider adequate declines in the unemployment rate. While this period marks a definite turn towards the full employment path, by the end of 1972 we forecast overall unemployment rates to remain at the relatively high level of 5.6 to 5.7%. Unemployment, therefore, will continue to be a problem throughout this period, and continued growth at 1972 rates will be needed to bring us anywhere close to "full employment" by late 1973.

On the more positive side, a careful look at the movements in the components of real aggregate demand, as displayed in Table 5, reveals a generally well balanced growth process over the next 18 months. This is potentially important as balanced growth can make an important contribution to the maintenance of greater price stability, by greatly easing the task of generating an orderly move full employment. Of the various principal components of aggregate demand only business expenditures for plant and equipment are forecasted to play a rather weak role in the expansion. The 4.9% growth in real output (GNP) during calendar 1972 is composed of increases, in real terms, of—

(1) 5.1 percent in consumer durables;
(2) 4.5 percent in consumer non-durables and services;
(3) 1.9 percent in business fixed investment;
(4) 3.8 percent in residential construction; and
(5) 4.9 percent in government purchases.

However, given the recent cuts in corporate taxes and the new depreciation rules announced recently by the Treasury, there does remain some uncertainty in my own mind about the future course of business investment. Although I see little chance of any sharp change during 1971, a more rapid pick-up than currently forecasted, beginning in the second quarter of next year remains a distinct possibility. I will discuss this alternative possibility in more detail below.

Another notable feature of our forecast is the continued high savings rate maintained by consumers. Consumer expenditures are forecasted to grow very much in step with the growth in personal income, but not any faster—leaving savings rates at their current rather high levels. We see no evidence at the moment of any strong new surge in household expenditures.

V. ALTERNATIVES AND UNCERTAINTIES

While I believe the forecast I have just presented (RSQE (1)) describes the most likely path of economic activity through 1972, given our assumptions regarding economic policy, other possibilities are certainly highly worthy of consideration in the current economic environment. One alternative is to assume a more expansionary stance for Federal Government expenditures in the coming 18 months. Table (1) above gives the details of an alternative Federal budget for Fiscal 1972 embodying a rather rapid increase in Federal expenditures. The increase is $5¾ billion for Fiscal 1972 and $8 billion for calendar 1972. A second alternative allows for an acceleration of business expenditures in plant and equipment—beginning in the second quarter of 1972. Table 7 contains summary data comparing the path of economic growth in 1971 and 1972 implied by the RSQE "control" forecast (RSQE(1)) and these two principal alternatives.

TABLE 7.—COMPARISON OF RSQE CONTROL FORECAST AND ALTERNATIVE POSSIBILITIES SELECTED MEASURES OF CHANGE

	RSQE control forecast			Alternative number 1, expansionary expansionary fiscal policy			Alternative number 2, 1972 revival of business fixed expenditures		
	1971	1972	1972.4–1972.4	1971	9172	1972.2–1972.4	1971	1972	1972.2–1972.4
Gross national product (percent change, 1958 dollars)	2.7	4.9	6.0	2.9	5.7	5.8	2.7	5.1	7.0
Prices and costs:									
Gross national product deflator (percent change)	5.2	4.8	4.8	5.2	4.9	4.9	5.2	4.8	4.6
Private nonfarm deflator (percent change)	4.9	4.0	4.0	4.9	4.1	4.3	4.9	4.0	4.0
Unit labor costs (percent change)	4.4	2.8	3.1	4.3	2.7	4.0	4.4	2.7	2.7
Unemployment rates (percent)	6.0	5.8	[1] 5.7	6.0	5.5	[1] 5.3	6.0	5.7	[1] 5.5
Gross national product (billions of current dollars)	1,052.6	1,156.5	[1] 1,200.0	1,055.0	1,170.0	[1] 1,214.0	1,052.6	1,159.1	[1] 1,206.3
Gross national product (billions of 1958 dollars)	739.6	775.6	[1] 791.3	741.0	782.9	[1] 798.4	739.6	777.4	[1] 795.7
Consolidated Government surplus (NIA basis, billions of current dollars)	−19.7	−22.6	[1] −24.3	−20.5	−25.2	[1] −26.5	−19.7	−21.5	[1] −21.7

[1] Absolute level 4th quarter 1972.

As expected, a more expansionary fiscal policy raises the rate of real growth and lowers unemployment levels. The rate of growth output rises to 5.7% for the year 1972 as a whole and the unemployment rate falls to a level of 5.5% for the year. By year end the unemployment rate is close to 5.3%. On the other side of the issue a more expansionary policy does begin to raise unit labor cost by the end of 1972, but the size of this increase does not seem critical in view of the sharp gains made in employment. This seems to be a policy worthy of strong consideration.

Turning our attention to Alternative #2 we can note that a stronger revival of private demand (e.g., business fixed investment expenditures) in 1972 also makes a significant additional contribution to the expansion. Although I have not presented the results here the same can be said of a drop in personal income taxes. It is true, of course, that almost any increase in aggregate demand from the public or private sectors generates some potential pressure on prices. However, the economy is currently characterized by low utilization rates of both labor and capital as well as certain institutional rigidities which should insulate prices somewhat from the pressures of rising aggregate demand. In this respect I consider our own price forecasts to be on the pessimistic side. Given the current levels of unemployment, the non-unionized sector of the labor force may not quite follow the pattern set in recent wage negotiations, and thus permit somewhat better performance on unit labor costs and prices for the economy as a whole.

Finally a word about monetary policy. As I have noted above, we have projected a slow rise in interest rates for the next six quarters. Given our projected expansion in real output and prices, such a modest rise in interest rates can only be sustained by a fairly rapid rate of growth in the money supply. Given the 5.0% increase in real output and the 4.7 to 4.8% increase in prices forecast for 1972, a 6% rate of growth in the money supply would imply a far higher rise in interest rates than we have allowed for. Since I view a more rapid rise in interest rates as undesirable, I would not favor any attempt to retain the rate of growth of the money supply, to a figure in the range of 6%.

Representative GRIFFITHS. Thank you. I thank all of you.

I would like to ask you: Do you sometimes feel in the situation we are in today, that economics and economists can no longer offer a general solution to solve the problem?

Now, let me be specific. Mr. Gordon, I believe, suggested that one of the great things to do was to increase social security. We have been increasing social security regularly and——

Mr. GORDON. I did not say that.

Representative GRIFFITHS (continuing). We have been increasing it at the rate of inflation. But that is not enough and one of the real answers is that the rate of inflation in the things that people buy who are on social security is much higher than the general rate of inflation.

One of the highest rates of inflation of anything in this country is doctors and hospitals and that is what old people on social security are buying. So, if the general price level is going up 6 percent a year and we give them 6 percent, it is still not enough for them because doctors and hospitals are going up 13 percent.

Mr. GORDON. There is no obstacle to creating a price index for older people.

Representative GRIFFITHS. All right.

The second thing is: I have had five letters in 2 days out of my district. The district represents one of the largest, highest percentage of homeowner-occupied areas in America. These people have owned the places; they have been paying taxes on them and they have maintained them and in the last 6 years taxes have gone up 100 percent.

So, no matter what we do we cannot help those people sufficiently.

Mr. GORDON. Wait a minute.

Representative GRIFFITHS. Not with social security we cannot.

Mr. GORDON. That is not a panacea for every problem. Take State and local taxes, for instance. One problem is that the income tax, which is the most income-elastic source of revenue, has been monopolized by the Federal Government. We all know that.

Representative GRIFFITHS. That is completely wrong. Any State can enact its own income tax and our State has and the city has. So that there is no monopoly in income taxes. Everybody can have one that wants one if the State will give them the authority.

Mr. GORDON. Most of the property taxes are levied by local authorities. Local authorities compete with each other and you don't find many local municipalities in this country levying income taxes because of the fear or loss of businesses and residents to nearby communities.

Representative GRIFFITHS. All of these cities are moving rapidly to income taxes.

But the thing I am asking you is: Hasn't the time passed when you can do something generally which actually is of help in this problem?

Now, the thing that amazes me as I sit here listening to you, as I listened to everybody else all year, why doesn't somebody object to what these big corporations are doing with the money that is vested in them?

My husband and I have a few modest investments. One of the things I enjoy every January is sitting down and figuring out how much we made on those investments, and I look back to see what happened years before. I am amazed at the number of those corporations that give you exactly the same return on that investment year-in and year-out. What kind of nonsense is that? Why don't you get more money out of your investment?

You know why you don't. They are taking that capital and buying other kinds of businesses. That is what they are doing with it. They are not giving you a return on your investment; the return is going to the management and they are increasing their investment with your capital.

But don't you think that the time has arrived that in place of saying: Well, let's give more interest or reduce the interest rates, or reduce this or that, why don't we zero in on some specific remedies? Wouldn't it be of some help; what do you think, Mr. Shapiro?

Mr. SHAPIRO. I am not quite clear what problems you are trying to find a remedy for.

Representative GRIFFITHS. Any problem. Just name any of them. For instance, you talk about nonfarm income. Listen, 15 years ago I knew a man who had one of these model milk farms, milked 100 cows, night and morning. The man who delivered the milk in Detroit made more money than he did. In investment he had perhaps a couple hundred thousand dollars, and he was working morning, noon, and night. So were his wife and the children, and the man who delivered the milk made more money than he did.

What kind of a world is that and what kind of remedies do you offer?

Now, economists, anything you offered here today isn't going to help him.

Mr. SHAPIRO. It is certainly not going to help the model milk producing part of it, and I would say he had a bad investment, even though it is a lot of money and a personal tragedy for him.

Mr. GORDON. But that is the consequence of free enterprise; that is the system we have. We rely upon the automatic operation of the price system to establish relative rewards. Why are janitors paid more than some teachers in some communities? That is what has to be paid to get people to do the work of a janitor.

Representative GRIFFITHS. You are all coming in here opposing wage and price controls. Right? Everyone of you has opposed it. What kind of remedy do you offer to help out?

Mr. LEVY. First of all, I would like to make clear: I have not opposed wage and price controls. I, for one, think that we have to go beyond traditional aggregate policies. This is a very difficult area. I think the questions which you have raised generally point to the fact that we live in a very complex economy where simple and sweeping measures will not get you off the hook when you have difficult economic problems.

For instance, some of the questions you raised deal with problems where the Government itself, to some extent, is not free of blame.

Representative GRIFFITHS. I agree.

Mr. LEVY. You mentioned the high inflation in medical costs. Now, there is no doubt that we have expanded, and I think it is very good that we have expanded, medical services to all segments of the population through medicare, medicaid, and other Government programs. As you expand the demand for these services, or the ability of people to reach out for these services, obviously the supply of the service must be sharply increased. If not, prices will increase very rapidly.

The same is true in construction, where we have subsidized housing for middle- and lower-income groups. Now, in housing and in the medical area, for example, the supply of services expands slowly in part because of artificial barriers to entry. The unions have "closed shops" in an area where, under changed circumstances, there may be great potential for employment, for instance, for minorities.

That the American Medical Association has restricted the supply of doctors provided through medical schools is a well-known fact. We are not turning them out as fast as we should and as fast as we could. Thus in certain areas where increased services and expansion of services to middle- and lower-income groups and the poor are desirable, the Government has done something that boosts the demand and the ability of people to reach out for these services, but we have done very little to see to it that the supply of these services is increased commensurately.

I am very pleased to see that one area where we have moved to do something is the construction industry. The administration points to the fact that the Construction Industry Stabilization Committee has had some success in moderating wage increases somewhat below the very rapid rate which we have seen in the past and which otherwise probably would have accelerated.

These are examples of complex specific segments of our economy where you have to analyze the problem in considerable depth and where, I think, economists could provide improved policies or remedies. Politically, and in terms of the overall mix of interest groups and interests, it is not always easy to carry out some of these policies. But then, difficult problems cannot be easily solved—they have difficult solutions.

I think there are areas here where economists have studied the problem, where they can give some reasonably good advice. In a few of these areas some improvements have taken place and there are many other areas where, hopefully, some greater efforts will be made in the future and we will see further improvements.

Representative GRIFFITHS. The real truth is this: Unless we put some type of lid on medical costs and doctor's fees, this will continue to be the greatest growth of inflation in the whole economy.

Mr. LEVY. I do not think that ceiling will do a great deal for you for a very long period of time and I will tell you why. If you place ceilings, then those who are well off and can pay much more than the ceiling rate will virtually monopolize the services of good doctors. As long as there are some people who can buy these services at much higher prices in the free market and the supply of these services—the number of doctors—is too small, you will find that those who are better off will simply get almost full-time service of the best doctors in the country and these doctors will not have the time, nor the interest, to provide services for the others.

Therefore, part of the problem is that we cannot arbitrarily tamper with the market mechanism through simple ceilings or similar solutions. In the short run, they might be stopgap measure—but in the long run, economics tell us that in an area like this we have to be able to expand the supply of skilled people able to provide these services in order to solve the problem.

Representative GRIFFITHS. I think we are going to make an attempt, but you are going to have to do them both. There is no need worrying about the fact that the best doctors are going to be taking care of the people with the money. That is what they are doing now. You know, that is obvious.

Furthermore, the people who have the money to pay for anything are not worrying over a particular doctor, choosing their own doctor. They go to Mayo's and make sure they are taken care of, or to some other big concern and make sure they are taken care of.

Nevertheless, just to increase social security without doing something where medical care is concerned is never going to be enough, because we can increase social security until it takes all of our money and you are still not going to pay the bills. Because the largest part of the inflation in medical care is doctors' fees and doctors were not starving before medicare went into effect. Those who had the ability to get the money took it and that is really one of the things, it seems to me is happening all over the country now.

Mr. GORDON. That is Government-fostered monopoly. They can get the money because there is not the supply of new doctors coming out as necessary.

Representative GRIFFITHS. You also have that in every union. It has a sort of monopoly, too.

Mr. GORDON. We have union regulations——

Representative GRIFFITHS. Look at the other sorts of things that you have. The big auto unions are now beginning to make themselves really felt. They are providing for their people in their old age and who is providing for them? You and I as we purchase those cars. That is who is providing for them.

But they, themselves, are not doing anything about changing the work hours for their employees, so that a skilled workman in their plants, the union negotiates and that man works 7 days a week, 10 or 12 hours a day, and they cannot get off. Whereas, they would prefer perhaps a shorter workweek.

But it seems to me what we have to begin to look at is a specific remedy and how it is going to work.

Now, we are struggling in the Ways and Means Committee with revenue sharing. In theory, this is to help out cities and States. In fact, unless you put some strings on it what it is going to help out is firemen and policemen and garbage collectors in the city. That is who it is going to help out. And the teachers unions. You are not going to be able to do much else about it. That is it, unless you put some kind of a string on it; unless you say it has to go for this or has to go for that.

You possibly would agree that wage-price controls are going to have some effect; is that right or not, or is that too much?

Mr. LEVY. I think the term "wage-and-price controls" has been used so loosely and in so many different ways that it is hard to answer a question of that kind with a "yes" or "no." I would say in a situation like the present one, we ought to pay great attention to, and try to develop, additional tools bearing more directly on the wage-and-price problem, rather than just applying the simple aggregate economic policies. Unless we do that even if we ultimately get price stability, we will have paid for it with very high and prolonged unemployment rates and large losses of output.

Now, how to go about attacking the wage-price problem of inflation more directly is a question lots of countries have struggled with and there are no pat, simple answers.

For instance, among the various measures the administration has taken—and while they indicate that they are strongly against this approach, in the supplementary material I am submitting with my prepared statement I have reviewed this and shown that they have already gone part of the way in certain areas—I think what they have done in the construction industry is probably the most interesting and, possibly, the most fruitful step taken so far. I have noticed with some interest that Paul McCracken, the Chairman of the Council of Economic Advisers, recently reviewed this before this committee and found that the record was a rather good one, that it indeed resulted in lower wage agreements than you could have otherwise expected. The last sentence of his statement dealing with this particular aspect was a bit cryptic but rather interesting. He said that the President had promised that the administration will also act in other cases where the appropriate conditions exist.

Of course, the administration has pointed out that the construction industry is unique in many ways, but we all know it is a very difficult and complex industry; yet we have set up an experiment there that seems to bring at least some moderation and some results. In our complex U.S. economy, every industry is unique to some extent, and if we have found a temporary answer in construction that has some promise, maybe with some effort we could find new methods for attacking the problem in certain other industries, too.

I would suggest that this committee, since it is very much interested in this problem, may want at some point to hold hearings, trying to see what additional tools can be developed that hold out promise in attacking this wage-price problem of inflation more directly and at less real economic costs than just aggregate fiscal and monetary restraints. Maybe, as the result of such hearings we could develop some new methods, some new consensus. I hope that this would be explored very seriously. I do see promise here, but again, there are no simple solutions.

Representative GRIFFITHS. Do you want to make some comments, Mr. Shapiro?

Mr. SHAPIRO. Yes. I think anywhere we find the existing monopolies in the economy which are protected one way or the other, for example, union monopolization of the supply of workers to the construction industry, the AMA monopolizing the supply of doctors and so on, it is perfectly appropriate for the Congress or another agency to take action and break up these monopolies and the kind of practices which enable them to easily pass on price increases to their consumers.

Turning to the construction industry—our much-heralded experiment in wage and price control—it is not clear to me at all that the experiment has really been so successful. In Michigan, for example, without the "work" of any "wage commission" a number of construction unions have forgone part of their scheduled wage increases for this year in order to try to increase the demand for their services. The plumbers are one; there are a number of others who have forgone some of their wage increases scheduled for this year just because they are feeling the "crunch" in certain areas.

I would certainly favor any move this committee would initiate or any other committee in Congress would initiate that would break up some of these monopolistic practices. I think that would be a very great help.

I would, however, like to point to what I believe to be the critical thing. We can, for example, come back to the area of medical care. The problem simply is not going to be solved until we manage to increase the supply of doctors and other medical services to a level adequate to provide for the people as a whole. The danger is that we always concentrate on stop gap measures, which create only short-run influences of a temporary kind. There is a fair amount of talk in Congress now about various large sums of moneys to be given to medical schools to increase the supply of doctors. I think this is, in general, a good idea, but if you speak to the people in the medical schools, they can hardly wait until it is passed, because they feel the measures are much too impractical—ask for too much too soon—and the only thing that will happen, is to increase the salaries of those in the medical schools and you still won't have the necessary doctor supply.

The only thing I would like to encourage this committee and other Members of the Congress to consider in such legislation, is that it should very carefully design it in a way to insure increased interest in the supply of doctors and other medical services.

We cannot give adequate medical care until we have many, many more doctors and if it breaks up monopoly to do it, we ought to do it. If it takes breaking up some of the ways in which the construction unions operate we ought to do that, because these can be very important changes and I would certainly support the measures like this.

Representative GRIFFITHS. We can do a lot about changing the method of delivery.

Mr. SHAPIRO. I think that is right.

Representative GRIFFITHS. I hope it will be passed and I think it will make some real sense to pass that bill now because it does put a lid on some of the inflation. But older people in my district are, in many cases, paying today more to visit a doctor than they paid before medicare went into effect, because the doctors have raised their fees, too.

Mr. SHAPIRO. That is right.

Representative GRIFFITHS. I would like to ask you: Do all of you agree that inflation will be between 3 and 4.5 percent at the end of 1972, or do you think it will be greater than that?

Mr. GORDON. You have to specify something else about what you think is going to happen to the economy. These are conditional forecasts. I think the main point which I have made and I think this is certainly in agreement with the Michigan forecast, is that the rate of inflation is not very sensitive in the short run over the next year or two, to the particular rate of increase of output, within limits. Because most of these union negotiations are based on what the unions feel they have lost in the past by the previous inflation, these negotiations are not going to be very much influenced one way or the other by the pace of expansion of the economy.

I am a little bit more optimistic than Professor Shapiro on this.

I look at the nonfarm private deflator, the price index which excludes the cost of Federal salary increases because this happens at an irregular pace. That deflator actually increased at less than 4 percent in the second quarter, and I anticipate on average that this performance might be typical of the next six quarters or so, to the end of 1972.

Miss DINGLE. I think it is very unlikely that it will be less than 4 percent. If we really plug along and say all we have to do is increase Government spending substantially more and do whatever needs to be done to get the Federal Reserve to be as expansionary as some people feel it should be with monetary policy, I think it could be more.

In the absence of anything I can foresee at the moment, I would say 4 percent is the floor. Given what I suspect are going to be political developments, I would be more likely to put it in the 5 to 5.5 percent range.

Representative GRIFFITHS. Now, as I understand it, you recommend against stimulative policies?

Miss DINGLE. I recommend that we at least not go overboard. Everybody would like a moderately stimulative policy, but the question of how to define moderate is, I think, very difficult under the circumstances.

I do not feel that we should be too concerned about an increase in interest rates. That does reflect to a considerable extent inflationary expectations. I think there is a problem here of reconciling the long-term and the short term. I probably feel interest rates in the long run as a capitalization factor are more important than most people would feel they are.

On the other hand, with the big expectation of price increase and its reflection in interest rates—I think really for the first time in the United States—I just think the monetary authorities do not know what different interest rates mean, not only in terms of immediate increase in the money supply—however, you want to define the money supply, broadly or narrowly—but with respect to the effects on the economy.

For some years we have been noticing how the expectation of price increase is reflected in inflationary wage contracts on the part of unions. But I really think it has only been in the past few years that we have had a substantial reflection of this in interest rates.

I think maybe we are too literate; this may be one of the problems. I understand inflations in the period before the First World War did not involve such problems of expectations, but now everybody knows what is happening to the consumer price index the minute it is published. And this includes a lot of people not economically very sophisticated. Also, everybody hears Milton Friedman's comments about the real rate of interest.

I think that it would be awfully easy to go overboard. I am pessimistic about the possibility of overcoming inflationary expectations. Responses to fiscal and monetary policies are so difficult to predict once you have such expectations—this is one reason why I wish we could do something about them and would be willing perhaps to sacrifice some employment in the short run to do so. I am not convinced, though, that what I recommend would be buying a lot more unemployment because I am just not sure the trade off exists.

But once expectations are so important, it is so difficult to predict their effect. Under some circumstances, inflationary expectations may lead to a very large increase in expenditures. Under other circumstances they may lead to a reduction. Like you, I am concerned about retired people, but not only about those relying primarily on social security; also, I am concerned about my colleagues who thought they had saved enough to provide for their old age by buying savings bonds back in the 1940's and by having savings and loan shares and savings deposits. Inflation may have the precise opposite effect as far as their spending is concerned from what one might think it would have.

I think in looking at consumer savings figures for the second quarter, I would be less reluctant at the present time to see a reduction in taxes—that is, a bringing forward of the already planned reductions—than I would have several weeks ago.

If one is going to be stimulative, it seems to me that tax reduction is the way to bring it about. I think it is less likely to have unfavorable psychological repercussions than increased spending. I think it might actually have some favorable repercussions by increasing take-home pay, but I would be reluctant to propose anything additional other than bringing forward some of the already planned tax reductions.

I agree with you that the increase in social security payments is not taking care of all of the problems of the old people. On the other hand, I am also concerned about the fact that social security taxes have been rising as rapidly as they have. Not only are they regressive in their nature—and also a nuisance for anybody that gets big tax withholdings the first few months of the year and then has an increase in his take-home pay and then gets new withholdings the first few months of the next year. But I think one additional factor in the bargaining for higher wages has been the effect of increased social security taxes on take-home pay.

Representative GRIFFITHS. Mr. Gordon, you do recommend expansionary policies and Mr. Levy and Mr. Shapiro, I am not quite clear. Where do you come out on this?

Mr. LEVY. Well, as I indicated, there is a certain trade off here. If all you do is expand fiscal and monetary policy under the present circumstances of inflationary expectations, I think that a substantial part of that will spill over into costs and prices.

The high savings rate has been mentioned here. To me the high savings rate has not been a great surprise. Professor Katona has established in his surveys and analyses that the response to inflation of the American consumer is substantially different from the response of the European consumer. The Europeans have gone through a large number of very large inflations; now they rush out and engage in hedge buying when they expect inflation. The American consumer has not been burned to any similar extent and apparently his normal response to inflation is to increase his savings rate in order to provide additional protection, since everything is more expensive. The continuation of inflation which creates consumer concern, and high unemployment rates that create consumer concern, are bound to lead to high savings rates and these tend to hold back the expansion of the economy. Now, if you stimulate in this kind of setting, and while business is rebuilding liquidity, you can stimulate substantially and get a large spillover into wages, costs, and prices and only moderate real gains.

Therefore, I would like to see some additional stimulation beyond what has been planned, and I am very concerned that the Federal Reserve may take corrective action to now average down the growth of the money supply—after letting it grow at a very fast pace—but I would also like to see somewhat more serious and determined efforts to develop and put in place additional policies in order to restrain this stimulation from spilling over extensively into wages and prices.

To this extent, I subscribe to what you may call loosely "income policies." There are no easy answers, but I think we should devote more thought and effort to new measures in this area—while expanding our other policies—than what has been done so far.

Representative GRIFFITHS. Mr. Gordon.

Mr. GORDON. I wanted to say a bit about tax cuts, because in general I think in the statement I emphasized the desirability of having stable growth. It is not a good idea to cut taxes if we plan later on to increase them again. For one thing, if people expect the tax cut to be temporary, they will not react to it in the same way as if they expect the tax cut to be permanent.

So, I would not want to go on record as being in favor of rapid and frequent changes in taxes. However, now is a good opportunity to cut taxes because we do have these planned reductions which will go into effect any way in another year or two, and these will be expected to be permanent cuts.

So, if we were to do that now, it would probably have a desirable effect and people would not expect it to be reversed.

The reason tax reductions are a particularly good idea is because they do increase after-tax income, and it is the squeeze on after-tax real income that has been the main reason for these high wage negotiations in the past few years.

What we have had, beginning in 1969, is very slow growth in productivity due to the slump in output. That has cut both workers' incomes and profits of corporations at the same time. So, in order to make up for that we have had workers demanding large wage increases, and firms passing these on immediately as higher prices because profits are so low. If we can break the cycle by giving the workers some increases in wages that stick, through cuts in taxes, that would tend to moderate some of the pressures for wage demands. That is one of the ways in which we can get an expansion in output, at least temporarily, without additional pressure on prices.

Representative GRIFFITHS. The real truth is: If we are going to get a tax cut, anybody working at $8,000 is not going to get much of a tax cut. The only way to give them a tax cut that means anything, in my judgment, is to cut social security.

Mr. GORDON. I would be very much in favor of that.

Representative GRIFFITHS. To cut payroll taxes, but even when we do it their own government, their own State government, their city government, take it up so quickly in an increased tax or the property tax on the house that the tax cuts, in my opinion, have not had really that much influence.

Mr. GORDON. We are talking about two different problems. The second problem you mentioned, the likelihood of the cities picking it up, refers to a structural problem requiring a long-run solution, increasing the share of income taxes and reducing the share of property taxes. The first problem is one of short-term stabilization, and we should not mix the two together. We would all like to have solutions together, but we cannot say we cannot accomplish the first because of the second.

Representative GRIFFITHS. You don't do the second; the first doesn't do anything. That is really the truth of the matter. The first time the tax cut was ever suggested, I was a member of this committee and I was vastly impressed by the idea. So finally I wrote my district and asked them. I asked them if they wanted a tax cut, and what would they do with the money?

My district wrote back and volunteered the information, all on their own; 66 percent of those who replied said: "don't cut the taxes; just pay the bills," which I thought was quite interesting.

But I was also fascinated. Some of them were going to buy a dog for their grandchild; somebody was going to fix the pavement and all of that kind of stuff.

Mr. SHAPIRO. One question raised was if we agreed the rate of price inflation would be between 3.5 and 4.5 percent. If we are talking about the rate of price inflation in the private nonfarm sector, I agree with that range and I personally think it will be very close to 4 percent. If you are talking about the rate of price inflation for the economy as a whole, which includes the public sector as well, I think we won't do that well; that the rate of inflation will more likely be close to 4.5 percent, even higher.

I do not see any chance of the rate of inflation getting below 4 percent or something like that. And the 3.5 range, I don't see that at all.

As regards stimulation to the economy, I agree very much with what Professor Gordon said. I understand the problem you raised about getting Federal tax relief into the pockets of consumers and not having some other level of government take it out again as soon as you put the money in. I think, nonetheless, it would be a good idea. The State and local governments are having a hard enough time raising taxes and I think it might do a bit of good for both.

There is another thing I would like to emphasize, something Professor Gordon said earlier in his testimony, and that is what is critically important is the changing rate of inflation. The rate of inflation as far as stabilization policies of the next 2 years are concerned is not the key thing; it is the changing rate of inflation. If you look at Professor Katonas' analysis drawn from consumer surveys, he notes: "Old news is no news." The Vietnam war affected consumers for a while but it is no longer news. As long as the rate of inflation is the old rate of inflation, that is no news to consumers either.

I think from the point of view of people's attitudes and from the point of view of economics, it is really the changing rate of inflation we have to focus our attention on. If interest rates are going to rise because of inflation it is going to be because of a changing rate of inflation. They will not rise solely because inflation is remaining at 4 percent or 4.5 percent. They will rise if we change our ideas and say inflation is not going to 4.5; it is going to be 6 or 10 percent. They will then rise.

That is why I do not believe that inflation is going to have much effect on behavior in the next 18 months, or 2 years, because I do not believe the rate of inflation is going to change very much, except in a downward direction. However, if we stimulate the economy either by lower taxes, which is what I would prefer, or by raising expenditures and so on, we will not do as well as we would have otherwise on the price front. We will pay something; we don't get it for nothing. But, with the current state of the economy, we can get a very good buy. If I must put my bets anywhere, I would put them there. There is no certainty in this, as you well know.

Representative GRIFFITHS. Thank you. I want to thank all of you for the remarks you have made. I hope sometime this year you will have your students or will yourself look into this matter of specific actions and specific things.

For instance, one of the things I think we may be making a mistake with all of the time is we correct the tax laws to fit one horrible case and all at once we discover the wealth of the United States is flowing out through that loophole. One of the things I would be interested in knowing is what was the economic effect of the Pennsylvania Railroad on the United States. I do not think you can say that this is any small thing. People invested; they expected to live on their investments in their old age. What happened?

Obviously the management bled off the lucrative business and left the company holding the bag, the railroad itself.

I think it would be fascinating to know what would be the effect of our bailing out Lockheed or not bailing out Lockheed, economically. As far as I am personally concerned, they can be forgotten about. But now they come here with this sad story: 60,000 more people will be out of work. But why should we perpetuate bracing up these people?

Mr. GORDON. Who are you going to bail out next? It is a precedent.

Miss DINGLE. Also, don't forget the pressures for various import quotas and so forth, when industries become noncompetitive.

Representative GRIFFITHS. That is right. We also consider trade. I was practically born a free trader. I was for free trading—boy, when I look at what they are doing now, I wonder if I really am for free trade. I shudder when I see the things they are doing. How can we compete where an American company can go into Scotland and have furnished a plant, fully equipped, and pay one-third the labor rates, and send all of that stuff back over here and sell it?

I think it would be great if you folks would push on some of these specific instances and I expect to hear from you.

This committee will stand adjourned until 10 a.m. on Thursday, July 22, in room 457 of the Old Senate Office Building.

The witnesses will be: Phillip Cagan, professor of economics at Columbia University; Hyman Minsky, professor of economics at Washington University; Richard O'Neill, president, Housing Advisory Council, Ltd.; and Craig Swan, professor of economics at the University of Minnesota.

I would say again what a pleasure it has been hearing you.

(Whereupon, at 11:50 a.m., the committee was recessed, to reconvene at 10 a.m., Thursday, July 22, 1971.)

THE 1971 MIDYEAR REVIEW OF THE ECONOMY

THURSDAY, JULY 22, 1971

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

The committee met, pursuant to recess, at 10:10 a.m., in room 457, Old Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Reuss.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Courtenay M. Slater, economist; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

This morning the Joint Economic Committee is continuing its midyear review of the economy. Our witnesses today have been asked to address themselves especially to monetary policy and housing. There is widespread puzzlement at the present time about the relation between the money supply and interest rates. How can interest rates be rising when the money supply has been growing at a rate exceeding 10 percent per year? Yet interest rates are rising.

Rising interest rates cause concern for a number of reasons. An especially important concern is the impact that high interest rates and tight money conditions have on housing. Residential construction is one of the few sectors of the economy—perhaps the only sector—which has lately exhibited some real strength. It seems important to maintain the sort of credit conditions which will continue to foster this strength, both because housing is so important to the overall strength of the economy and because of the very fundamental need to improve and expand our housing supply.

Our witnesses this morning are all extremely well qualified to discuss this subject. Mr. Phillip Cagan is a professor of economics at Columbia University and a member of the senior research staff of the National Bureau of Economic Research. During 1969 and 1970 he served as a senior staff economist with the Council of Economic Advisers. His research for the National Bureau has included studies of the cyclical behavior of interest rates—a very timely subject this morning.

Mr. Hyman Minsky is a professor of economics at Washington University in St. Louis and author of many well known studies of monetary policy. He has testified before the Joint Economic Committee on past occasions and we welcome him again.

Mr. Richard O'Neill is president of Housing Advisory Council, Ltd., and a well known consultant in the field of housing and urban affairs. He was a member of the National Commission on Urban Problems, appointed by President Johnson in 1967, and for many years he was editor of House and Home, a business publication for the housing industry.

Mr. Craig Swan is a professor of economics at the University of Minnesota. He has done a great deal of research relating to the impact of monetary policy on housing and is the author of a recent Brookings study, "Homebuilding, A Review of Experience."

We are very grateful to all of you for your willingness to appear this morning. Since we do have four witnesses, and we want to leave time for questioning, I would like to ask each of you to hold your statements to 10 or 15 minutes. Your full prepared statements will, of course, be printed in the hearing record.

Mr. Cagan, go right ahead.

STATEMENT OF PHILLIP CAGAN, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY

Mr. CAGAN. My remarks will probably take the full 15 minutes; is that all right, Mr. Chairman?

Chairman PROXMIRE. It is all right; what you could do, if you want to, is stop at any point you wish or summarize what remains. I would appreciate it if you could hold it down as much as possible.

Mr. CAGAN. The rapid growth of the money stock in the first half of this year has made the choice of a monetary policy for the coming months more difficult. The rapid monetary growth, while appropriate to make up for slow growth last year, cannot be maintained without threatening to accelerate the inflation. A lower growth rate is in order and appears to be underway.

Chairman PROXMIRE. I might interrupt to explain. I want to apologize. I do not mean to rush you. You are all very distinguished economists and you can help us very greatly. The trouble is the Lockheed giveaway bill—that is the way I like to phrase it, it is not completely objective, I suppose—is on the floor. I am doing my best to oppose it. Consequently, I am going to have to leave early this morning. Congressman Reuss is coming, but I would like to get some questions in before I have to leave.

Mr. CAGAN. The problem is that a reduction in monetary growth will initially push up interest rates, whereas policy has pursued rapid monetary growth in part to hold them down. I shall direct my remarks this morning to an appropriate monetary policy for the rest of this year and the associated behavior of interest rates.

Let me summarize some work I have done on previous cyclical recoveries in the United States since World War II. Generally we have had a fairly strong spurt in the first year of recovery. I estimated from this experience how we might achieve the targets that were originally thought acceptable at the beginning of this year; namely, to reduce unemployment to about the 5-percent level by the end of the year, and to bring down the rate of inflation to 3.5 percent by the end of the year.

These targets seemed to be feasible if the rate of growth of real GNP were 3.5 percent per year, measured from the previous peak, which is an average for a 2-year period.

I translated that figure into a desirable growth in dollar GNP by adding to it the price increase that we had in 1970, and the target price increase then set for 1971. The result is an average rate of growth in dollar GNP for the 2 years 1970–71 of 8⅓ percent per year.

That target seemed feasible and able to achieve a desired reduction in unemployment and inflation.

So far this year we are below the target, but that is not a reason to abandon the monetary policy which was originally designed to achieve it. There is a lag in the effect of a change in monetary policy; to change it from month to month, depending on what is happening to the economy, is a mistake.

The appropriate rate of monetary growth depends upon the behavior of monetary velocity, which I measure as the ratio of GNP to the money stock (narrow definition, M_1). If you look at the trend growth of velocity over the postwar period since World War II, it had been growing at about 3.25 percent per year, but in the last several years its growth rate was about 2.5 percent. It was lower than that during the last year, but we expect it to be lower during a business recession. By past behavior it will tend to pick up as the cyclical recovery gains speed.

I look for an average growth in monetary velocity over this 2-year period, 1970–71, of about 2 to 2.5 percent. This means that if we want dollar GNP to grow by about 8 percent, we need an average growth in the money supply of 6 percent per year for the 2-year period.

We had in 1970 a growth in the money supply of 5.1 percent. If we want the average for the 2 years to be 6 percent, the money supply should grow 7 percent in 1971. These are rough figures, of course, but I think they provide an appropriate target.

Given the 7-percent growth this year, that would give a money stock—by the narrow definition—of $228 billion in the fourth quarter of this year. But the money stock has already risen to $228 billion in the week of July 7, reflecting very high growth since February. To stay on the above target, it should rise no further for the rest of the year. That is perhaps too sharp a break in the growth rate, but since the economy is not yet adjusted to the high growth that we had in the second quarter, a large reduction should not be disturbing. Nevertheless, if policy decides to reduce the rate of monetary growth, it faces the dilemma that the initial adjustments in financial markets will tend to raise interest rates.

Let me discuss the recent behavior of interest rates. Corporate bond yields unexpectedly rose during last year's business contraction. Moody's index of Aaa bond yields rose 44 basis points, that is, almost one-half of a percentage point. The Baa bond index rose over twice as much. These increases were unexpected and threw the bond market off balance. In the previous four business contractions since World War II corporate bond yields declined, on the average by 30 basis points for Aaa bonds and 20 points for Baa bonds.

However, the increase during 1970 was confined to outstanding corporate bonds. New issues of corporate bonds, as well as United States and municipal bonds outstanding, had a slight decline in yields, and short-term open-market rates fell sharply as they usually do in a recession.

The unexpected behavior was not that corporate bond yields did not decline at all, however. They rose to a peak in June 1970 for Aaa bonds and in August for Baa bonds, which came 7 and 9 months after the cyclical peak in business activity, and fell to their lowest point in February 1971, 3 months after the business trough. This lag behind the turning points in business activity was the common pattern before World War I. The lag was very long at that time, about 3 to 4 quarters, so that during a decline in business activity bond yields might rise the whole time or not fall by much. After World War I the lag shortened, and after World War II it shortened further, until bond yields had no consistent lead or lag with the peaks and troughs in business activity.

Except, for the reoccurrence of a lag in corporate bond yields in 1970, therefore, they declined as expected in response to the latest business contraction. But the decline was steeper than usual. In the three previous post-World War II cycles corporate Aaa bonds declined from their peak yield an average of 3.7 basis points per month. In the recent contraction the yield declined 13.7 basis points per month from June 1970 to February 1971. Even as a percentage of the higher level of the yields in this cycle, the decline was half again as large as the average percentage decline in the three previous cycles. Such a steep cyclical decline in bond yields is rare for this country based on records back to the 1850's.

Several years ago I made a study of cyclical movements in interest rates for the National Bureau of Economic Research published as "Occasional Paper 100." The study examined a wide variety of interest rates and showed that over the past half century the lag at turning points had shortened and the cyclical amplitude had increased. I concluded that the change in cyclical timing and amplitude reflected, first, an increased sensitivity in the response of financial markets to changes in the demand and supply of credit and, second, a faster response of monetary policy to turns in business activity. The timing of monetary policy is important, because a tightening of monetary growth as the economy recovers from a recession reinforces the upward pull on interest rates of the expansion in activity and shortens the lag. In earlier periods monetary growth was slower to begin to offset cyclical movements and frequently failed to follow a countercyclical pattern at all, thus contributing to a long lag in interest rates.

Neither the sensitivity of financial markets nor the timing of changes in monetary policy has reverted to the earlier behavior. Financial markets are even more sensitive now than they used to be, and monetary policy changed at the end of 1969 from tight to easier conditions immediately after the peak in business activity. Neither one explains the reappearance in 1970 of a longer cyclical lag in bond yields.

Why then the longer lag? One reason was the strong demand for credit by business. Despite high interest rates in 1970, business investment did not decline during the recession but remained virtually constant in dollar amount; in real terms it fell slightly. In all previous nonwar cycles back to 1919, business investment declined in dollar and real terms, usually sharply. The strength of investment in 1970 was indeed unusual for a recession. It is no doubt related to a second reason for the continued high level of bond yields, anticipations of inflation.

As has been widely pointed out, anticipations of rising prices, which have hardened in recent years, make bond yields higher. The higher yields compensate for the depreciation in real value of securities when prices of goods are rising.

How much higher are yields today because of such anticipations? For a rough estimate we may take as a benchmark the 1965 level of bond yields, when the Aaa index averaged around 4.5 percent, and raise it to 5 percent to allow for the increase in demand for credit since 1965. This adjustment is conjecture, but it seems to me too little rather than too much. Then the 7.5 percent yields today exceed the adjusted 1965 yields by at most 2.5 percent. This excess can be attributed to the increase in the anticipated rate of inflation since 1965. Since the GNP private deflator (chain index) has lately been rising at more than 5 percent per year compared with 2 percent in 1965, a difference of about 3 percent, there appears to be at least one-half of 1 percentage point of the present rate of inflation not yet incorporated into current anticipations of future inflation. But if inflation continues at the same rate, the other one-half percent could be added on, which would raise Aaa yields to the 8-percent level.

Because an increase in inflation tends to raise bond yields, a policy of holding interest rates down by rapid monetary growth may work temporarily, but over the longer run it will prove self-defeating.

We can expect bond yields to rise in the coming months because the demand for credit is strong and gives all appearances of getting stronger, both from Government and private sources. But the contribution to a rise in bond yields from a reduction in monetary growth should not be very great. While a change in monetary growth can affect short term interest rates dramatically, bond yields by past experience are affected much less. This was illustrated earlier this year when bond yields rose despite the increased rate of monetary growth. Bonds are a long term investment, and their yield to maturity is usually little affected by current developments if they appear to be temporary as is a shortrun change in monetary policy.

Under certain circumstances current developments may have implications for the long run, however, which are relevant to bonds. An important example is the anticipations of inflation just mentioned, which are based on past and current price movements. Moreover, anticipations of inflation may be based, not only on the recent rate of inflation, but also on the direction of monetary policy. I would ordinarily be doubtful that anticipations of inflation would be affected by changes in monetary policy, but in the present economic situation it is quite possible. At least sudden revisions of anticipations of inflation seem to explain the unusually large fluctuations in bond yields in recent years. For example, the large decline in bond yields in the second half of 1970 may have reflected a reduction in the anticipated rate of inflation as business activity contracted. Then the subsequent failure of prices to decelerate may have reinstated the previous anticipations of inflation, whereupon bond yields erased part of their earlier decline. If anticipations have become sensitive to the direction of monetary policy, a reduction in monetary growth now could actually work to reduce bond yields or at least keep them from rising as much as they otherwise would.

This means that monetary policy has limited power to prevent bond yields from rising when credit demand is expanding, and that policy may even have a perverse effect.

But suppose that bond yields do rise in the coming months. Would that do any harm? There is a widespread view that rising yields are bad for a business recovery. But it all depends upon the reason for the rise. If due to a tight monetary policy, the rising yields tend to restrict the expansion. But policy has been too easy this year and needs to be more restrictive. Insofar as an expanding demand for credit is pulling up yields, a rise is appropriate. It helps to allocate expenditures between investment and consumption goods on a basis which can be sustained when the economy reaches full employment. This is also true insofar as rising yields reflect heightened anticipations of inflation.

Most of the concern over rising yields centers on the mortgage market. The fear is that higher mortgage rates will choke off residential construction, now running at a rate which for the first time in several years gives promise of meeting national housing goals. The current strength of housing, with mortgage rates currently at 7.5 to 8 percent, means that the demand can be effective even at high rates if mortgage credit is available. High rates have their major impact in reducing housing demand when they are thought to be temporary. Then home buyers hold back for lower rates. The 7.5-percent rate on mortgages today does not appear temporary, as it did when it was first reached, and may appear attractive to those who anticipate 4- to 5-percent inflation.

Housing declined in 1969 because the credit was not available. The supply of credit for the mortgage market depends upon deposit flows into savings institutions, which supply a large fraction of the market. In 1969 their deposits were not competitive with the high rates available on open-market instruments.

Would a cutback in monetary growth produce another credit crisis for savings institutions? I do not think so. Today, these institutions are in a much better position to pay higher rates to depositors and, if given the freedom, would be able to do so.

In conclusion, my own research and other work with which I am familiar leads me to the conclusion that we place far too much concern on movements in interest rates. The special problems of the mortgage market should be handled by structural reforms of depository institutions. Concern over rising interest rates should not stand in the way of reducing monetary growth, now too high, to an appropriate lower rate.

(The prepared statement of Mr. Cagan follows:)

Prepared Statement of Phillip Cagan

The rapid growth of the money stock in the first half of this year has made the choice of a monetary policy for the coming months more difficult. The rapid monetary growth, while appropriate to make up for slow growth last year, cannot be maintained without threatening to accelerate the inflation. A lower growth rate is in order and appears to be underway. The problem is that a reduction in monetary growth will initially push up interest rates, whereas policy has pursued rapid monetary growth in part to hold them down. I shall direct my remarks this morning to an appropriate monetary policy for the rest of this year and the associated behavior of interest rates.

THE APPROPRIATE RATE OF MONETARY GROWTH

Earlier this year I made a study of the first year of recovery from previous business recessions to see what would be a feasible policy for 1971. (My findings were presented in the *Commercial and Financial Chronicle*, May 6, 1971). The strength of a business recovery depends upon the depth of the preceding recession. To allow for this dependence, I measured the average growth in the economy from the peak in business activity to the end of the first year of recovery. The National Bureau of Economic Research dates the recent recession from November 1969 to November 1970, so the end of the first year of recovery will be next November. The goals of national policy which seemed within reach were a reduction in unemployment to 5 percent and in inflation to 3½ percent per year. These goals have proved optimistic. But the monetary policy designed to achieve them is still appropriate even if delayed in its effects and, in my view, should not be abandoned. I found that a growth in real GNP of 3 to 3½ percent per year for the two-year period since the business peak in the fourth quarter of 1969 would be consistent with the experience of past cycles and also seemed the best target to achieve the goals of reducing unemployment and inflation.

An additional advantage of such a two-year target is that it sets our sights on a period long enough for monetary policy to be effective. Since monetary policy has a lag of six months or more, the effects can be very misleading when judged over short periods. It therefore seems to me wiser to set a longer-run target and not try to adjust it to every short-run change in the economy.

The 3 to 3½ percent target growth in real GNP can be translated into a growth in dollar GNP by adding the actual rise in prices in 1970, which was 5.3 percent, and a target rise for all of 1971, which I take to be 4 percent. This is probably the best we can hope for this year. The implied two-year growth in dollar GNP averages 8 to 8¼ percent per year. Remember that this is a two-year average which includes the decline in 1970.

So far this year we are below the target. But that is no reason not to stick to the monetary policy designed to achieve it. Any shortfall this year will tend to be made up next year. Moreover, an 8-percent growth in dollar GNP for the two years 1970–71 seems to me the highest that policy should try to achieve, given the persistence of inflation. And, as unemployment and the rate of inflation decline, the desired rate of growth in GNP will have to be reduced.

The appropriate rate of monetary growth depends upon the behavior of monetary velocity (that is, the ratio of GNP to the money stock). The long-run growth in velocity (of the narrow money stock, M_1) seems to have declined in recent years. This is important, because the effect of its growth on aggregate expenditures is the same as issuing more money. In the 1950s and early 1960s velocity was rising 3¼ percent per year, so that only 3 percent growth in the money supply was equivalent to 6¼ percent growth in aggregate expenditures. In the last several years the growth in velocity has declined to around 2½ percent. From the third quarter last year to the first quarter this year the growth was 1.7 percent per year, but we expect it to be slower during a recession. It will undoubtedly pick up as the business recovery gains speed. An average growth in velocity of 2 to 2½ percent per year for the two years 1970–71 seems consistent with past cycles and its current trend. An average monetary growth of 5½ to 6 percent per year would therefore produce an average GNP growth of 7½ to 8½ percent per year, around the target proposed above. From the fourth quarter of 1969 to the fourth quarter of 1970 monetary growth was 5.1 percent. To achieve the desired two-year average, monetary growth in the first year of recovery should be 6–7 percent. At the 7 percent rate, that would be $228 billion in the fourth quarter of this year.

But the money stock has already risen to $225 billion by the end of June, reflecting very high growth since February. To stay on the above target, it should rise only $3 billion to the fourth quarter, an annual rate of growth for the second half of less than 3 percent.

If policy decides to reduce the rate of monetary growth, it faces the dilemma that the initial adjustments in financial markets will tend to raise interest rates. That would be the same effect on interest rates but in the opposite direction which policy hoped to achieve earlier this year with rapid monetary growth. Let me comment briefly on the recent behavior of interest rates.

RECENT BEHAVIOR OF BOND YIELDS IN HISTORICAL PERSPECTIVE

Corporate bond yields unexpectedly rose during last year's business contraction. Moody's index of Aaa bond yields rose 44 basis points, that is, almost ½ of a percentage point. The Baa bond index rose over twice as much. These increases were unexpected and threw the bond market off balance. In the previous four business contractions since World War II corporate bond yields declined, on the average by 30 points for Aaa bonds and 20 points for Baa bonds.

However, the increase during 1970 was confined to outstanding corporate bonds. New issues of corporate bonds, as well as U.S. and municipal bonds outstanding, had a slight decline in yields, and short-term open market rates fell sharply as they usually do in a recession.

The unexpected behavior was not that corporate bond yields did not decline at all, however. They rose to a peak in June 1970 for Aaa bonds and in August for Baa bonds, which came 7 and 9 months after the cyclical peak in business activity, and fell to their lowest point in February 1971, 3 months after the business trough. This lag behind the turning points in business activity was the common pattern before World War I. While we have no index for industrial corporate bonds before World War I, judging by high-quality railroad bonds the lag was very long at that time—about 3 to 4 quarters, so that during a decline in busines activity bond yields might rise the whole time or not fall by much. After World War I the lag shortened, and after World War II it shortened further, when the turning point in bond yields tended on the average to coincide with the peaks and troughs in business activity.

Except for the reoccurrence of a lag in corporate bond yields, therefore, they declined as expcted in response to the business contraction in 1970. But the decline was steeper than usual. In previous post-World War II cycles corporate Aaa bonds declined from their peak yield an average of 3.9 points per month. In the recent contraction the yield declined 13.7 basis points per month from June 1970 to February 1971. Even as a percentage of the higher level of the yields in this cycle, the decline was half again as large as the average percentage decline in the four previous cycles. Such a steep cyclical decline in bond yields is rare for this country based on records back to the 1850s.

Several years ago I made a study of cyclical movements in interest rates for the National Bureau of Economic Research (published as Occasional Paper 100). The study examined a wide variety of interest rates and showed that over the past half century the lag at turning points had shortened and the cyclical amplitude had increased. I concluded that the change in cyclical timing and amplitude reflected, first, an increased sensitivity in the response of financial markets to changes in the demand and supply of credit and, second, a faster response of monetary policy to turns in business activity. The timing of monetary policy is important, because a tightening of monetary growth as the economy recovers from a recession reinforces the upward pull on interest rates of the expansion in activity. This shortens the usual cyclical lag in interest rates. In earlier periods monetary growth was slower to begin to offset cyclical movements and frequently failed to follow a countercyclical pattern at all, thus contributing to a long lag in interest rates.

Neither the sensitivity of financial markets nor the timing of changes in monetary policy has reverted to the earlier behavior. Financial markets are even more sensitive now than they used to be, and monetary policy changed at the end of 1969 from tight to easier conditions immediately after the peak in business activity. Neither one explains the reappearance in 1970 of a longer cyclical lag in bond yields.

Why then the longer lag? One reason was the strong demand for credit by business. Despite high interest rates in 1970, business investment did not decline during the recession but remained virtually constant in dollar amount; in real terms it fell slightly. In all previous nonwar cycles back to 1919, business investment declined in dollar and real terms, usually sharply. The strength of investment in 1970 was indeed unusual for a recession. It is no doubt related to a second reason for the continued high level of bond yields, anticipations of inflation.

As has been widely pointed out, anticipations of rising prices, which have hardened in recent years, make bond yields higher. The higher yields compensate for the depreciation in real value of securities when prices are rising. Lenders want a higher return to offset the depreciation in purchasing power of their loans, and borrowers are willing to pay more to obtain funds, because both anticipate rising prices. We cannot readily measure anticipations, but there are many indications of their presence in the economy, especially in financial markets.

How much higher are yields today because of such anticipations? For a rough estimate we may take as a benchmark the 1965 level of bond yields, when the Aaa index averaged around 4½ percent, and raise it to 5 percent to allow for the increase in demand for credit since 1965. This adjustment is conjecture, but it seems to me too little rather than too much. Then the 7½-percent yields today exceed the 1965 yield by at most 2½ percent. This excess can be attributed to the increase in the anticipated rate of inflation since 1965. Since the GNP private deflator (chain index) has lately been rising at more than 5 percent per year compared with 2 percent in 1965, a difference of 3 percent, there appears to be at least ½ of one percentage point of the present rate of inflation not yet incorporated into current anticipations of future inflation. But if inflation continues at the same rate, the other one-half percent could be added on which would raise Aaa yields to the 8-percent level.

Thus an increase in inflation tends to raise bond yields. A policy of holding interest rates down by rapid monetary growth, therefore, may work temporarily, but over the longer run it will prove self-defeating.

An important reason for expecting bond yields to rise in the coming months is that the demand for credit is strong and gives all appearances of getting stronger, both from government and private sources. But the contribution to a rise in bond yields from a reduction in monetary growth should not be very great. While a change in monetary growth can affect short-term interest rates dramatically, bond yields by past experience are affected much less. This was illustrated earlier this year when bond yields rose despite the increased rate of monetary growth. Bonds are a long-term investment, and their yield to maturity is usually little affected by current developments viewed as temporary, such as a short-run change in monetary policy.

Under certain circumstances current developments may have implications for the long run, however, which are relevant to bonds. An important example is anticipations of inflation based on past and current price movements. Moreover, anticipations of inflation may be based, not only on the actual rate of inflation, but also on the direction of monetary policy. I would ordinarily be doubtful that anticipations would respond rapidly to current developments, but in the present economic situation it is quite possible. Sudden revisions of anticipations of inflation seem to explain the unusually large fluctuations in bond yields in recent years. For example, the large decline in bond yields in the second half of 1970 may have reflected a reduction in the anticipated rate of inflation as business activity contracted. Then the subsequent failure of prices to decelerate may have reinstated the previous anticipations of inflation, whereupon bond yields erased part of their earlier decline. If anticipations have become sensitive to the direction of monetary policy, a reduction in monetary growth now could actually work to reduce bond yields or at least keep them from rising as much as they otherwise would.

This means that monetary policy has limited power to prevent bond yields from rising when credit demand is expanding, and that policy may even have a perverse effect.

But suppose that bond yields do rise in the coming months. Would that do any harm? There is a widespread view that rising yields are bad for a business recovery. But it all depends upon the reason for the rise. If due to a tight monetary policy, the rising yields tend to restrict the expansion. But policy has been too easy this year and needs to be brought back to the middle of the road. Insofar as an expanding demand for credit is pulling up yields, a rise is appropriate. It helps to allocate expenditures between investment and consumption goods on a basis which can be sustained when the economy reaches full employment. This is also true insofar as rising yields reflect heightened anticipations of inflation.

Most of the concern over rising yields centers on the mortgage market. The fear is that higher mortgage rates will choke off residential construction, now running at a rate which for the first time in several years gives promise of meeting national housing goals. The current strength of housing, with mortgage rates currently at 7½ to 8 percent, means that the demand can be effective even at high rates if mortgage credit is available. High rates have their major impact in reducing housing demand when they are thought to be temporary. Then homebuyers hold back for lower rates. The 7½-percent rate on mortgages today does not appear temporary, as it did when it first appeared, and may appear attractive to those who anticipate 4 to 5 percent inflation.

Housing declined in 1969 because the credit was not available. The supply of credit for the mortgage market depends upon deposit flows into savings institutions, which supply a large fraction of the market. In 1969 they could not compete with the high rates available on open-market instruments.

Would a cutback in monetary growth produce another credit crisis for savings institutions? I do not think so. Today these institutions are in much better position to pay higher rates to depositors and, if given the freedom, would be able to do so.

CONCLUDING REMARKS

My own research and other work with which I am familiar leads me to the conclusion that we place far too much concern on movements in interest rates. The special problems of the mortgage market should be handled by structural reforms of depository institutions. Concern over rising interest rates should not stand in the way of reducing monetary growth, now too high, to an appropriate lower rate.

Chairman PROXMIRE. Thank you very much, Mr. Cagan.

Mr. Minsky, you go right ahead. I want to say those are very helpful tables you have attached to your statement, which will also be printed in full in the record.

STATEMENT OF HYMAN P. MINSKY, PROFESSOR OF ECONOMICS, WASHINGTON UNIVERSITY, ST. LOUIS, MO.

Mr. MINSKY. There are signs that we have entered upon an era of protracted slack. The recovery is lazy, the economy is suspended someplace between full employment prosperity and a serious depression.

There is no substantial evidence that a strong expansion is about to take place. Consumer confidence is weak, State and municipal governments are under strong financial constraints, and private investment is on a plateau that may be too high to be sustained.

Even at its sluggish pace the recovery is fragile. It depends upon the continuation of large-scale deficit financing of investment by the corporate business sector. As is shown in attached table III to my statement, corporate liabilities are much greater relative to both cash flows and liquid and protected assets than they were earlier in the post-1946 era. This burden of corporate debt may well lead to a reduction in corporate investment. If this takes place then, unless offset, a relapse into recession will take place.

The economy has not been conforming to the various game plans announced in the past 2½ years. Instead of policy eliminating inflation without any increase in unemployment, to date we have had increased unemployment without any significant abatement of inflation.

This record of policy failure indicates that economic policy is falliable even when influenced by Chicago's monetarism. This failure does not mean that the mislabeled Keynesian fiscalist school has a better track record. When the economists of the Kennedy-Johnson era were office holders they did not recognize, in their published reports and forecasts, that accelerating inflation will result from the recommended policy.

For each popular model of the economy there are a large number of anomalous observations. There should be widespread doubt as to their unconditional validity.

Both the monetarist and fiscalist views depend upon a heroic assumption that the financial system is always robust and basically passive. However, at times the financial system is fragile and an active determinant of the behavior of the economy. When this is true the economy does not conform to either the monetarist or the fiscalist scenario.

We are now in such a period. The financial system is fragile and financial factors are important in determining what happens.

In this presentation I will emphasize the aggregate financial position of the nonfinancial corporate sector. Similar changes in financial relations have occurred for other sectors. On the basis of the financial picture, I believed that an extrapolation of past relations does not yield a valid estimate of what we can expect.

The Penn Central Railway failed 1 year ago when it was unable to repay some $80 million of commercial paper. This was the climactic event to a fantastic runup of commercial and finance company open-market paper, from $14 billion at the end of 1966 to $40 billion in May of 1970. The Penn Central's failure set off a "run" on the commercial paper market.

The Federal Reserve System behaved as a lender of last resort and prevented the Penn Central fiasco from triggering a chain reaction of financial distress. Reserves were liberally supplied by the discount window and open market operations so that bank financing was available to those who found it difficult to roll over their maturing commercial paper. Ill advised ceilings were removed from interest rates commercial banks could pay on certificates of deposit.

This was not the first time in recent years that the Federal Reserve acted as a lender of last resort. In the late summer of 1966 the famous credit crunch took place. That mini-crisis centered around the illiquidity and insolvency of savings institutions and the losses commercial banks were taking as they made position by selling municipal securities. As in 1970 the Federal Reserve took the correct steps and offset the financial trauma by rapidly increasing the reserve base and by improving the competitive position of commercial banks in the market for time funds.

Both the credit crunch and the liquidity squeeze took place after the Federal Reserve sharply decreased the rate of increase of the money supply and the reserves of member banks and allowed ceiling interest rates on certificates of deposit to become effective, thus forcing a reduction in the amount outstanding.

These two episodes are the only really relevant post-1946 observations of the Federal Reserve's ability to constrain the growth of the money supply when the economy is buoyant. They indicate that the Federal Reserve System has only limited powers to constrain the rate of increase of the money supply in a strongly expanding economy.

Attempts in this direction lead to actual and threatened financial instability. This forces the Federal Reserve to abandon its policy of monetary constraint and to accelerate the rate of growth of the money supply and the reserve base. In a deep sense when the duties of the Federal Reserve as a lender of last resort are taken into account it is the behavior of the economy that controls the growth of the money supply. In the present circumstances I believe the Federal Reserve really has little freedom to constrain the rate of growth of the money supply unless it is willing to play a game of brinkmanship with the stability of the financial system. Monetary constraint is really not available as an anti-inflationary policy instrument.

I am introducing into the record two pieces I wrote which may interest the committee. One appeared in Trans-action and is entitled "The Crunch of 1966—Model for a New Financial Crisis." The second is a memorandum I prepared for a meeting on September 17, 1969, of academic consultants with the Board of Governors of the Federal Reserve System. The title of the memorandum is "Notes on the Susceptibility of the U.S. Economy to a Financial Crisis."

In 1967 the economy bounced back swiftly from the credit crunch, in 1971 the economy is sluggish after the liquidity squeeze. In 1967 the Federal Government's full employment budget was running a deficit of $11.6 billion, in 1971–I the full employment budget was running a surplus at a $6.6 billion annual rate. Fiscal policy was more expansive in 1967 than it is now.

The fiscal drag is not the entire explanation of the current sluggishness. It does not hold out a threat that a relapse into recession will occur. It is the financial relations of the corporate sector which indicate that a relapse may take place. These financial relations are to a large degree a reflection of the extent to which corporations financed investmeint by external funds during the truly euphoric investment boom of 1967–69.

Over the postwar period and prior to the post-1966 expansion aggregate corporate fixed investment was to an overwhelming extent financed by gross internal funds. In years when fixed investment was low or corporate internal funds high, internal funds were larger than fixed investment; in other years they were smaller. Modest surpluses and small deficits occurred. After 1966 corporate fixed investment increased rapidly while corporate internal funds remained on a plateau. As a result the corporate sector financing deficit rose from 4.9 percent of fixed investment in 1967 to 10.5 percent in 1968, 21.3 percent in 1969, 25.7 percent in 1970, and 24.2 percent in the first quarter of 1971 as shown in attached table I to my statement.

This deficit was accompanied by a huge outpouring of corporate long term financing. In 1950 long term external financing was but 17.9 percent of the sum of gross internal funds and long term financing, in 1966 external funds were 20.3 percent of total long term and internal funds. In 1970 this ratio was 34.4 percent and in 1971–I it was 37.6 percent as shown in attached table II to my statement.

As is shown in attached tables III and IV to my statement, corporate deficit financing has been accompanied by both a decrease in the quantity and a deterioration in the quality of corporate liquidity.

The present pace of investment can be sustained only if corporations continue to engage in large scale deficit financing. It is this need for continued corporate deficits in the face of their deteriorated financial position that makes a relapse into recession a real possibility. If the corporate sector as a whole brings investment more closely into line with internal funds, then a decline in income will take place. In the first quarter of 1971 corporate fixed investment was at an annual rate of $87 billions and internal funds were only $66 billions. A cutback of investment to that which could be financed internally would lower income by some multiple of $21 billions.

From the viewpoint of the standard models the runup of both long and short term interest rates since March of 1971 is an anomaly. The economy has been slack and the money supply and the monetary base have both been growing much faster than income. This should make for falling interest rates, especially short term open market rates.

A tentative interpretation is that the need by the corporate sector to deficit finance ongoing investment programs and to fund and turn over the inherited short term debt has not abated. In order to carry out these operations, corporations are pouring out long term securities and mortgaging property. This tends to sustain long term rates. In addition corporations seem to be divesting themselves of Treasury and other short term marketable debt. This development means that such debt has to find a place in new portfolios. This implies higher short term interest rates. Thus the current behavior of interest rates may be an anomaly from the point of view of models that look only at income and money supply changes, it is not as much of an anomaly once financial markets and financing needs are taken into account.

Although both a decline in investment and additional financial trauma might very well take place in 1971–72, this will not set off an open ended debt deflation process. The prospect is not that 1929–33 will be played out again.

Certainly the Federal Reserve will quickly respond to a financial shock to make sure that banks, other financial institutions, and financial markets continue to function normally.

Prompt Federal Reserve action is not the only reason why further financial trauma will not lead to a great depression. The major factor preventing such a cumulative decline is the large size of the Federal Government budget relative to gross national product. In 1971–I with gross national product at $1,020.7 billion, Federal Government expenditures and transfer payments were $214 billion. A Federal Government whose budget is in excess of 21 percent of gross national product is a strong stabilizer of the economy. If gross national product decreases private payrolls decrease but Government demand, social security and welfare continue—thus sustaining demand for output.

Sustained Government expenditures as gross national product decreases leads to a large Federal deficit. As a result surpluses show up in other sectors—households or corporate business. Even a passive fiscal policy with a large Government is effective insurance against a truly deep depression. A deficit not only stabilizes income but it strengthens the financial position of other non-Government sectors.

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However, a large Government sector does not rule out the occurrence of a protracted period of slack. The prospect therefore remains that at least the first part of the seventies will be sluggish. The soaring of the sixties seems to be a thing of the past for now.

Monetary and fiscal policies at their present levels are not sufficient to set off a strong recovery. With the present trends in private demand, for a strong recovery to take place it seems as if a movement to a modest deficit at full employment is necessary. If the financial factors I mentioned do lead to a reduction in private investment, then a full employment deficit of about $20 billion may be required to speed a strong recovery.

It seems to me that we have exhausted the possibilities of aggregate monetary and fiscal policy as controllers of aggregate demand and economic growth. It is time for us to explore new dimensions of both policy objectives and policy instruments.

To a very large extent our present policy wisdom is the result of an initiative by this committee. I refer to the "Study of Employment, Growth and Price Levels" undertaken by this committee in 1959–60 with Senator Paul H. Douglas as Chairman. That was a very productive study. It developed the instruments and philosophy that guided policy through most of the sixties.

I had the privilege of reviewing the staff report and the "Study Papers for the Review of Economics and Statistics" (February 1961). I thereby urged that this committee undertake such a comprehensive study of the economy and the state of the economist's art at frequent intervals.

I believe that the current doldrums of the economy as well as the lethargic nature of the administration's economic policy is evidence that the time is ripe for this committee to take the initiative once again. I respectfully urge you to undertake a thorough study of the economy of the 1970's and the state of the art of the economist with a view to determining the appropriate objectives and instruments of economic policy for the remainder of this decade.

Thank you, Mr. Chairman.

(The tables and supplementary information referred to in Mr. Minsky's statement follow:)

TABLE I.—FIXED INVESTMENT AND GROSS INTERNAL FUNDS, NONFINANCIAL CORPORATE BUSINESS, 1950, 1955, 1960, 1965–70, AND 1971–I

[In billions of dollars]

Item	Year— 1950	1955	1960	1965	1966	1967	1968	1969	1970	1971–I (annual rate)
Gross internal funds	17.9	29.2	34.4	56.6	61.2	61.5	62.5	62.5	61.6	66.1
Fixed investment	19.3	26.6	36.0	54.9	62.7	64.7	69.8	79.4	82.9	87.2
Surplus (+) or deficit (−)	−1.4	+2.6	−1.6	+1.7	−1.5	−3.2	−7.3	−16.9	−21.3	−21.1
Deficit as a percent of fixed investment	7.3	(1)	4.4	(1)	2.4	4.9	10.5	21.3	25.7	24.2

1 Not applicable: Surplus years.

Source: Board of Governors, Federal Reserve System flow of funds accounts.

TABLE II.—EXTERNAL AND INTERNAL LONG-TERM FINANCING OF INVESTMENT, NONFINANCIAL CORPORATE BUSINESS, 1950, 1955, 1960, 1965–70, AND 1971–I

[In billion of dollars]

Item	Year— 1950	1955	1960	1965	1966	1967	1968	1969	1970	1971–I (annual rate)
Corporate bonds	1.6	2.8	3.5	5.4	10.2	14.7	12.9	12.1	20.3	25.2
Corporate stock	1.4	1.9	1.6		1.2	2.3	–.8	4.3	6.8	5.6
Corporate mortgages	.9	1.8	2.5	3.9	4.2	4.3	5.8	4.8	5.2	9.4
Long term exteneral financing	3.9	6.5	7.6	9.3	15.6	21.3	17.9	21.3	32.3	40.2
Gross internal funds	17.9	29.2	34.4	56.6	61.2	61.5	62.5	62.5	61.6	66.1
Total long-term financing	21.8	35.7	42.0	65.8	76.8	82.8	80.4	83.8	93.9	106.3
External funds as a percent of total long-term financing	17.9	18.2	18.1	14.1	20.3	29.9	22.3	25.4	34.4	37.6

Source: Board of Governors, Federal Reserve System flow of funds accounts.

TABLE III.—LIABILITIES, GROSS PROFITS, AND FINANCIAL ASSETS, NONFINANCIAL CORPORATE BUSINESS, 1950, 1955, 1960, 1965–70

(Ratios)

Item	Year— 1950	1955	1960	1965	1966	1967	1968	1969	1970
Liabilities — gross profits after taxes	5.4	5.2	6.0	5.2	5.3	5.6	6.0	6.6	7.2
Liabilities — financial assets	1.3	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.5
Liabilities — liquid assets	3.0	3.5	4.8	5.4	5.8	6.1	6.0	7.0	6.8
Liabilities — protected assets [1]	3.0	3.6	5.0	5.9	6.6	7.0	7.2	9.8	9.0

[1] Protected assets are liquid assets minus commercial paper.

Note: Underlying data from the flow of funds accounts.

TABLE IV.—COMPOSITION OF LIQUID ASSETS, NONFINANCIAL CORPORATE BUSINESS, 1950, 1955, 1960, 1965–70

(Percent of liquid assets)

Item	Year— 1950	1955	1960	1965	1966	1967	1968	1969	1970
Demand deposits and currency	55.8	55.7	56.6	39.8	40.3	40.0	37.4	38.0	34.4
Time deposits	1.9	1.7	4.9	27.1	25.9	28.9	27.9	17.0	29.8
U.S. Government securities	41.4	40.4	34.4	24.0	22.0	17.6	17.4	16.3	11.2
Open market papers	.8	2.1	4.2	9.2	11.8	13.5	17.2	28.8	24.7

Note: Underlying data from the flow of funds accounts.

The Crunch of 1966—Model for New Financial Crises?

The events of 1966 show that a major financial crisis can happen again

HYMAN P. MINSKY

For the millions of Americans old enough to remember it, the Bank Holiday of 1933 was grimly misnamed. Those ten days, with the doors of the nation's banks locked and its businesses standing still, marked the climax of the prolonged debt-deflation that began with the stock-market crash of 1929. This period of financial instability was the initial phase of the Great Depression, which lingered on until the defense and war efforts of the 1940s. In response, the Roosevelt Administration undertook thorough reforms of the American banking and financial system—reforms designed to guarantee that a financial crisis of these dimensions could never occur again.

In the period following the Great Depression, the strength of the reformed financial system was not really tested. But then, in late summer of 1966, the stability of the U.S. financial system was once again in jeopardy. Fortunately, in 1966 the financial pressures were kept within manageable bounds—the crisis turned out to be only a mini-crisis, as befits an era of miniskirts. Thus it seemed that the defenses erected in the 1930s had passed their first serious test.

Nevertheless, the events of 1966 are a warning: They show that a financial crisis, carrying the seeds of a deep depression, can happen again. Thus, we need to examine the forces that created and resolved the mini-crisis of 1966, and to explore some of its repercussions.

The financial community's label for the crisis that reached its climax in the late summer of 1966 was the "Crunch," a colorful way of describing intense pressure upon banks and other financial institutions—pressure for cash or, to put it another way, for liquidity. However, more was involved than just pressure for cash. On Wall Street, in late August of that year, the atmosphere was one of controlled panic. That the panic was controlled represented an act of faith—everyone felt sure that *this* time, in contrast with the 1930s, the Federal Reserve would step in and prevent a cash stringency from escalating into a fully developed panic that would shake the entire economy. But although Wall Street was confident that the Federal Reserve would act, it was still uncertain throughout August as to how—and how soon—this intervention would come. Nobody was sure what losses he or his organization would have to face before the pressure was relaxed.

As it turned out, the price wrung from the financial community was sufficiently high, both in money and in fear and uncertainty, to cause a major restructuring of desired portfolios. Throughout 1967, commercial banks, life-insurance companies, savings banks (meaning here both savings and loan associations and mutual-savings banks), and nonfinancial corporations all preferred distinctly more conservative asset and liability positions than they held during the euphoric boom period just before the Crunch. Cash flows have been used to acquire liquid assets, and the desire for liquidity has led some businesses to raise funds in the capital market in order to improve balance sheets rather than for investment in plant and equipment. As a result, the mini-crisis of 1966 led to a mini-recession in 1967; the economy slowed down, despite strong expansionary pressures generated by steeply rising Federal defense-spending for the war in Vietnam. In fact, had it not been for this increased defense-spending, the employment repercussions of the 1966 crisis might have been grave indeed.

The fundamental economic law behind the Crunch is this: The only way to break an inflationary investment boom set off by an evaporation of uncertainty is to reintroduce uncertainty. This is what the Crunch did. In short, the Crunch was both an instrument of policy and a result of that policy.

What Triggered the Crunch?

To see how the Crunch developed, it is necessary to recall the political and economic climate of 1966. Today, in the gloom of late winter 1968, with the country heavily burdened by an unpopular war, civil disorders, and sagging confidence in the quality of national leadership, it is hard to remember the optimism and pride that ruled America's thinking as recently as two years ago. The contribution of eco-

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nomics to this modern era of good feeling was the belated achievement of a consensus that the Keynesian New Economics really worked. It was felt that if the policy prescriptions of the New Economics were applied, business cycles as they had been known would be a thing of the past. The accepted view was that businessmen and householders need no longer fear a "haircurling depression." From then on, the perfected tools of economic policy would "fine-tune" the economy so that, period by period, it would stay on a course of sustained growth. Seven good years would be succeeded not by seven lean years, but always by seven more good ones. The resulting rapid and sustained growth would make all good and desirable goals compatible: Americans would be able to have tax reductions *and* the Great Society.

Because of this confidence, there was a swing away from portfolios designed to protect against unfavorable economic conditions. As soon as the belief became dominant that business cycles had been eliminated and that steady growth was assured, the country embarked upon an unprecedented investment boom. This boom was partly financed by portfolio changes designed to decrease liquidity, since having ready cash—or having securities readily convertible into cash—was under these circumstances of lesser importance.

Investment Boom in the Sixties

An unprecedented investment boom made the mid-1960s soar. In 1966, the dollar value of physical assets purchased by nonfarm, nonfinancial corporate business was $73.8 billion, almost twice the $37.0 billion of 1961. When the investment boom accelerated in 1965 and 1966, business began to rely heavily on external financing. In the years 1961 through 1964, roughly 3 to 6 percent of corporate investment was financed with net external funds; in 1965, about 11 percent of investment was financed from outside sources; and in 1966, the figure had climbed to more than 20 percent. (See Table I.)

This vast demand for external financing generated stresses and strains throughout the financial system. To obtain the funds they wanted, corporations borrowed a great deal from banks and issued a huge number of bonds—both public offerings and direct placements (offered to large-scale lenders, such as insurance companies and educational institutions). Because the demand for financing was so intense, interest rates climbed steadily during 1965 and 1966 despite developments that should have helped stabilize them—namely rapidly increasing supplies of money and bank credit.

The rapid rate of increase of money and bank credit during this period was due to two factors, which we can label as the traditional and the innovational elements in the developing picture. The traditional element was a rapid increase in the reserves of member commercial banks at the Federal Reserve Banks. The innovational element was that the efficiency of reserves was being increased due to the very rapid growth of negotiable certificates of deposit ("CDs").

The reserves of member banks consist mainly of deposits by member commercial banks at their district Federal Reserve Bank. To a large extent, changes in the amount of such deposits are determined by the Federal Reserve System. The favorite instrument of the Federal Reserve for affecting the volume of such deposits is "open-market operations." If the Federal Reserve wants to increase member-bank reserves, it will purchase U.S. government debt in the very active market in which banks, other financial institutions, and ordinary business corporations participate; if the aim is to decrease reserves, then the Federal Reserve sells U.S. government debt. As the U.S. banking system is a fractional reserve banking system, commercial banks need keep only a fraction of such reserves against their demand-deposit liabilities. Their other assets held against deposits are earning assets, which are bank loans and investments, that is, bank credit.

Foreshadowing some of the story to follow, we can note that open-market operations are not the only Federal Reserve operation by which the reserves of member banks can vary. Another way is by member-bank borrowing from the Federal Reserve at the "dis-

TABLE I—Investment and Internal Sources of Funds—Nonfarm, Nonfinancial Corporate Business 1961-1966

Year	Purchase of Physical Assets Billions of $	Purchase of Physical Assets Growth Rate %*	Internal Sources of Funds Billions of $	Net External Funds Billions of $	Net External Funds as a Percentage of Purchases of Physical Assets
1961	37.0	- 5.6%	35.6	1.4	3.8%
1962	44.7	20.8	41.8	2.9	6.5
1963	46.7	4.5	43.9	2.8	6.0
1964	52.2	11.8	50.8	1.4	2.7
1965	61.9	18.6	55.3	6.6	10.7
1966	73.8	19.2	58.6	15.2	20.6

Source: Table B-69 p. 294: 1967 Economic Report of the President.
* Value year t ÷ value year t-1 x 100 - 100

count window." The discount window was an important source of total bank reserves in earlier days; however, during the period under discussion the discount window was not much used. As will be pointed out, this abstention from the discount window, even though interest rates were such that borrowing from the window seemed profitable, was one of the special characteristics of this period.

Negotiable certificates of deposit, which have been called the "new instrument" of the 1960s, are evidence of large (minimum $100,000) time (interest-earning) deposits at commercial banks that cannot be withdrawn until a stated due date—typically 90 days, 180 days, or one year after deposit. However, as leading Wall Street investment banking houses make a secondary market (buy and sell) in these certificates of deposit, any owner of such a deposit can obtain cash by selling in this market prior to the due date of his certificate. Almost always anyone with idle funds can purchase a CD from the market with a desired number of days, less than the minimum of 90 days for which banks issue such certificates, to maturity. As certificates of deposit are time deposits, by Federal Reserve regulations the emitting bank need keep a smaller fraction of reserves against these deposits than against demand deposits. Thus if banks can get depositors to shift funds from demand deposits to certificates of deposit, the amount that can be lent or invested increases. During the period of rapid bank-loan expansion in the mid-1960s, money-market banks were able to sell such CDs in increasing volume, which enabled them to increase loans at a faster rate than reserves were increasing.

These CDs compete with Treasury bills and open-market commercial paper for the temporarily idle funds of large-scale enterprises such as corporations, other financial institutions, and state and local governments. However, whereas there is no ceiling on the interest rates that these competing instruments can buy, there is a ceiling, set by the Federal Reserve System, on the rate that banks can pay on their newly-issued CDs. Whenever other money-market rates rise above this ceiling, banks cannot "sell" new deposits, and as a result of runoffs of maturing deposits they face a decrease in their ability to lend. In December 1965, when this was threatened, the Federal Reserve responded by simultaneously raising the ceiling rate on CDs to 5.5 percent and the discount rate (the rate at which the Federal Reserve lends to member banks) to 4.5 percent.

"I say, don't you think we've cooled the boom off enough?"
(Drawing by Alan Dunn; © 1966 The New Yorker Magazine, Inc.)

December 1965, when the Federal Reserve raised allowable interest rates on CDs to protect the commercial banks that had them outstanding, is a good place to start on detailed examination of the events leading up to the Crunch. An investment boom was in full swing, and the rise in interest rates following the Federal Reserve action did not "cool" the boom. Between December 1965 and April 1966, the reserve base of member banks and the money stock grew at the rapid annual rate of 6.8 percent. Since time deposits (heavily CDs) grew even more rapidly, bank credit grew at an 8.0 percent annual rate. But in spite of this, the interest rates for financing private business continued to climb. For example, the yield of prime (highest quality) commercial paper rose by 63 basis points (63/100 of a percentage point), and the yield of Aaa (highest quality) corporate bonds rose by 25 basis points.

TABLE II—Money and Bank Credit—Annual Rates of Change for Various Periods December '65-November '67

	Dec. '65 to April '66	April '66 to July '66	July '66 to Dec. '66	Dec. '66 to Nov. '67
		Percentage rate of change per year		
Reserves of Member Banks	6.8	2.6	-4.3	11.4
Money Stock	6.8	-3.0	1.0	7.0
Time Deposits	9.5	10.7	4.2	16.6
Bank Credit	8.0	8.0	1.5	12.4

Source: Federal Reserve Bank of St. Louis, *Monetary Trends*.

TABLE III—Interest Rates—First Week in Selected Months Plus Peak and Trough Rates January 1966-November 1967

	Jan. '66	Apr. '66	July '66	Sept. '66	Peak '66	Jan. '67	Trough '67	Nov. '67
3-Month Treasury Bills	4.53	4.51	4.47	5.07	5.52 Sept. 23	4.80	3.41 June 9	4.57
Federal Funds	4.63	4.65	5.42	5.35	6.00 Sept. 9	5.31	3.45 July 21	4.05
Large CDs	4.80	5.30	5.60	5.75	5.90 Oct. 14 & 21	5.70	4.25 April 7	5.30
Prime Commercial Paper	4.75	5.38	5.58	5.88	6.00 Oct. 7, '66—Jan. 6, '67	6.00	4.63 May 19—June 23	5.13
Long-Term Government Bonds	4.44	4.54	4.69	4.87	4.87 Aug. 26, Sept. 2	4.46	4.37 Feb. 3	5.35
Corporate Bonds Aaa	4.73	4.98	5.10	5.44	5.44 Sept. 9	5.38	5.00 Feb. 10	5.95

Source: Federal Reserve Bank of St. Louis, *U.S. Financial Data.*

In April, by decreasing the rate at which it purchased government securities in the open market, the Federal Reserve slowed down the rate of growth of the reserve base, and with it the money supply. Between April and July, the reserves of member banks grew at only a 2.6 percent annual rate, and the money stock actually declined at a rate of 1.4 percent. However, time deposits at commercial banks grew at a rate of 10.7 percent annually—so that bank credit grew at an accelerated rate of 8.6 percent. Interest rates also continued to rise.

It was at this point that CDs—the *Wunderkind* new instrument of the 1960s—began to cause difficulties. Toward the end of June 1966, the price of large CDs carrying the ceiling rate of interest went to a discount in the secondary market (the return on "used" CDs became greater than the largest return allowed on new CDs). This effectively stopped the increase in the volume of such CDs outstanding, and beginning in August the amount outstanding began to fall rapidly. This change in the trend of CDs outstanding combined with a decline in member-bank reserves—between July and December of 1966, member-bank reserves fell at an annual rate of 4.3 percent—slowed down the rate of increase in bank credit.

In December 1965, at the same time it had put a ceiling of 5.5 percent on CDs, the Federal Reserve placed a maximum of 4 percent on the interest commercial banks could pay on passbook savings deposits—the typical savings account kept by householders. Since this rate was considerably lower than the rates offered by savings and loan associations and mutual-savings banks, commercial-bank savings deposits were not a threat to the savings banks.

Late in the second quarter of 1966, the savings institutions felt the squeeze when some Eastern banks, struggling to attract new deposits, started promoting *small*, household-sized CDs at the ceiling interest rate of 5.5 percent. These household CDs posed a serious threat to the savings and loan associations—particularly in California, where a large portion of the deposits were from out of state—and the mutual-savings banks, mainly concentrated in New York and New England. In July 1966, the previously rapidly growing savings and loan associations experienced an unprecedented $1.5 billion decrease in deposits.

The Savings-Bank Squeeze

Throughout the rest of the year, a major concern of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board—three arms of the peculiarly decentralized central bank of the United States—was to protect the savings institutions. Savings institutions have mortgages as their principal asset, and the standard American mortgage is a long-term, fully amortized, fixed-interest contract. Hence, most savings institutions were locked into assets that reflected past interest rates. For example, the New York savings banks were under pressure to pay interest rates competitive with the 5.5 percent that New York commercial banks were willing to pay on their household CDs, but the savings banks' portfolios consisted mainly of mortgages that yielded substantially less than 5 percent.

Not only were these banks technically insolvent—the market value of their mortgage portfolios was substantially lower than the face value, so that their deposit liabilities exceeded the market value of their assets—but they were making running losses, since the returns on their portfolios were well below the cost of borrowing money plus operating costs.

Another trouble spot in the savings-bank picture was California. Interest rates on California mortgages had long been high enough so that, on the surface, the California savings institutions seemed able to meet commercial-bank-rate competition for deposits. During 1966, however, when the rise in competing interest rates slowed the flow of money to the California savings institutions, elements of weakness in their mortgage portfolios became apparent. Over the July 4 weekend, the Federal Home Loan Bank Board—the regulating and deposit-insurance agency for savings and loan associations—stepped in and arranged for the quiet take-over of a threatened institution by one that was considered sound. Such discreetly managed takeovers, rather than public closings and liquidations, constituted the pattern preferred by the deposit-insurance agencies throughout the rest of the year. The power of deposit insurance to prevent explosive instability was tested for the first time in 1966, and it passed with honors. Events that would have triggered "runs" in the past occurred without causing any major deposit withdrawals.

In turn, these pressures upon the savings banks swiftly affected the market for housing. Not only did savings banks raise the interest rate, increase the down payment, and shorten the duration of new mortgages, but they also decreased their commitments to acquire future mortgages. Generally, the savings banks make financing commitments to speculative builders in the fall of the year for the following spring. The savings banks' shaky position in the late summer and fall of '66, however, assured decreased commitments and poor "new starts" for housing in the spring of '67.

In addition, the cash squeeze hit the insurance companies, adding to the trouble in the housing industry and putting additional pressure on commercial banks. Many life-insurance policies guarantee the policy-holder borrowing rights at 5 percent. As interest rates rose, life-insurance companies experienced a sharp rise in the exercise of these rights. Further, the loan demand was reinforced by the need for ready cash to meet stock-market margin calls following the sharp decline in August. The result of this pressure on the life-insurance companies was that they, too, radically decreased their mortgage take-out commitments for the following spring—a move that further weakened the home-building industry. In addition, as prior commitments to acquire mortgages and corporate bonds became current, many life-insurance companies resorted to borrowing from commercial banks.

Thin Market for Municipals

Another element in the developing crisis centered on the market for municipal securities ("municipals" is the market term for state and local bonds). Banks are required to pledge collateral against the deposits of state and local government units. The usual collateral is U.S. government debt. By mid-year 1966, commercial banks had very little in the way of government debt that had not been pledged as collateral for such deposits. The combination of a decrease in the reserve base due to Federal Reserve action, the rundown of CDs due to the interest-rate relations, the lack of unpledged U.S. government debt, and the strong business-loan demand led many banks to try to obtain cash reserves by selling some of their municipals. As a result, the price of municipals fell sharply.

The effect on new issues of municipals was disastrous. Commercial banks normally take about one-third of the new issues of municipals, but as the Crunch developed, they withdrew from the market. By the end of August, the market for municipals was "disorganized," to say the least. The yield on high-grade municipals reached 5 percent—and income from municipals is tax-exempt—but even at such rates the market was thin.

Let us now follow the movement of interest rates that were not under "ceilings." Between the first week in July and the first week in September of 1966, the three-month Treasury bill rate rose by 60 basis points; prime commercial paper rose by 30 basis points. This rise in money-market rates, which apply to relatively short-term notes, was paralleled by increases in the longer term capital-market rates: Government bonds rose by 18 basis points, and the highest-grade corporate bonds rose by 34 basis points. (See Table III.)

Meanwhile, despite these rising interest rates, investment continued to boom. It is a phenomenon of the American economy that, as long as interest rates remain within a range that is compatible with institutional stability in the American setting, business investment is not likely to be greatly inhibited—or stimulated—by fluctuations in interest rates.

Throughout this period the Federal Reserve, while maintaining the discount rate at 4.5 percent, allowed but a slight increase—some $300 million during the first half of 1966 (out of the total member-bank reserves of $23 billion)—in borrowings by member banks at the discount "window." In theory the discount window serves as a source of funds to member banks so that they do not need to pay much more than the discount rate for funds. It also serves as a safety valve against too great a build-up of pressure for liquidity. In practice, the discount window is administered by the various Reserve banks, and the rules guiding the administration of the window are mysterious if not devious.

During July and August the window was so tightly administered that even though banks were paying up to 1.5 percent more than the discount rate for reserves, member-bank borrowings at the Federal Reserve, on the average, did not increase. In particular the money-market banks believed that the discount window was effectively closed to them: As liquidity pressures were building up, the safety valve that the discount window in principle represents was not allowed to function.

By the end of August 1966, the disorganization in the municipals market, rumors about the solvency and liquidity of various savings institutions, and the frantic position-making efforts of money-market banks confronting a discount window that was apparently closed generated a controlled panic. It was clear that the next move was up to the Federal Reserve.

Because of the shortage of cash in 1966, savings banks raised interest rates and down payments on mortgages. This discouraged homebuyers, and many speculative builders stopped work.

The Resolution

There are a considerable number of instruments of control at the disposal of the Federal Reserve Board. Conversely, at any time there are many interdependent variables and constraints upon Federal Reserve actions. At this time perhaps the most urgent constraint came from the savings banks. In order to protect them from losing deposits and incurring even greater operating losses, the Federal Reserve ruled out the possibility of raising the ceiling rate on CDs or the discount rate, as had been done in December 1965. In other words, although the intent was to constrain business investment, the orthodox solution of across-the-board increases in interest rates could not be applied.

Thus, the Crunch developed with some rates fixed—at effective ceilings—and others free to vary. Had the Federal Reserve taken the course of expanding the reserve base, which, through the banking process, would have increased available credit, the investment boom could have been financed without significant increases in interest rates. But that course would have meant that the Federal Reserve would quite literally have become an engine of inflation.

It is not necessary to approve the timing or the details of the Federal Reserve's constraining action in order to recognize that the situation developing in 1966—which was due to a rapidly exploding demand for financing from the private sector, combined with expansionary economic forces unleashed by the war in Vietnam—was such that sooner or later the Federal Reserve would have had to undertake a policy of active constraint.

A money panic is ephemeral, compounded of a combination of real cash shortages and a precautionary demand designed to protect against awesome, unknown contingencies. As was true for some of the money panics of the 19th century, the 1966 crisis evaporated when the authorities sent out a letter.

On September 1, the president of each of the twelve district Reserve banks sent every member bank in his district an identical letter stating that loans were available at the discount window to banks whose policies corresponded to Federal Reserve objectives. In particular, funds were available to finance current holdings of municipal securities for banks that could show that they were constraining expansion of business loans. In addition, the letter stated that the Federal Reserve recognized "that banks adjusting their position through loan curtailment may need a longer period of discount accommodation than would be required for the disposition of securities." The import of the letter was that the Federal Reserve acted to bolster municipal securities. By allowing municipals to be used at the discount window, it set a firm floor to their price and quite suddenly made what had been an illiquid asset liquid. As the money-market banks had been actively trying to restrain expansion of business loans even before ceiling-rate CDs went to a discount at the end of June, each bank considered itself eligible for such accommodations. The Federal Reserve's discount window, which had been assumed to be closed, now appeared provisionally open: The safety valve was allowed to work.

During the first week in September, a slight "peak" (about $100 million) occurred in borrowings at the Federal Reserve. Thus, although statistically little had been changed by the September 1 letter, the psychological elements of the mini-panic had been dissipated. More important than the extent to which the window was actually used was the fact that once discounting was available, there was no further need to hoard reserves against future crises.

Other events combined with the letter to ease the pressure in financial markets. Congress passed a law, effective in late September, permitting the Federal Reserve to discriminate by size when it set ceiling interest rates on time deposits. Simultaneously, Congress granted the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board the power to set ceiling and differential interest rates on deposits at institutions under their jurisdiction. The authorities immediately set a 5 percent ceiling on time deposits of less than $100,000 at commercial banks, effectively checking their competition with the higher-paying savings institutions.

Furthermore, the Administration requested that the

investment tax credit be put aside. To the financial community, this move signaled that a larger share of the effort to control inflation was to be made through fiscal policy—by means of adjustments in taxation and spending. Presumably, this would permit the Federal Reserve to relax some of its monetary constraints upon banks and other financial markets.

Throughout the rest of the year, the Federal Reserve continued to restrict expansion of the reserve base and bank credit. However, in spite of this constraint, liquidity pressures eased—and even more quickly than they had developed. Borrowings by member banks at the Federal Reserve fell from a peak of almost $900 million to about $500 million by the year's end. A further fall to $200 million occurred by March of 1967. The three-month Treasury bill rate fell by 72 basis points between the September peak and the first week in January. Over roughly the same period, the yield on long-term government bonds fell by 41 basis points. (See Table III.)

The Aftermath

The Crunch worked. The investment boom was broken. Gross private domestic investment decreased at an annual rate of 26.0 percent between the fourth quarter of 1966 and the second quarter of 1967. In large part, this drop signaled a halt in inventory accumulation, but equally significant was the fact that it was accompanied by no growth in the volume of business investment in plant and equipment. This was in sharp contrast with the rapid increases in 1966. (See Table I.)

In December 1966, the Federal Reserve switched to an expansionary monetary policy, which was maintained for most of 1967. Through November of 1967, the reserves of member banks grew at an annual rate of 11.4 percent, and bank credit grew at an annual rate of 12.4 percent. (See Table II.) Large-denomination certificates of deposit reached a trough of $15.4 billion in mid-December of 1966. By December 1967, the amount outstanding exceeded $21 billion—a significant increase over the $18.5 billion of August 1966.

Normally, with the money supply and the reserve base increasing rapidly, the gross national product static or growing slowly, and private investment dropping swiftly, interest rates would fall. Certainly, money-market and capital-market rates would normally be below the peak they reached when the economy was growing rapidly and the Federal Reserve Board was imposing monetary constraint. And, in fact, in December of 1967 short-term rates *were* below the levels they had reached during September and October of 1966. But each rate was well above its post-Crunch trough. For example, the rate for three-month Treasury bills rode a roller coaster: from a peak of 5.52 percent on Sept. 23, 1966, to a trough of 3.41 percent on June 9, 1967, to 4.92 percent in early December of 1967.

The most significant post-Crunch developments, however, took place in the market for long-term government and corporate bonds. In December of 1967, both these rates were well above their Crunch peak. For example, Aaa corporate bonds reached a peak yield of 5.52 percent in September 1966, and a trough of 5.00 percent in February 1967. In early December the rate of return on such securities was 6.13 percent.

The climb in these interest rates was due to a huge outpouring of corporate bonds in 1967. These issues were not the result of any rapid expansion of business investment. Quite the contrary; business investment did not change, or declined. However, an institution with a long-term debt to pay is more liquid than one with an equivalent amount of short-term debt; its cash needs in the near future are smaller. Furthermore, in the fall of 1966, corporations were made aware that banks can be unreliable sources of financing, and many wished to decrease their dependence upon bank borrowings. That is, the pressure in the long-term bond market in 1967—and it was acute, with many new issues yielding well over 6.00 percent—in substantial part reflected a desire on the part of business to rectify balance sheets rather than to finance any burst of new investment.

Through 1967, the economy was sustained by a sharp increase in Federal spending, especially for defense. As a result, a hefty government deficit was racked up—in part due to the decline in tax revenue stemming from the decline in corporate profits. Government debt fed into the portfolios of banks, financial institutions, households, and ordinary businesses increases their liquidity. The combination of government expansion sustaining total demand, government deficits feeding liquid assets into portfolios, and the use of long-term debt by corporations is now satisfying the increased preference for liquidity that developed after the 1966 Crunch. But once this preference is satisfied, conditions will be ripe for another take-off of investment demand.

The events of 1966-67 show that in the intensely financial American economy—despite the precision ministrations of the New Economics—investment booms and liquidity crises are still possible. Business cycles remain very much part of the picture, even though the 1966 Crunch led to no more than a mini-recession rather than a true depression. The modest overall impact was the result of the offsetting rapid increases in Federal spending in Vietnam. Without them, it is very likely that an event such as the Crunch of 1966 would have had serious employment repercussions. Because of the accident of Vietnam, there is a danger that the Crunch's lesson about the perils attending stretched liquidity positions may soon be forgotten.

The period covered here closes before any serious impact from the devaluation of the British pound could become manifest. The next chapter in the history of America's financial system most likely will center on the way in which the precarious international position of the dollar is resolved. The current emphasis upon defending the dollar can very well lead to economic policies that generate continuing constraint on financial markets. If this constraint takes place in the midst of strong expansionary pressures from business, then liquidity-stretching financial changes will occur to offset at least part of the constraint. Under these circumstances we will not have to wait another 30 years before the authorities' ability to handle a liquidity stringency is once again tested.

On the other hand, constraint on financial markets may be so severe that strong expansionary pressures from business do not develop. In such a relatively stagnant economy, financial instability of the type discussed here is not an issue. Thus the alternatives before us may be either to stagnate—albeit at a high level—or to live with the danger of recurrent Crunches.

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[A memorandum prepared for a meeting of the academic consultants with the Board of Governors of the Federal Reserve System, Washington, D.C., Sept. 17, 1969]

NOTES ON THE SUSCEPTIBILITY OF THE U.S. ECONOMY TO A FINANCIAL CRISIS

(By Hyman P. Minsky, Washington University, St. Louis)

1. The susceptibility of the U.S. economy to a financial crisis due to internal conditions can be split into two parts: the susceptibility of the financial system to a financial disturbance and the impact upon the real economy, (income, employment and prices) of such a disturbance if it occurs.

2. A financial disturbance is viewed as a shock. What follows the shock depends upon the reaction of both "financial" and "real" portions of the economy. Inasmuch as the "real" reactions will feed back upon the financial system (real assets are simultaneously financial assets) and tend to either amplify or dampen the financial repercussions of the initial disturbance, the likelihood of a full fledged crisis occurring with any set of financial relations cannot be divorced from the structure and behavior of real income. In particular, a U.S. economy in which the Federal Government sector is in excess of 10% of G.N.P., as it is currently, can be expected to react differently, after an initial disturbance, with respect to both income and the subsequent financial reactions, than an economy in which the Federal Government sector is in the neighborhood of 1% of G.N.P., as it was in 1929.

3. Whether financial disturbance and crisis prone situations necessarily follow from characteristics essential to capitalism or whether they are due to human error or institutional flaws which can be readily eliminated need not be dealt with at this time. Our immediate concern is with the stability properties of the existing financial system. However once the determinants of the likelihood of a financial disturbance taking place are identified, both the arena within which human error may play a part and the institutional characteristics that might require modification in the interests of increasing the stability of the financial system can be identified.

4. A distinction is made between a financial disturbance and a financial crisis. A financial crisis is a widespread event, with large scale declines in asset values, generalized difficulty in refinancing positions, the taking of losses in an effort to meet cash needs and the appearance of markets which "cease" to function. Institutions quite generally behave differently after a crisis than before. A financial disturbance is a failure, illiquidity or the taking of losses to meet payment commitments on the part of a unit or sector of the economy. A financial disturbance can be as small as the failure of a minor non-financial firm and as such it is a daily occurrence. It can also be as extensive as the problems faced by the California savings and loan associations in 1966, the losses taken on municipals by banks in the same year, or the run on commercial banks in 1969 via the run-off of C.D.'s. The border between interesting financial disturbances and minor financial crisis is vague and narrow, perhaps it can only be drawn after the event.

5. The economy is not viewed as always being on the verge of a financial crisis; markets are able to offset and absorb losses as well as "shortfalls" in cash flows. The type of instability envisaged by Roosa, when he wrote about the New York Money Market in the 1950's, is *not* at issue here.

6. The financial system is broadly conceived. Each unit in the economy is a financial unit and can be viewed as a bank with effective liquidity and solvency constraints upon its behavior. In the analysis of financial stability the liquidity constraints are essential. Market developments which affect technical solvency become important when the need arises to use price sensitive financial assets to acquire cash.

7. The factors underlying the ability of a unit to meet its payment commitments are the ratio of cash receipts, net of current operating expenses, to payment commitments and the ability to offset a shortfall of cash receipts or an unexpectedly large surge of cash payments by selling assets or emitting liabilities on not too unfavorable terms. The sale of assets or the emission of liabilities for cash is called position-making activity. The larger the amount of position-making activity and the more exotic or unusual the instruments used the greater the danger that either insufficient cash will be raised or that the "solvency" of the unit will be impaired, i.e. the greater the danger of a financial disturbance.

8. For each unit or sector, the likelihood of a financial disturbance depends upon:

(1) The ratio, over various periods, of cash payment commitments due to liabilities to the normal or usual sources of cash, including net liability emission as a source of cash.

(2) The ratio over a period of cash plus protected assets to payment commitments, in particular demand and contingent commitments, due to liabilities.

(3) The ratio, as above, of explicit or implicit refinancing agreements or rights to payment commitments.

(4) The ratio of assets whose face value reflects recent increases in asset prices to total assets.

(5) The ratio of long-term assets with fixed interest rates to total assets, especially in the portfolios of institutions which continuously finance their position at current interest rates.

9. The first of the above ratios states that there exists a network of payments and that the liability structure can be read as payment commitments. The important aspect is how are these payments to be met? The normal source is income receipts for households, gross profits after taxes for business firms and tax receipts for State and Municipal governments. On the other hand, financial institutions expect to meet payment commitments by the cash flows their assets generate as well, by a "normal" growth in liabilities and by dealing in assets.

10. The next two items refer to how units, especially financial institutions but also all units that follow a policy of being fully invested, will meet a need for cash if there is a surge of withdrawals, a shortfall of income or expected receipts, or if costs exceed expectations on income account. Such activity is by analogy with banking practice labeled position-making activity. In the immediate post-war period such surges of needs for cash payments could be met by drawing down cash on hand, or selling Treasury Bills. The techniques and instruments used in position-making have changed markedly over the post-war period, not only for financial institutions but for business firms and households.

11. The final two items refer to the impact of a boom on balance sheets. A boom has three not independent aspects: a marked increase in desired capital stock combined with an ability and willingness to finance an increased pace of investment, a runup in the price of the stock of real and equity assets, and a rise in interest rates. The financing of the increased investment takes place via portfolio transformations, that result in closer articulation of cash payments to cash receipts, as well as by a running down of the ratio of traditional position-making instruments to cash flows. The runup of asset values means an increased vulnerability of asset price to a failure of expectation or a need to use these assets to make position. The increase in interest rates means that at least paper losses accompany the boom, and if these paper losse are heavily concentrated in a region or a sector a source of financial disturbance is revealed during the expansion.

12. In the mid-sixties the U.S. economy experienced a change of state, it became "euphoric." Whereas in the earlier post-war period prosperity was thrust upon the economy, in the mid-sixties business and households alike accepted the emergence of a new era of permanent prosperity. The current (1969 Fall) resistance of private spending to both monetary and fiscal restraint is indicative of the change in state.

13. Stable growth is an impossibility for the American economy, with its history of financial and economic instability. The achievement of growth that looks like it will continue, raises asset values, so that desired investment increases at an increasing rate. Simultaneously the expectation of continued expansion decreases the value of protected or safe balance sheets. Thus even in the face of monetary constraint, portfolio transformations will finance the accelerating investment. Both borrowers and lenders are affected by boom expectations: the borrower is willing to hazard a closer articulation of expected cash receipts to payment commitments, the lender accepts balance sheets that previously would have been rejected. The expectation of steady growth or the belief that a serious depression cannot occur tends to raise velocity.

14. Once an investment boom is set off then either an accelerating rate of inflation must be accepted, financing terms must be allowed to rise so high that private spending is constrained or the expectations that lead to the boom must be broken. Assuming that inflation at an accelerating rate is unacceptable, then

the apparent options are rationing by financing terms along a stable investment function or shifting the investment function via a shock to expectations.

15. The world is not born *de nova* each day; higher financing terms result in a fall in the market value of inherited fixed interest paper. If institutions exist which are vulnerable to "operating" and "paper" losses once interest rates rise then two policy options do not exist. High and rapidly rising interest rates set the stage for sectoral financial distress. Thus ignoring policy options such as investment licensing or wage and price controls, the only way a boom can be brought to an end, given these institutional limitations, is if a financial disturbance takes place which leads to a general reconsideration of desired portfolios.

16. A reconsideration of desired portfolio composition leads to a sharp reduction in the price of equity assets and real capital and in investment and aggregate demand. These changes, in turn, reinforce the shifting of desired portfolios, reduction in equity prices and the decline in investment. In the absence of stabilizers the above is a scenario for a deep depression. As is well known a large Federal Government sector combined with an income-sensitive tax take tends to stabilize aggregate demand.

17. The large Federal Government sector also stabilizes the financial system. The deficit feeds protected assets (government debt) into balance sheets. If there are constraints upon the type of liability that the Treasury can emit, then the deficit will take the form of an increase in the money supply or in near monies (Treasury Bills). By stabilizing both income and the financial sectors, a large Federal Government sector not only prevents a serious depression, it also sets the stage for a renewed expansion.

18. If as in 1967 a potential recession is offset not just by stabilized but by increased Government spending, then the stabilizing and stage setting for future expansion attributes of the Federal Government are accentuated. This is especially so if expectations are reinforced that the monetary and fiscal authorities will not allow financial difficulties to escalate to a financial crisis and will not permit a serious depression. With a Federal Government sector that is 10% of G.N.P. the income reaction to financial shocks is initially attenuated and then offset. A Government sector that effectively stabilizes the economy may leave us with only unacceptable options: a larger regime of direct controls or accelerating inflation.

19. For a smooth transition from an accelerating expansion to sustainable growth to be possible it must be possible to have high and rising interest rates. In our complex innovative financial system it may be true that strong investment demand will almost always be financed by portfolio transformations at interest rates well below those necessary to effectively constrain investment. That is, interest rate rationing is not really a possibility for portfolio transformations will continue until financial relations are such that a slight shortfall of expectations will lead to serious financial disturbances.

20. However, even if the above is not true, institutional weaknesses centering around the standard mortgage and the housing-oriented savings and insurance institutions prevent unconstrained reliance upon interest rate increases. In addition, direct controls upon commercial banks are rationalized by the need to protect such institutions. Such direct controls tend to facilitate the growth of non-bank as over against bank financing, which in the language used above increases the ratio of unprotected to protected assets in portfolios.

21. Monetary policy is constrained by the need to prevent a run or disintermediation from savings and loan associations and mutual savings books. The present deposit rate pattern was set in the aftermath of 1966. These institutions have had three years in which higher interest rate assets have been added to their portfolios. They can now afford higher rates on their deposits, certainly commercial banks can afford significantly higher deposit rates.

22. I see no reason whatsoever for ceilings on wholesale C.D.'s. at commercial banks; I see very good reasons why the emitter of protected assets should be allowed to emit competitive liabilities. High interest rate C.D.'s. are a smaller risk to financial stability than commercial paper, participations, repurchase agreements or Eurodollar manipulations.

23. The substitution of a variable interest rate mortgage for the present standard mortgage is a necessary step for the elimination of an institutional flaw. I suggest that at all times the standard F.H.A. insured mortgage should be written at an 8% or some other sufficiently high interest rate. If the market rate

is higher, then the length of the morgage life will be extended; if the market rate is lower, then the debtor will be given the option of reducing the unpaid balance at a faster clip or paying a smaller amount per month. The contractural payment will remain the same, the expectation is that usually there will be a rebate analagous to the dividends on an insurance policy.

24. This model has not been tested empirically. One reason is that the relevant events are rare. Neil Murphy and Harry Weintraub at F.D.I.C. are engaged in a simulation study of intertemporal cash flows under uncertainty using numbers based upon mutual savings banks. The theory underlying their study is consistent with the cash-flow and position-making arguments advanced here.

Chairman PROXMIRE. Thank you very much, Mr. Minsky. A very interesting suggestion.

Mr. O'Neill, you have a substantial prepared statement here. If you can, leaf through that in 15 minutes.

As I say, the entire prepared statement will be printed in full in the record at the end of your oral statement.

STATEMENT OF RICHARD W. O'NEILL, PRESIDENT, HOUSING ADVISORY COUNCIL, LTD.

Mr. O'NEILL. My purpose here is to focus attention on a vast pool of housing need, a pool now inadequately served by a type of housing that is relatively costly in the long run. I refer to lower income families who now get no subsidy but are served by only the most expensive housing financing on housing assets that depreciate to zero value in about 15 years at the outside. The thrust of my remarks is to urge a change in approach, particularly by the Department of Housing and Urban Development, to extend purposefully FHA insurance to code-conforming dwelling units for lower income families who, so housed, would require little or no Federal housing subsidies.

In his third annual report on efforts to meet the Nation's housing goals, President Nixon, a few weeks ago, pointed out that 40 percent of the Nation's families could now meet eligibility criteria for Federal housing subsidies. He said this has created a—

> Need to deal with inequities which arise when some families receive subsidies and others do not. If all eligible families were subsidized the cost would be astronomical. Yet, unless major changes are made as these programs continue production momentum, it will be difficult to continue favoring a select few in the population while the rest of the Nation is left to seek decent housing completely on its own.
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> Since it is doubtful that the public, and hence the Congress, will be prepared to accept the staggering budgetary costs of a more global coverage toward which present subsidy housing programs may be forced to head, the time to make needed changes is rapidly approaching.

Subsidized dwelling units will jump from 932,349 on June 30, 1970, to an estimated 1,825,500 on June 30, 1972. Subsidy payments will rise over the same period from $525,500,000 to $1,373,800,000.

The House Appropriations Committee has estimated that over the 30- to 40-year life of subsidized dwelling units, the subsidy for this year's units alone could total $18.9 billion.

HUD has been under pressure from the Office of Management and Budget to do something about FHA section 235 and 236 programs because of the burgeoning commitments those two programs will make in the Federal budget. They are now running at about a half a billion a year and could make up a total of $8 billion, that the administration can do nothing about, by 1978, almost a capital budget in our expense budget.

Secretary Romney has been asked by the President to find other ways of helping low-income families get better housing. He, in effect, told the House Committee on Banking and Currency in early April that section 235 probably should be ended, if a good substitute could be found, because of abuses in both new and old housing under that interest rate subsidy program. He said at the time that over 100 cases of such abuse had been turned over to the FBI.

He confirmed what the committee's own staff report had found back in January. He said 235 was an administrative monstrosity and that detailed steps were being taken by HUD to tighten up on the program. A basic problem in 235 is that if the house appreciates at 3 percent per year, there is no incentive for the owner of a house financed under 235 to pay the principal on the mortgage at all.

Of course, the whole problem goes back to housing's cost, and as costs rise, dwelling units get smaller, whether subsidized or not. According to Census and HUD, smaller and cheaper houses were a major factor in new housing in 1970.

During 1970, there were 485,000 new one-family homes, an 8-percent increase over the 448,000 new homes sold in 1969. But the average price of new houses sold during 1970 was $26,600, off 5 percent from 1969's $27,900, and the average floor area was down 8 percent from the average on the 1969 house—from 1,640 to 1,510 square feet.

The increase in new one-family houses in 1970 was concentrated in smaller houses: New houses with floor area of less than 1,200 square feet increased by about two-thirds over 1969.

Another way of looking at the cost factor is to point out that half the families in this country have not been able to qualify for a mortgage loan to purchase a new single-family code-conforming dwelling unit with an FHA 203 mortgage since 1966 and have not been able to do so with a conventionally financed mortgage since 1964, according to figures of the U.S. Savings and Loan League.

Mr. Michael Sumichrast, of the National Association of Home Builders, points out that 27.2 million U.S. families, 44 percent, have incomes under $7,000 and another 17.9 million, 29 percent, have incomes between $7,000 and $11,800. None of them can qualify for mortgages to purchase today's average-priced, new single-family code-conforming dwelling unit without some form of subsidy.

The need for lower-priced dwelling units is absolutely staggering. Governor Sherman Maisel of the Federal Reserve Board made a projection back in March of this year that housing starts for each year of this decade should total 2,020,000, as opposed to an actual average rate of 1,410,000 in each year for the decade—for the entire decade of the 1960's. Biggest component in that housing projection is our current growth in net new households of 1,400,000 per year each year in this decade as opposed to 1,040,000 net new households each year in the decade of the 1960's.

In general, the only way we now have of lowering the costs of housing—and I will go into the implications of this statement in some detail further on in this paper—is to cut down its size, as we have seen happen in the last 2 years.

Current FHA construction cost, including an improved lot, is about $16.90 per square foot. To get house prices down to, say, $12,500 we would have to produce single-family houses of 740 square feet, assuming we still had to use lots allowable under most zoning ordinances and subdivision regulations.

According to Mr. Sumichrast, this size would expand the demand for housing (assuming people would prefer to buy and will be able to qualify) at least twofold from what it is now. This might increase production of FHA homes from the current rate of some 260,000 to half a million. The economic impact would be substantially less than would be the case if this position could be taken in a more expansive unit, such as a typical FHA house with 1,289 square feet of living space. Still an increase of some 250,000 units would create an additional 380,000 to 400,000 new jobs. It would reduce total unemployment by some 8 percent.

Now, all of the foregoing explains why 95 percent of all new detached single-family housing priced below $15,000 is in mobile homes. Is there anything wrong with that? From most points of view, there is nothing wrong with that.

I have attempted to develop a case that would have the Federal Government insure that the lower-income American family will get the full benefit of code-conforming residential realty—at no significant expense to the Government—and at comparable expense, to the American family, to what it is now paying to live in mobile housing. Such code-conforming housing could and probably would be produced by present manufacturers of mobile housing.

The fact is that current mobile homes will not last longer than 15 years. And I establish that in my statement. They enjoy their market only by default, they cost almost as much as code-conforming housing, are as expensive to live in as such housing.

Current thrust of FHA and VA is to let the unassisted poor have only chattel mortgages on wasting assets, while the thrust could easily be turned around to make sure that these families could get realty mortgages on units of the same size on which there would be an equity buildup.

We should not get hung up on how big a dwelling unit should be, or how big its lot should be. Our standards in this regard make little sense now. We also should drop the illusion that we can solve the problem of low-income housing by production methods, when we must use good specifications for any improvements to realty.

Then, too, we should not anticipate slums, poor land use, or bad design, simply because we must deal with smaller-sized dwelling units.

Zoning, of course, in all but rural areas, will be our biggest problem in housing the unassisted poor adequately. The usual density control by zoning ordinance is a fraud, and most suburban communities today cannot afford the large lot single-family housing they so passionately espouse, anyhow.

Mobile homes provide shelter for some 2.2 million U.S. households, according to the Mobile Manufacturers Association, although some

67-650—71——15

people regard that shelter as somewhat less than adequate. Their first cost is cheaper than most code-conforming dwelling units, primarily because of smaller sizes and lower standards. And the expense of living in them is generally lower than that of living in a code-conforming dwelling unit, almost entirely due to the fact that they are used outside of the purview of zoning ordinances and subdivision regulations that apply to code-conforming dwelling units.

Is there anything wrong with that? Not really, from most points of view except one: They deteriorate to zero value in about 15 years.

They run from about $8.33 per square foot, without the land and utility hookup, to $14.00 a square foot.

In the tables I have pointed out that you can make a case for both mobiles and code-conforming housing in monthly housing expense including first costs.

The fact of the matter is statistically you can prove both points, a little on this side and a little on that side. But most observers, with no ax to grind, would settle for the generality that it costs a family as much to live in a mobile home, in a mobile home park, including the purchase price of the mobile, as it would cost them to buy and live in a new home costing two- to three-times as much. Furthermore, the realty would appreciate over time, while the mobile home would depreciate to zero value.

The question is why should FHA and the VA not insure chattel mortgages, or realty mortgages, on dwelling units of the same minimal size that meet building codes and will last 40 years instead of a mobile's average 10 to 15 years.

And the legislation that would be contemplated as precedent is title I, section 8 of the National Housing Act. That section was deactivated, I believe by the Congress, but it might have been by administrative act by the FHA in 1954.

Who could build these code-conforming small dwelling units? Almost anybody. As a matter of fact, some mobile manufacturers are: To name a few—Fleetwood, Redman, Guerdon, Marlette, Zimmer,

There is a problem of size. The Douglas Commission in 1967 and 1968 studied that very carefully, with no conclusive results on size. And, of course, in Europe, the sizes of most new dwelling units are only 600 square feet.

Of course, we also have the question of whether we can cut the cost of housing technologically, and the answer is no, because the shell of the house, which is the only thing we are contemplating cutting the cost of and putting it on the assembly line, does not respond to production line economies. Our Operation Breakthrough has shown absolutely no production economies whatsoever. The other problem is, of course, that if we could cut the cost of the shell of the house by 15 percent, assuming you could in a factory, then you could not lower the monthly housing expense by much more than 1 percent. I develop those figures in my statement.

The thing is that we have an obligation in our dwelling units to be sure that they last the life of the mortgage, that they perform all of the things which we in the larger society expect the dwelling unit to do, and they not erode the tax base. But, of course, those three specifications are very stiff and there is no cheap way around that particular problem. So you cannot make this specification more economic. Housing on the production line will continue to grow as it has in the last 100 years, because of the price of building labor. But the assembly line offers us no economies in production.

We cannot expect modular production or anything else to solve the problem for us. It will solve the problem for us as sectionalized housing has in the last 15 years in the rural areas.

Thank you, Mr. Chairman.

(The prepared statement of Mr. O'Neill follows:)

PREPARED STATEMENT OF RICHARD W. O'NEILL

AN ANSWER TO THE HOUSING SUBSIDY PROBLEM

My purpose here is to focus attention on a vast pool of housing needs, a pool now inadequately served by a type of housing that is relatively costly in the long run. I refer to lower-income families who now get no subsidy but are served by only the most expensive housing financing on housing assets that depreciate to zero value in about 15 years at the outside. The thrust of my remarks is to urge a change in approach, particularly by the Department of Housing and Urban Development, to extend purposefully FHA insurance to code-conforming dwelling units for lower-income families who, so housed, would require little or no Federal housing subsidies.

In his third annual report on efforts to meet the nation's housing goals, President Nixon, a few weeks ago, pointed out that 40% of the nation's families could now meet eligibility criteria for Federal housing subsidies. He said this has created a "need to deal with inequities which arise when some families receive subsidies and others do not. If all eligible families were subsidized the cost would be astronomical. Yet, unless major changes are made as these programs continue production momentum, it will be difficult to continue favoring a select few in the population while the rest of the nation is left to seek decent housing completely on its own.

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Of course, the whole problem goes back to housing's cost, and *as costs rise, dwelling units get smaller, whether subsidized or not.* According to Census and HUD, smaller and cheaper houses were a major factor in new housing in 1970.

During 1970, there were 485,000 new one-family homes, an 8% increase over the 448,000 new homes sold in 1969. But the average price of new homes sold during 1970 was $26,600, off 5% from 1969's $27,900, and the average floor area was down 8% from the average on the 1969 house—from 1640 sq. ft. to 1510 sq. ft.

The increase in new one-family houses in 1970 was concentrated in smaller houses: new houses with floor area of less than 1,200 sq. ft. increased by about two-thirds over 1969.

Another way of looking at the cost factor is to point out that *half the families in this country have not been able to qualify* for a mortgage loan to purchase a new single-family code-conforming dwelling unit with an FHA 203 mortgage since 1966 and have not been able to do so with a conventionally financed mortgage since 1964, according to figures of the U.S. Savings and Loan League.

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In general, the only way we now have of lowering the cost of housing—and I will go into the implications of this statement in some detail further on in this paper—is to cut down its size, as we have seen happen in the last two years.

Current FHA construction cost, including an improved lot, is about $16.90 per sq. ft. To get house prices down to, say, $12,500 we would have to produce single-family houses of 740 sq. ft., assuming we still had to use lots allowable under most zoning ordinances and subdivision regulations. (Average size of new houses was 1400 sq. ft. in 1970 and 1585 sq. ft. in 1969, according to Census.)

According to Dr. Sumichrast, this size would expand the demand for housing (assuming people would prefer to buy and will be able to qualify) at least two-fold from what it is now. *This might increase production of FHA homes from the current rate of some 260,000 to half a million.* The economic impact would be substantially less than would be the case if this position could be taken in a more expensive unit, such as a typical FHA house with 1289 sq. ft. of living space. Still an increase of some 250,000 units would create an additional 380,000 to 400,000 new jobs. It would reduce total unemployment by some 8%.

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On the pages which follow I have attempted to develop a case that would have the Federal government insure that the lower-income American family will get the full benefit of code-conforming residential realty—at no significant expenses to the government—and at comparable expenses, to the American family, to what it is now paying to live in mobile housing. Such code-conforming housing could and probably would be produced by present manufacturers of mobile housing.

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Then, too, we should not anticipate slums, poor land use or bad design, simply because we must deal with smaller-sized dwelling units.

Zoning, of course, in all but rural areas, will be our biggest problem in housing the unassisted poor adequately. The usual density control by zoning ordinance is a fraud, and most suburban communities today cannot afford the large lot single-family housing they so passionately espouse, anyhow.

Is there anything wrong with that? Not really, from most points of view except one: *they deteriorate to zero value in about 15 years,* even if well-maintained, whereas code-conforming improvements to realty, if well-maintained, last at least the life of the mortgage (average age of dwelling units in this country is about 67 years) and generally appreciate in value. Substantiation of various of my assertions here follow in this paper.

For roughly the same kinds of expense to the consumer of mobile homes, we could, in this country, provide him with technologically code-conforming dwelling units that would appreciate in value, not depreciate, if the thrust of legislation and its administration is changed purposefully. And at no particular cost to the Federal government.

HOW LONG WILL MOBILE HOMES LAST?

The Official Mobile Home Market Report, the Blue Book, May 1970, 10th Edition. Volume 34, No. 2 indicates 60% depreciation in eight years, or 7.5% per year. Extrapolating that figure gives a fully depreciated life of a mobile home of 14 years.

For FHA Title I insurance that agency sets 115% of the wholesale Blue Book price, if a previously financed used mobile home is involved, as one upper limit of loan amount. FHA maximum term of mobile home loans is 15 years.

There are 2.2 million mobile homes in use in this country, and knowledgeable mobile home people estimate that some one-half million of them are substandard, by their own standards. About 80% of the total occupied mobile homes have been produced since 1960, again according to these experts, from which we might infer that mobiles on the average now have a life of 10 to 12 years.

At any rate they don't last, with anything other than salvage value for various materials in them, any more than 15 years. So any consumer buying one, in lieu of code-conforming dwelling unit (if such were available at comparable living expense), should have had the prior advice of someone like Ralph Nader, perhaps.

As I indicated earlier in this paper I will get to the question of costs and expenses in a moment, but first I'd like to examine some other points briefly.

What created the mobile home market in the first place? Quite simply, the imposed cost factors of lot size and dwelling unit size in improved realty and the complexity of buying improved realty. Mobile homes have thrived on market conditions that do not involve those considerations: Where the market may call for consummation of the purchase in less than an hour; where the market calls for easy credit and few questions asked; where municipal ordinances can in general be ignored, or where they don't apply; where depreciation, immobility and cramped living factors can be fogged over in the sale; where lower-income families cannot qualify for any available improved residential realty.

That's why one-half of all mobiles are in rural areas (according to the Mobile Home Manufacturers Association) where 60% of the nation's substandard housing is. According to HUD 60% of new mobiles today are going into mobile home parks, at densities of 6 to 10 to the acre, generally in the least desirable areas in town.

Who lives in them and why?

According to Census, 9 out of 10 owners of new mobile homes use them as their principal place of residence. Construction economist Robinson Newcomb, in a recent monograph[1] for the Urban Land Institute, wrote that "Over 31% of the sales in 1967 were to households with incomes under $5,000 according to the sample study (Census). The percentage of households with incomes under $5,000 is expected to decline by nearly 10% between 1967 and 1980. About 54% of the sales were to households with incomes from $5,000–$10,000. The proportion of such households may increase 20% by 1980. Only about 9% of the mobile homes were bought by families with incomes over $15,000 but this group is expected to nearly triple its proportion of the total by 1980."

Another Census survey of purchasers of mobiles from October 1, 1965 through September 30, 1966, shows that 84.2% of them were by households with less than $10,000 yearly incomes.

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[1] ULI Technical Bulletin 66, 1971.

What does a mobile home really cost? Just about the same per sq. ft. as low-rise code-conforming residential realty built with the same economies of scale—by builders, prefabricators, modular manufacturers or mobile home manufacturers themselves who are building in big volume.

A typical mobile home is a 12′ x 60′ priced on the dealer's lot from $6,000 to $9,000, depending upon quality and appointments. That's $8.33 per sq. ft. to $12.50 per sq. ft. Current plans of the New York City Housing authority call for purchasing 56 mobiles that will cost about $10.000 per sq. ft. A recent figure from a Long Island mobile home dealer for his best seller was $11,000 for a unit 12′ x 65′, over $14.00 per sq. ft.

In comparison, FHA's Table 55A, Specific Characteristics by Total Acquisition Cost New One Family Occupant Purchase Homes, 1969 (most recent figures available) show that new section 221(d)(2), below $8,000, were built for an average $7.78 per sq. ft. then, which would be about $8.50 now. However, FHA quotes the average per sq. ft. cost of Section 203 houses, without land, in 1970 as $14.18.

Of course, the real problem in housing is monthly expense, not the first cost of the dwelling unit. Monthly housing expense determines the level of subsidy, the cost to government, who can qualify to buy without subsidy, etc. The following tables were prepared by the Pease Company, Hamilton, Ohio, a prefabricator, building supply dealer and building product manufacturer. Pease is a company which has been in the housing and building supply business for two generations.

The first table details net monthly expense to dwell in a mobile home, the second that for a modular home, the third that for a conventional prefabricated home. The mobile is the most expensive, and its first cost was $6,315. Least expensive was the modular and its first cost was $11,700. In between is the conventional, with its lot, for which the total first cost was $16,700. For the net housing expense involved in living in the $6,315 mobile, the owner could have lived in a $19,000 conventional house.

MOBILE HOME

Size	12′x65′
Square feet	780′
Specifications, unfurnished	A119.1
Cost FOB factory	$6,240.00
Freight	75.00
Total in-place cost	6,315.00
Down payment	—1,315.00
Chattel mortgage	5,000.00
6½ percent add on interest 7 years	2,275.00
Credit life insurance	167.00
	7,442.00
Monthly payment—7-year loan	86.60
Hazard insurance	4.40
Pad rent	50.00
Utilities	15.00
Maintenance	9.00
Total monthly cost	165.00
Less income tax on interest	7.00
Net cost per month	158.00

MOBILE HOME—Continued

7-year cost	$13,272.00
Down payment	1,315.00
No salvage:	
Net cost 7 years	14,587.00
Net cost per month	173.65

MODULAR HOME

Needs to be larger because (12'×66') of thicker walls equals	792'

CODE APPROVED, UNFURNISHED

Lot cost	$1,500.00
Cost FOB factory	9,500.00
Freight (2 loads)	150.00
Field hookup and closing	550.00
Total in-place cost	11,700.00
Downpayment	—1,700.00
Real estate mortgage	10,000.00
8 percent simple interest 7 years (FHA or conventional)	5,303.80
Monthly payment 25-year loan	77.20
Hazard insurance	4.10
Real estate taxes	28.75
Utilities	15.00
Maintenance	25.00
Total monthly cost	150.05
Less income tax on average interest and taxes	—15.75
Net cash flow per month	134.30
7-year cost	11,281.00
Downpayment	1,700.00
Less equity buildup (resale value same as cost because of inflation)	—2,881.00
Net cost 7 years	10,100.00
Net cost per month	120.23

CONVENTIONAL HOME

Needs to be larger because (24'×34') of thicker walls equals	816'

CONVENTIONAL HOME—Continued

CODE APPROVED, UNFURNISHED

Lot cost	$2,000.00
Cost FOB factory Freight (2 loads) Field hookup and closing	14,700.00
Total in-place cost	16,700.00
Downpayment	—1,700.00
Real estate mortgage	15,000.00
8 percent simple interest 7 years (FHA or conventional)	7,955.70
Monthly payment 25-year loan	115.80
Hazard insurance	6.15
Real estate taxes	43.05
Utilities	15.00
Maintenance	25.00
Total monthly cost	205.00
Less income tax on average interest and taxes	—34.44
Net cash flow per month	170.56
7-year cost	14,327.00
Downpayment	1,700.00
Less equity buildup (resale value same as cost because of inflation)	—3,472.00
Net cost 7 years	12,555.00
Net cost per month	149.46

Naturally, enough, there are other figures which can show a slightly different picture of what the housing expense is. Economist Robinson Newcomb in his monograph for ULI shows it this way.

"Let us start the comparison of conventional and mobile home financial ownership costs by calculating the costs over a 15-year period of owning a three-bedroom 1,000 sq. ft. 10-year old home, purchased for $20,000 including closing costs. (To simplify the problem, we have assumed that instead of buying property, the family would invest in tax-exempts that yield a net return of 6 percent.)

"Assume that the house is paid for over a 20-year period with an 8%, $16,000 mortgage and a $4,000 cash payment. Let us assume an average inflation rate of 2%, and that property taxes start at 2% of the paid-for-price and rise 4% per year. Maintenance costs are 1% per year of this value and rise by 2% per year. Operating costs, including the depreciation of the furniture start at $700 per year, insurance costs start at $75 per year, and both increase by 2% per year. Let us assume that the family moves only once during this 15-year period. The present value of the cost of this move, including broker's fees and difference in price for another comparable house and the one being vacated, discounted at 6%, is $1,285. In effect, we assume there is no loss or gain in the exchange of properties, but that there is a moving cost. At the end of the 15-year period the family will have a house, that if well maintained in a good neighborhood, will be worth more than was paid for it, while the unpaid principal on the mortgage will be reduced to $6,570.

PRESENT VALUE OF COSTS OF CONVENTIONAL HOME, 20 YEARS, 8 PERCENT MORTGAGE CALCULATED OVER A 15-YEAR PERIOD

	1st year	Costs discounted at 6 percent
Costs:		
Down payment	$4,000	$4,000
Mortgage payments, 15 years	1,607	15,606
Mortgage obligations at end of 15 years		3,347
Property tax	400	5,140
Maintenance	200	2,225
Operation	800	8,900
Moving		1,285
Insurance	75	895
Total costs [1]	7,682	41,398
Benefits:		
Salvage value of land (compounded at 4 percent)		2,970
Salvage value of building (compounded at 2 percent)		8,880
		11,850
Income tax savings (20 percent of taxes and interest payments)		2,495
Total benefits		14,345
Net cost		27,053

[1] Excluding furniture costs.

"Instead of buying a conventional house, let us assume that the family buys a mobile home with furniture, for $10,000, finances it at a 10% true interest rate for ten years, (with a down payment of $2,000) and then discards the unit after 15 years. The family pays $600 per year for pad rental and utility services during the first year, and 4% more each successive year. Assume one move at a cost discounted at 6% of 195, and a 2% per year inflation rate (as was assumed for the house). The resulting costs to that family might be approximately those listed on the following page.

PRESENT VALUE OF MOBILE HOME COSTS OVER 15-YEAR PERIOD

	1st year	Years	Discounted at 6 percent, 10 years
Cost:			
Down payment	$2,000		$2,000
Contract payment [1]	1,269	10	9,339
Pad rental	600	15	7,705
Property tax	200	15	2,570
Maintenance and insurance	150	15	1,600
Moving			195
Total costs	4,219		23,489
Benefits:			
Income tax savings			1,200
Salvage value [2]			
Total benefits			1,200
Net cost, mobile home			22,289
Net cost, conventional			27,053
Ratio conventional to mobile costs			1,21/1

[1] 10 years only.
[2] Assume to be zero after 15 years.

"Even after allowing for no outlays for furniture and a 4% increase in the value of the land on which the conventional house is placed, and for a 2% increase in the value of the conventional house itself, the mobile unit proves cheaper than the conventional house under the assumptions used. Of course, the mobile unit does not provide all the space or amenities of a conventional home, nor does it provide all the headaches. On a purely dollar for dollar basis, the mobile unit is less expensive in the comparison used here."

Obviously, a careful statistical analysis of living expense can be made in favor of either mobiles or code-conforming dwelling units. Most observers, with no axe to grind, would settle for the generality that *it costs a family as much to live in a mobile home, in a mobile home park, including the purchase price of the mobile, as it would cost them to buy and live in a new home costing two to three times as much.* Furthermore, the realty would appreciate over time, while the mobile home would depreciate to zero value.

FHA, under Title I of the National Housing Act, as amended in 1969, will insure mortgages on mobile homes, complying with the mobile homes technical standard A119.1, down to as small as 400 sq. ft. VA and Savings & Loans (empowered now by the Federal Home Loan Bank Board) will do the same. FHA will insure up to 15 years and $15,000, but the present rate of 7.63% precludes almost any lender from using it. They are all getting around 12% these days on mobile homes. VA will insure up to $10,000 for 12 years at 10¾%, which is also too low currently to be of much interest to chattel lenders. Moves are afoot, however, to raise both rates to make the programs more attractive to lenders. Even the extension of the interest rate subsidy program, like Section 235, has been suggested for chattel mortgages. Lenders would just love to see those two moves put into effect. Then the Office of Management and Budget would have another headache on its hands.

The hard questions are, of course, why should FHA and VA insure chattel mortgages on dwelling units with a minimum living area of 400 sq. ft. that only meet mobile home standard A119.1? *Why should FHA and VA not insure chattel mortgages, or realty mortgages, on dwelling units of the same minimal size that meet building codes and will last 40 years instead of a mobile's average 10 to 15 years?*

FHA's Minimum Property Standards (MPS) do not preclude dwelling units as small as 400 sq. ft., and the Farmers Home Administration sets no limits on size. But due to custom, the thrust of current legislation, and a perfectly natural bureaucratic fear of pioneering, very few code-conforming units of, say, 720 sq. ft. could get FHA 203 insurance. Some might be allowed by offices of the Farmers Home Administration.

In effect, the unassisted low- and moderate-income family is only satisfied, in new housing, by conventionally financed (chattel mortgages up to 14% simple interest) mobile homes.

What is needed is a purposeful thrust by HUD towards insuring code-conforming units of mobile home size. If such a thrust calls for legislation, there is a precedent.

The legislation envisaged by many complaining about the current dichotomy in Federal programs—chattel for the poor, mortgages for the more well-to-do—would be a resurrection of Title I, Section 8, of the National Housing Act, a provision that was deactivated by Congress in 1954. Its statutory language is still a part of the National Housing Act. In particular the seekers of change would like that section to apply to code-conforming dwelling units under Section 203(i) or Section 221(d)(2): as low as 3% down payment, or $200 down, and up to 35 years for the mortgage term.

Legislation would be specifically changed to include dwelling units down to sizes as small as 400 sq. ft.

Under Section 221(d)(2) mortgages bearing market interest rates are insured by the Federal Housing Administration to finance the construction, purchase, or rehabilitation of one- to four-family homes. The mortgage amount on a single-family home may be up to $15,000 ($17,500 in high-cost areas—plus another $2,500 for large families). Families displaced by government action or by natural disaster may pay as little as $200 down on a single-family home. A 3% down payment is required from others.

Under 203(i), and other special 203 programs, the mortgage limit for properties that meet only FHA low-cost housing standards is $13,500. A mortgage equal to 100% of appraised value (up to $12,000) of a new or existing one-family house may be insured for a buyer whose home was completely or substantially destroyed by a natural disaster. This program includes special mortgage insurance terms for home-buying veterans.

Why not extend such insurance to permanently placed mobiles? Because they won't last, built simply to the A119.1 standard. Furthermore, FHA's MPSs preclude the standards of A119.1. A119.1 is a rather stiff standard and not a bad one, but it still does not insure that the mobiles will last any longer than 15 years.

Who would build such units? Anybody who wanted to get into the business. Very likely most of them would be built by the major mobile home manufacturers, some of whom are already producing some code-conforming units: Fleetwood, Redman, Guerdon, Marlette, Zimmer, just to name a few. They also could be produced by prefabricators, modular manufacturers, lumber dealers and builders.

What about the problem of size? How big should a dwelling unit be? How big should a bedroom be? How big should a lot be? Who knows? The National Commission on Urban Problems, The Douglas Commission, looked into those questions with no conclusive results. I quote from its report "Building The American City", House Document No. 91–34, 91st Congress, 1st Session:

"Sleeping room space requirements. The American Public Health Association-U.S. Public Health Service (APHA-PHS) model housing code requires that sleeping rooms for occupancy by one person contain a minimum area of 70 sq. ft. The model code of the International Conference of Building Officials requires a minimum of 90 sq. ft. Local and state housing codes show such variation as 80 sq. ft. (Seattle), 100 sq. ft. (San Francisco), and 120 sq. ft. (Hawaii). The wide variation carries over from dwellings to accommodations for transients. A survey of state standards for transient housing indicated that minimum area for rooms in hotels and motels varies as follows: 50 sq. ft. (three states); 60 sq. ft. (two states); 80 sq. ft. (two states); and 100 sq. ft. cabins and tourist camps (one state). Standards for minimum room volume for the first occupant in these rooms also have wide variation: 400 cubic feet (five states); 500 cubic feet (two states); 600 cubic feet (one state) and 640 cubic feet (one state).

"Minimum habitable floor space. For five persons in an existing dwelling unit, model housing codes call for the following standards of minimum habitable floor space: 525 sq. ft. (Southern Standard Housing Code), 550 sq. ft. (APHS-PHS and BOCA Housing Codes), and only 380 sq. ft. (ICBO Housing Code.) Turning from housing codes to zoning ordinances, which similarly set standards for minimum floor area, note the figures in table I. Even if the minimum standards specified in housing codes for existing housing were to be doubled to reflect a desire for a more suitable living environment as specified in zoning ordinances for new housing, what technical rationale can explain the wide variation and apparent excessiveness of these standards currently in use in New Jersey and New York?"

TABLE I.—VARIATIONS IN BUILDING FLOOR AREA REQUIREMENTS FOR RESIDENTIAL LOTS OF SIMILAR SIZE (GENERALLY EXCLUDING NONLIVING AREAS SUCH AS UTILITY AREAS, BASEMENTS)

Locality	Lot size (square feet)	Minimum floor area (square feet)
Edison, N.J	7,500	960
Cherry Hill, N.J	7,800	1,350
Milburn, N.J	20,000	1,800
Smithtown, N.Y	21,780	1,100
Milburn, N.J	29,000	2,000
Wayne, N.J	30,000	1,200–1,600
Somers, N.J	40,000	1,250
Parsippany-Troy, N.J	40,000	1,350–1,900

Why have limits at all? The usual new European dwelling unit, according to NAHB's Dr. Sumichrast, is about 60 sq. meters, roughly 600 sq. ft. In an article on housing conditions abroad, published in the Washington Post earlier this year, he noted that:

"Crowding conditions can be compared by using the average number of persons per room. In the United States this average comes to 0.54 persons, the

United Kingdom has 0.60 persons per room, Belgium 0.62, Denmark 0.8, Austria 1.0, Czechoslovakia 1.30, U.S.S.R. 1.55, Poland 1.66. Thus, the U.S.S.R. and Poland have nearly three times as many people per room space than the United States.

"Another way to measure space is by the number of rooms per unit. The 1970 Census shows that on the average an American unit has 5 rooms, the same as Belgium; Netherlands has 5.2 rooms; United Kingdom 4.7, West Germany 4.3; Switzerland 4.2, Denmark 4.2. On the other side of the ledger are Czechoslovakia with 3.4, Hungary 3.1, Poland 3.0, East Germany 2.5 and Yugoslavia 2.1 rooms per average unit. For the U.S.S.R., information is not available.

"In terms of living space, measured in square feet, the United States leads all other nations with 1,560, Belgium has 1,545, Denmark 1,122, Norway 914, West Germany 883, Sweden 861, France 813, Austria 807.

"The Communist countries have a pretty well standardized living space, in all cases substantially less than the average living space among Western countries. Czechoslovakia has 668 sq. ft. per unit, Bulgaria 667, Hungary 662, Poland 555, Romania 552, and U.S.S.R. only 479 square feet."

Can't we cut the cost of housing technologically? No. In the first place, the problem in low-income housing is monthly housing expense, something quite different from the first cost of construction. In the second place, the usual specifications preclude any economies: units must last the life of the mortgage or municipal bond issue, they must provide all of the amenity expected of any other housing, and they must not erode neighboring tax bases.

Has Operation Breakthrough shown any economies? None whatsoever. HUD reports unit costs run from $8.50 to $14 per sq. ft., $16.50 to $25 for high-rise, without land and transportation. Some observers believe final costs in Breakthrough, if all costs could be included, would run well in excess of $50,000 per unit.

But the business of industrialization bears a closer look. Industrialization in housing started back about 100 years ago in this country, when we first started putting light construction on the assembly-line—with two dimensional prefabrication systems. Prefab, the biggest form of industrialized building in light construction, has been growing slowly ever since.

Estimates are that at least three-quarters of all new dwelling units today in light construction use the tool of prefabrication in one way or another. If you want to include pre-hung doors and windows, then virtually all starts use prefabrication.

Reasons for prefab growth in our industry are clearly the greater dimensional control and shorter assembly time you can get on components assembled at waist-high level on jig tables. But a great many people are talking about three dimensional assemblies being industrialized housing, not two dimensional. Well, what's the big deal in assembling two dimensional panels into three dimensional modules in a plant instead of at the site? Not much.

The Housing problem concept is the hangup. Obviously, there are many in our industry and outside of it who think that the assembly, from two dimensional panels, into three dimensional modules is a far different ball game than traditional prefabricating. Behind the thinking is an honest desire to solve a problem only half conceived. The problem is the housing problem.

Do we have a housing shortage, or do we have a lot of people who cannot buy or rent without some kind of assistance? Obviously, the latter, and the idea is that in the production process we can achieve economies that will help solve the problem. We can't and for a lot of hard reasons.

Production economies do not ease the low-income problem. Let's assume there is both a labor-saving and a volume-purchasing advantage in three dimensional assembly of shelter. The biggest saving any expert will give you, on those assumptions, for the shell of the house (walls, roof and floor) is 15%. The shell is the only thing a shelter manufacturer is working on, he's not re-designing the refrigerator.

With the economies of scale, in single-family or high-rise the shell of the dwelling alone comprises less than 20% of the price of the entire finished dwelling to the consumer. In single-family you would add to the cost of the shell: land, land improvement, financing, legal design and engineering, marketing, overhead, miscellaneous, profit, foundation, core, finish to arrive at the final price to the consumer.

In high-rise you might build a structural skeleton in which modulars could be placed like cars in a mechanical parking garage. (The whole error in suggesting such a scheme is that it would involve a structure within a structure—entirely too much structure for the basic requirements of high-rise dwelling units.) A little interpolation of FHA high-rise figures, from 1962 to 1967, shows again that shells would be less than 20% of the cost of the job. The other elements would be land, excavation and foundation, structural frame and plate, interior finish, mechanical subcontracts, elevators, appliances, job overhead and profit.

A 15% saving in a less-than-20% shell cost would reduce the final price of the unit less than 3%. And in monthly housing expense—the problem for low-income families—it would lower budget outlays only about 1% (amortization of mortgage runs around 40% of a typical rent roll or monthly ownership expense). Inflation of any size makes the 1% saving disappear within one year.

A priori inferences keep enthusiasts in constant frustration. Whenever someone uses a title like "The Profit Potential of Modular Manufacturing", hopes soar among a small body of aficionados.

That title usually produces four specious inferences. One, that on-site construction trade wages will drive the whole shelter process into the plant. Two, that operative builders will become effective outlets or marketing arms for modular manufacturers. Three, that assembly line production will produce economies in code-conforming dwelling units. Four, that a given market will absorb high-volume production of look-alike units. None of those four will necessarily hold any water, and you can add to them some equally dangerous assumptions.

First dangerous assumption is that there is no difference between a chattel and realty, that you can put housing on an assembly line as easily as you can put cans of soup on the assembly line. This is not true because the legal and financial institutions controlling and surrounding the improvement of realty do not circumscribe chattels.

Second dangerous assumption is that to get around the problem of standardized houses coming off an assembly line, one can aggregate markets, if not in the free marketplace, then in the subsidized sector. This also is an invalid assumption for two reasons: 1) there is no forced aspect to subsidized housing that would override the problem of sameness, and 2) very few housing authorities will have exactly the same needs in dwelling unit type and appearance.

Third dangerous assumption is that there is something cheaper in the way of materials and fasteners than what we now use in housing. Trouble with this one is that there is nothing cheaper than the earth materials which we now use like wood, concrete, steel, glass, aluminum, brick, gypsum, asphalt, etc.

Will plant workers always accept less? Productivity per dollar is the single biggest reason for the growth of prefabrication, two dimensional or three dimensional. But there is no solid ground under the assumption that the disparity between plant wages and site wages is a disparity that will remain, even if everything goes on the assembly line in housing. It hasn't been true for any other industry in the history of this country—no reason why it should be true for housing.

Even if the disparity should remain, it would still be difficult to have it cover excess costs imposed by assembling panels in three dimensional boxes in a plant and shipping air, versus assembling those same panels at the site.

Probably the biggest factor that will erode the disparity between site and plant wages in construction is the problem of discrimination. Blacks criticize the AFL–CIO approach to in-plant workers (worked out with Stirling Homex) charging it doesn't open the door to more lucrative on-site work and tends to freeze them into the building trades unions as second class citizens. They complain that training programs in Stirling-Homex's labor agreements are related to in-plant factory techniques, do not lead to higher paying construction jobs.

What is the labor component now in new housing built with the economies of scale, components, power equipment? Best estimates have it at less than 20%, in some places as low as 15%. (The average annual pay of a construction worker today is only $8,100 a year, something less than the average pay of a manufacturing worker.) Plant wages would have to stay less than half of site wages to produce any measurable economies in three dimensional prefabrication.

Absorption rate of modular production is critical. Using the usual factors now extant in the modular industry, a 1,000-unit per year modular factory would be about a 50,000 to 75,000 square foot facility, costing about $1 million. An annual net return before taxes of at least $150,000 is needed to justify that investment in plant, machinery, distribution, personnel, etc.

Figuring a workable gross profit of 20% at the loading dock, best F.o.B. sales price of $10 per sq. ft. for good modulars today, the plant would have to produce and sell, for openers only, at least 250 finished dwelling units per year. $150,000/$10 × 1200 sq. ft. × 20% 1/4 (5%).

But the market within economic shipping radius (one day out and back) of the plant won't absorb 250 units all the same. And if the modular manufacturer wants to sell builders, each one of them will see his market opportunity as requiring a different model. When the manufacturer figures his costs of engineering, down-time, tooling and start-up for model changes, he finds his minimal production run in 50 units, or there is no profit at all.

So, with model changes, yearly sales and production must be figured on an absorption rate some four times greater than the first feasibility rate, or 1,000 units per year, all within a one-day-out-and-back radius.

Can modular specifications be made more economic? Dwelling units subjected to over-the-road hauling and lifting must be built to more exact structural specifications than dwelling units subjected only to being assembled on a foundation. That means that sectional and modular houses meeting a building code, and expected to last the life of a mortgage, usually are built with structural grade plywood sheathing and often corner bracing.

In states with state laws covering local acceptance of factory-built modular dwelling units, code requirements are as stiff as any model code. There are now 12 state-wide factory-built building codes, and draft codes are being readied for legislation in 22 other states. Those factory-built building codes are not likely to produce any great economies in housing. They are more demanding and impose higher costs than almost all other building codes for low-rise residential building.

Even so, the fact that they are state-wide is a great step ahead for the housing industry: they create a climate in which state legislatures can consider the obvious nonsense of maintaining any number of municipal building codes, at the same time having state-wide factory-built building codes which in effect duplicate 90% of the provisions of most municipal codes. Maybe we will have state-wide codes in every state a lot sooner than we once might have thought.

Usual building logistics are incompatible with modular production. Trucking modules is now running close to $1 per semi-trailer load per mile, if the radius out-and-back is one day. Costs quickly get out of line for hauls longer than a day. But to get market absorption a manufacturer has to think of ever-longer shipping radii.

There are two ways to cut this particular nut in modules. One is to have many factories scattered around the country and the other is to ship long distances by rail or barge. Both are expensive.

HUD has asked the U.S. railroads to ship at lower rates than the railroads charge others. The railroads already have a problem shipping 12-foot wide modules, they can't go over many rights-of-way, often have to ship circuitously just for 12-foot wide modules.

In barging, while the actual run of the barge is quite cheap per module, the loading and unloading of modules and trans-shipping short distances by truck can be exceedingly expensive. So barging may be no more than competitive with ordinary trucking within the common maximum of 300 miles.

And, of course, the trouble with having module producing factories scattered over the country is that no one factory will be efficient unless it can sell and produce about 1,000 units a year, something which very few modular factories are capable of doing even now.

Modular manufacturers are operative builders. After the shakedown cruise of the last three years, it is clear that a modular system is simply another way for a builder or developer to build for his own account, assuming the economies of scale.

In most metropolitan areas, the rule of thumb is to double the loading dock price to arrive at finished module price to the consumer, if the manufacturer is trying to sell builders. That means a $10 per sq. ft. cost at the dock goes to $20, which is usually non-competitive. So the manufacturer also becomes the builder.

Metropolitan land costs and improvements are only the beginning of the expense. With one crane, modular crews can set about 24 modules (or four town-houses) in place in a day. And to make sure that everything goes quickly and accurately, engineers must supervise the building of foundations. Finishing time for 24 modules varies with size of the crews, but generally speaking six men can do the job in four days. If four townhouses were delivered Monday morning, they would be ready for occupancy by Friday night.

The development has all of the traditional problems, that any other builder has and then some, with building departments, zoning commission, homes association, ecologists, environmentalists, conservationists, school boards, etc. The townhouses have to fit the environment, like any conventionally built, and have to provide livable, desirable dwellings to move in the marketplace at all against less expensive existing housing.

Although land costs and the level of improvements that must be made in metropolitan areas eliminate modular housing as a significant part of the market today, a few dozen modular manufacturers have found good customers in local housing authorities. Often because the housing authorities can get no one else to do the job. Here the operative-builder manufacturer is a general contractor.

Housing authorities are not concerned with marketing considerations which, in an unsubsidized market, would not allow the kind of standardization which a local housing authority can get away with in assisted housing. In other words, if most of the modular manufacturers you have heard about were not hip-deep in subsidized housing programs, they would have very little business to talk about.

Can any builders be sold? In theory, the small volume builder would be saved by becoming the modular producer's marketing arm. The inefficient builder, who struggles to finish 20 conventional houses a year, would be freed to acquire local sites, zoning and sales for packages of 200 factory-built units or more. The trouble usually is that the small inefficient builder can never be anything else no matter how he builds, and many modular manufacturers demand cash deposits before accepting orders from smaller builders. A number of manufacturers have already left the field because of builders' inability to finance their subdivisions.

In non-metropolitan areas, sectionalized houses—essentially modular houses for rural markets, particularly in the Southeast—still enjoy the market they have had for some 15 years. Of course, there the market potential of modulars is based on the scarcity of builders, subcontractors and labor force in many rural areas. In those areas, the ex-plant price of the sectional at $10 to $12 a sq. ft. does not get skyrocketed to double that in selling price because the cost of the land and the improvements that must be made to the land are so minimal.

In comparing assembly-line systems for producing shelter, keep in mind that whether the unit is a mobile, modular, prefab, component-built, or conventionally-built, the basic construction system in low-rise frame construction is all the same.

Large builders with the economies of scale, 100 or more dwelling units per year, operating in major metropolitan areas where a universe of subcontractors and construction labor is available, do use components in almost all of their work, but they do not buy housing packages from other producers. One way of examining why prefabricators can't sell volume builders lies in a value-added analysis.

The value-added factors in producing dwelling units on an assembly line have, to date, produced no measurable economies for in-place costs of a dwelling unit for a builder with large volume.

The value-added factor in prefabrication is only 50%. In sectionalized housing, the forerunner of modular housing, the value-added factor is only in the neighborhood of 25%. In mobile homes the value-added factor is only 16%. The reason for these declining factors is that as the manufacturer adds more and more finished products in the plant, like ovens and toilets, he adds virtually no value to his cost of those elements by the fact that he has installed them in the unit in the plant.

For the on-site builder who has the economies of scale, value-added factors, assuming that his assemblage of men, machinery and materials at the site is his factory, are in the neighborhood of 100%. In short, the high-volume on-site builder, using components as well as unassembled materials, is closer to a true manufacturer's value-added factors than is a prefabricator, a mobile home manufacturer, a sectionalized house manufacturer or a modular home manufacturer.

With a handful of exceptions, the modular housing industry today is not an industry and probably never will be. It is simply another way for a builder or developer to build for his own account or as a general contractor to a local Housing Authority, assuming the economies of scale.

An obvious question that always comes up when we consider small code-conforming housing is whether or not it will create slums. Slums are created essentially by people and not by structures or land use patterns. Even mobile home parks do not create slums. It's the use of the park, and the behavior patterns or value judgments that go with that use that can turn a mobile home park into a slum. Well-designed land use, for dwelling units of whatever size, plus the incentive of ownership of a dwelling unit that really appreciates in value, can turn a development of small dwelling units into a charming neighborhood that stays that way. There are some excellent examples of townhouse projects built in the 1920s and the 1930s, here and in Canada, that show us this.

In fact, the whole "slum" syndrome may be born of suburban xenophobia. And that's a major problem for smaller dwelling units for lower-income families.

Because our new suburban cities are afraid of crime, drugs, low-income families and things it associates with high density, the particular brand of politics found in most suburban areas is one of maintaining a mythical status quo of the recent past. Keep out anybody who wants to come in who is not already there. The only political success to be gained in local government in the suburbs is to appeal to the wishes and feelings of secure suburbanites.

There are plenty of experts who will tell you that cities as we know them today are doomed because so great a part of many cities is a waste land. It is very probably the inability of a rural culture to cope with urban life that leads to the creation of pockets of desolation right within the center of big and thriving cities.

Mayor John Lindsay at the NATO Countries Cities Conference in Indianapolis last month said: "Recently, I toured the Brownsville section of my own city with a group of twelve other big-city mayors. Seeing the empty shells of abandoned buildings and the ruins of a once thriving community of 170,000 people, the Mayor of Seattle, Wes Uhlman, said to me: 'God, it looks like Dresden after World War II.' I could not help but think that if it were Dresden, it would have long since been rebuilt with substantial American support."

What Mayor Lindsay did not say was how much had already been done in Brownsville. According to New York City's Citizens' Housing and Planning Council, some 35,000 to 40,000 people in Brownsville are living in publicly-aided housing and in the last twenty years about $145 million worth of public housing alone (over 8,500 units) has been built there.

Brownsville will continue to erode no matter how much money is spent. The desolation of Brownsville is due mostly to the displaced rural population which came to that inexpensive area of New York City in the last 20 and 30 years, a population unable to cope with the urban condition. No matter how much money may be poured into Brownsville, the hard cultural problems created by that massive dislocation of once-rural population must be treated first. We have handled alien cultural problems before with big Federal sums, why not our own.

Let me quote from the introduction to the Douglas Commission (National Commission on Urban Problems) report: "Our failure to assimilate the non-white slumdweller into the larger society is particularly shocking in light of the fact that we recognize the problems of assimilation for another group of people: Cubans entering the U.S. are provided—by the Department of Health, Education and Welfare—medical and psychiatric services, family counseling services, employment counseling services, plus financial assistance. For them, welfare is a national program. For poor American citizens, it is still a state by state or local matter. Before the refugee family moves North, East or West, efforts to locate jobs, housing, and neighborhood contacts are worked out by the staff of HEW's Cuban refugee programs. For the poor American family, few such services are provided.

"The accomplishments of this program for Cubans are outstanding and indicate what can be done once the nation commits itself to solving a specific problem. The uneducated and unskilled American rural migrant family needs even greater help than the typical Cuban refugee who arrives here with a good education and with job skills. Yet no institution responds to the massive migration of native rural families moving North, East and West from the South."

Brownsville's problems are not confined just to center city either, they are in the suburbs, too. Westchester County in New York has long been thought of as the epitome of all suburban counties: one in which everybody has money, lives in nice colonial houses, belongs to the country club, and commutes into the city. The fact is that the county budget in Westchester has a welfare role that eats up $150 million a year out of a total budget of $181 million. There are 50,000 people on welfare in Westchester and the number is growing by 1,400 a month.

Obviously, zoning has been and will still be the biggest problem for smaller dwelling units. Suburbs will fight low-income housing like crazy. Althou h the Attorney General has gone after Blackjack, Mo., and a bunch of other blatant cases of racial discrimination in low-income housing, there is no sign that any particular suburban area is ready to roll over and play dead on the issue. Almost every suburb can and will attempt to show that their racial bias is really an economic bias in favor of the municipal exchequer.

They will try to keep out most low-income housing under the interpretation that Justice Black put on the California referendum case. Even if they don't win their cases, the suburbs will be able to stall lower-income housing in the suburbs and therefore stall a lot of starts under various subsidy programs.

However, easily as important as the low-income housing problem is to most of us, just as important is the fact that exclusionary zoning zones our children out of most desirable suburbs. They can't afford to live out there, either. For a long time the biggest cost booster of housing has been zoning and subdivision regulations. Obviously, the insistence on big parcels of ground and broad, heavily engineered improvements, like roads, add to costs.

Density control by zoning ordinance is a fraud. Zoning was originally designed to keep people out. Perhaps we ought to send all of the city fathers and all Federal and Supreme Court Justices down to Houston to take a look at a city where there is no zoning. In Houston, urban growth is principally controlled by economic forces in the marketplace and secondarily through restrictive covenants in various subdivisions and a relatively limited number of land use ordinances adopted by the city. And Houston has no worse land use patterns than any zoned city in the country.

I think the best quotes on zoning and Houston's lack of it were made by Bernard H. Siegan, a Chicago attorney, in a speech in May: "Zoning gives control over the use of land to a strange combination of politicians, planners, owners, courts, citizens, do-gooders, do-badders, etc. As a result, forces are controlling land uses that have virtually no relationship to maximizing production, satisfying consumer demand, maintaining property rights and values, or planning soundly."

The whole body of zoning law should be in question. Zoning is a "police power" regulation, which each state has to legislate for the health, safety, morals and general welfare of its citizens. But it is only really a recent power and its legal roots are very questionable to a lot of us.

First zoning in this country was enacted in New York City in 1916. It set a pattern that has been the raison d'etre of zoning ever since: that original zoning was designed to prohibit loft-building industry from moving north of 14th Street up into the retailing districts along Fifth Avenue. That first zoning system left property entirely in private hands while regulating its use in the interest of the general public. Zoning simply codified development that was already there.

Then, in 1926 in the case of the City of Euclid v. Ambler, the Supreme Court tried its first and last zoning case, which held that cities and towns could determine, in the public interest, land use and densities of privately-held land. Almost all original zoning ordinances, adopted shortly after the Supreme Court decision in 1926, ignored real planning, just codified what was already in town.

Is zoning the dead hand of the past? From its beginnings in 1916 zoning did nothing to improve the urban plant, it simply provided legal sanctions for continuing to do what people were already doing. There was almost always a good economic rationale for a particular land use, and so zoning became a codification of economic imperatives. And what kind of a legal foundation is that?

Then, too, in the United States we developed from Colonial times our version of each man with his own land and manse set prominently upon it. And the owner of a lot was and is dependent on his neighbors for his environment. We traditionally used yards rather than walls as dividers between properties.

It was reasonable, therefore, that zoning's objectives became protection of the single-family home, as well as protection of the free marketplace. As lawyer Dick Babcock writes: "The first requires that government take positive action, and the second demands that government refuse to take positive action." Obviously a contradiction.

What kind of law is it that one can break with impunity? The legal foundation of zoning is further weakened, in my judgment, by the fact that it is the only body of law you can get the right to break: primarily by "re-zoning", the changing of use designations through political clout, and to a minor degree by variances. These actions permit rape and murder of the cityscape under zoning. One can't find anything like it in any body of Anglo-Saxon law.

Most of our laws affect everyone in nearly the same way. But a re-zoning is a special permit to break the law. So zoning laws differ from most other police regulations in a very fundamental respect a zoning ordinance affects property owners, or groups of property owners, in many ways, almost all of them economic.

Based as it is on the police power, zoning must be justified as protecting health, safety, morals and general welfare. It usually can be shown that it does this in keeping industrial and commercial areas out of residential areas. But does this justification ring true at all in controlling residential density? Hardly.

Most density control is defended as a fiscal necessity. Heavy financial burdens of local governments, and their struggles to meet expenditure needs through the property tax, result in "fiscal zoning". That means let in only those who can afford big lots and big property tax because most cities and towns live on the edge of bankruptcy. The relatively low tax revenues obtainable from lower income housing will add to the community's fiscal strain. But this is only true where housing must be subsidized through tax abatement.

On the other hand, municipal expenses per dwelling unit in multifamily housing are usually not as great as the burden of single-family, detached housing. Costs per unit of police, fire, water, sewer, road maintenance, all other environmental maintenance and protection costs, even the provision of parking on city-owned land, are cheaper in multifamily.

The fact is that more and more suburban municipalities can no longer afford the luxury of large lot single-families.

Chairman PROXMIRE. Thank you very much, Mr. O'Neill.

Our last witness is Professor Swan.

STATEMENT OF CRAIG SWAN, ASSISTANT PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. SWAN. Mr. Chairman and members of the committee, housing has been the one bright spot in an otherwise bleak economy. From January to December of 1970 the unemployment rate rose from 3.9 to 6.2 percent on a seasonally adjusted basis. Prices continued to rise at a rate of about 5 percent for the year, and real output actually declined. During the same period total private housing starts almost doubled, rising from an annual rate of 1,059,000 units to a rate of 2,054,000 units. In fact, housing starts in December 1970 were at their highest rate since mid-1950.

For the first half of this year housing starts have remained at historically high levels, at an annual rate of almost 1,880,000 starts as compared with a rate of 1,433,000 for the year 1970. The immediate outlook for housing starts, for the last half of this year and the third quarter in particular, is quite favorable. Because of lags in behavior the major factors influencing the level of starts for the third quarter are for the most part, already determined. Actual levels of housing starts next spring will depend crucially on current decisions with respect to monetary policy. A sharp escalation of interest rates now will moderate housing activity in the fourth quarter of this year and could lead to a repeat performance of the 1966 and 1969 experience next year. Since the major focus of these hearings is on appropriate conduct for monetary policy, it is appropriate to first review the evidence from the sixties documenting the impact of monetary policy on housing activity.

It is not surprising that monetary policy has such pronounced effects on housing starts as the purchase of a house has numerous characteristics which make it quite sensitive to changes in credit conditions: A large proportion of all purchases use mortgage credit, a large proportion of each purchase is financed with mortgage credit, and borrowers have few if any alternative sources to borrow from. A Federal Reserve study has estimated that 95 percent of new single-family housing units sold make use of mortgage financing with mortgages averaging 88 percent of the purchase price.

Besides relying heavily on mortgage financing to make their purchases, home buyers are relatively restricted on the source of mortgage financing. Unlike other borrowers who often have recourse to capital markets directly as well as financial institutions, home buyers are, by and large, limited to the traditional mortgage lenders, commercial banks, life insurance companies and the two major savings institutions, mutual savings banks and savings and loan associations. When funds are not available from those lenders there are few alternative sources the prospective homeowner can turn to. Large scale purchases of mortgages by the Federal National Mortgage Association are relatively recent and helped to moderate, but did not eliminate, the decline in housing starts in 1969.

It is also interesting to note that with new financing developments, multifamily starts showed more strength in 1969 than in 1966. In 1966 multifamily starts accounted for 40 percent of the decline in starts while accounting for only 34 percent of total starts before the decline. In 1969 while initially accounting for an even larger proportion of starts, 42 percent, multifamily starts counted for only 31 percent of the decline in starts. Part of the explanation for smaller decline of multifamily starts in 1969 is the development of equity kickers, an arrangement by which the lender gets not only the return on his mortgage but also participates in the profits of the project.

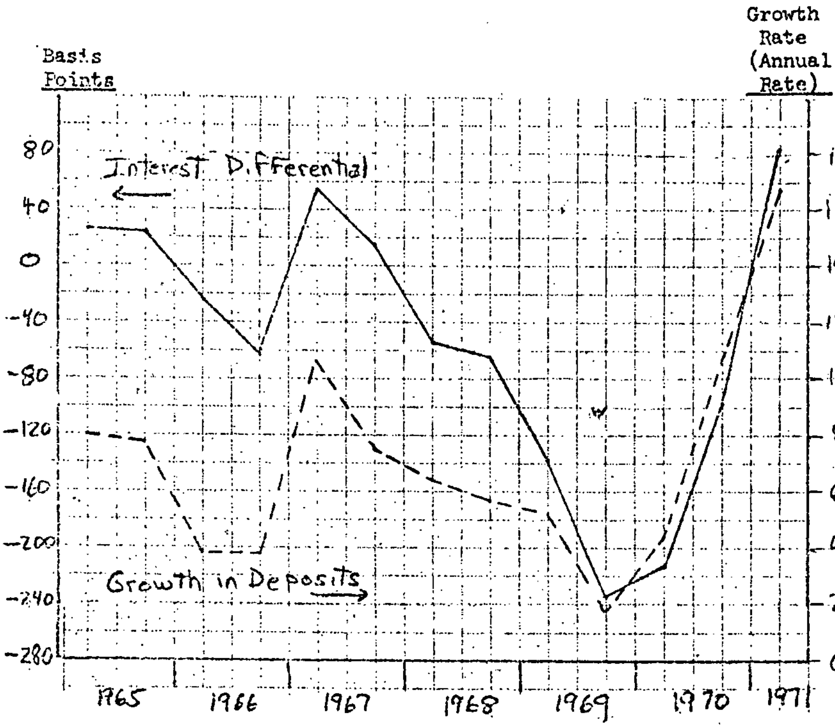
The importance of the four traditional mortgage lenders as a source of mortgage funds can be seen in the fact from 1960 to 1970 they supplied 83 percent of the increase in residential mortgages. Of primary importance among the four traditional lenders are mutual savings banks and savings and loan associations. Both institutions specialize in mortgage lending, turning deposits into mortgages, almost dollar for dollar. From 1960 through 1970 increased deposits at both institutions of $128.7 billion were accompanied by increased mortgage holdings of $130.4 billion. Among the traditional lenders, the two savings institutions hold 68 percent of all residential mortgages. From 1965 to 1970 they accounted for 71 percent of increased mortgage holdings by the traditional lenders.

Rising interest rates effect housing starts by their influence on home buyers and by their influence on the availability of mortgage credit. Rising interest rates raise the cost of homeownership and induce individuals to postpone the purchase of a house. Rising interest rates on market securities make them more attractive assets to savers and lead to reduced savings flows to the savings institutions with a consequent drop in the availability of mortgage funds. Finally, rising interest rates are usually associated with relative yield spreads that favor other securities over mortgages, leading those institutions with portfolio flexibility to allocate funds away from mortgages to other higher yielding assets. During the sixties the effect of rising interest rates on savings flows to the savings institution with the associated drop of mortgage funds has had a major impact on housing activity.

As can be seen in figures 1, 2, and table 1, monetary policy, through its impact on interest rates, has strong and direct effects on the flow of deposits to mutual savings banks and savings and loan associations. As market yields rise above the yield on savings deposits, individuals respond by reducing the flow of funds into the savings institution and instead accumulate higher yielding market securities.

(The figures and table referred to above follow:)

Figure 1. Interest Rate Differential and the Growth in Deposits at Savings Institutions, 1965-1971.



Notes:

Interest Differential: Difference between new issues yield on three month Treasury bills and the average yield on deposits at savings and loan associations and mutual savings banks.

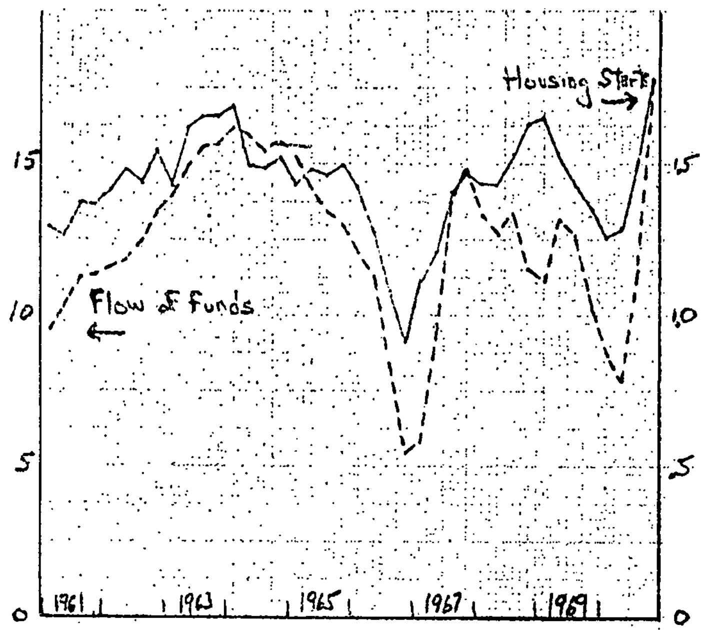
Growth in Deposits: Savings in flows at mutual savings banks and savings and loan associations as per cent of initial deposits. Annual Rate.

Sources: Treasury Bill Rate: Business Statistics, 1969 and Economic Indicators, various issues.
Yield on Savings Deposits: Saving and Loan Fact Book, 1970, U.S. Savings and Loan League.
Deposits: Federal Reserve, flow of funds.
Savings in flows for 1971 and deposit yields for 1970 and 1971 are author's estimates.

Figure 2. The Flow of Funds to Savings Institutions and Housing Starts 1961-1970.

billions of dollars

millions of units



Notes and Sources:

Flow of funds: Weighted average of past deposit inflows and Federal Home Loan bank advances at mutual savings banks and savings and loan associations. For more detail and sources see Craig Swan, "Homebuilding: A Review of Experience," Brookings Papers on Economic Activity, 1970:I.

Housing Starts: Business Statistics 1969; and Construction Review, various issues.

TABLE 1.—ALLOCATION OF INCREASES IN NONCONTRACTUAL, NONEQUITY ASSETS BY HOUSEHOLDS, 1960–70[1]

[In percent]

	Demands deposits and currency	Savings accounts: Commercial banks	Savings accounts: Savings institutions	Credit market instruments	Other assets
Year:					
1960	−7	17	57	30	3
1961	5	28	51	13	3
1962	10	37	47	4	2
1963	17	24	45	13	1
1964	17	23	44	13	3
1965	18	33	33	13	3
1966	9	31	21	36	3
1967	22	35	34	4	5
1968	20	28	23	24	5
1969	14	13	19	52	2
1970	7	32	33	23	5

[1] Noncontractual, nonequity assets of households are measured as total financial assets minus investment company shares, other corporate shares, life insurance reserves and pension fund reserves.

Source: Flow of Funds Accounts: Financial Assets and Liabilities Outstanding, 1959–70, Division of Research and Statistics, Board of Governors of the Federal Reserve System, May 4, 1971.

Mr. SWAN. During the early sixties households allocated most of their noncontractual. nonequity savings to commercial banks and the savings institutions. They accumulated only small amounts of market securities, averaging only $3.8 billion a year or 14 percent of noncontractual, nonequity savings. Commercial banks and savings institutions accounted for 73 percent of these savings, or $10.5 billion a year.

In 1966 as market rates rose, households responded by reducing the flow of deposits to savings institutions and purchasing instead large numbers of market securities. In 1967, as market rates declined, savings flows to the savings institutions revived. However, as rates rose through 1968 and again in 1969, households responded by reducing their accumulation of low yielding savings deposits and increasing their accumulation of market securities to a rate 4½ times higher than that of the early sixties. Through 1970, savings flows again picked up. responding to the drop in market interest rates over the year.

Fluctuations in the flow of savings to mutual savings banks and savings and loan associations have been mirrored, with appropriate lags, in the fluctuations of housing starts. In 1966 as the flow of funds to the savings institutions dropped abruptly, housing starts declined dramatically. As savings flows revived, so did the level of housing starts. Again in 1969 as the flow of funds declined, housing starts again turned down. When savings flows turned up so did the level of housing starts.

That the decline in starts in 1969 was not as severe relative to the decline in savings flows and the rise in interest rates is due to several reasons. Advances from the Federal home loan banks to savings and loan associations offset some of the decline in savings flows. Advances for the year totaled $4 billion. During 1969 the Federal National Mortgage Association (FNMA) also took effective action to maintain the flow of funds to the mortgage market. By the fourth quarter of 1969, FNMA was accumulating mortgages at an annual rate of $6.6 billion; FNMA was then providing 35 percent of residential mortgage funds.

The drop in market interest rates, with the associated revival in savings flows and drop in mortgage rates, have been major factors in the recent dramatic upswing in housing activity. Continued low vacancy rates and high rates of household formation are indicative of the strong underlying demand for houses. With the freeing of financial restraints during 1970 the result was a substantial increase in housing starts.

These factors have continued to be favorable for housing starts during the first half of 1971. Demand continues strong; vacancy rates are still at low levels and the rate of household formation continues at high rates. Savings flows to the savings institutions during the first half of 1971 have been at unprecedented rates. These savings flows, along with continued high demand, will support high levels of housing activity in the last half of the year. It is ont inconceivable that starts could reach an annual rate of 2 million units in the third quarter.

The outlook for housing next year is subject to more uncertainty than the short-term outlook, but will depend critically on the stance of monetary policy during the last half of this year. Several factors responsible for the current high level of housing activity are of a transitory nature and cannot be expected to have a continuing influence on housing starts. Even if interest rate differentials do not move adversely, the flow of savings to thrift institutions cannot be expected to remain at the high rates observed in the first half of this year. The savings rate is extremely high and may decline. Part of the inflow of savings appears to arise from a reallocation of the stock of financial assets by households away from lower yielding market instruments, specifically Government securities, to higher yielding deposits. Continuing inflows of savings must come from the flow of household savings and cannot be expected to match the rates of the first half of this year. Pressures to restore vacancy rates to more normal levels may also be of a transitory nature. If current high rates of homebuilding allow vacancy rates to return to more traditional levels, then this source of housing demand will be satisfied.

Taking these transitory factors into account and assuming monetary policy holds interest rates at current levels, the outlook for housing next year is for a continuing high level of starts. However, should monetary policy tighten and precipitate another sharp rise in interest rates, the results for housing will be all too familiar and predictable. As market rates rise, savings flows to mutual savings banks and savings and loan associations will decline, leading to a drop in the availability of mortgage credit and a consequent decline in housing starts. Such an escalation of rates would depress the one booming sector in the economy and further postpone the recovery to full employment.

Chairman PROXMIRE. Thank you very much, Mr. Swan.

Mr. Cagan, it is hard for me to understand your target of a growth in real GNP of 3 to 3.5 percent for the 2-year period since the business peak of 1969. If we make any realistic assumptions at all of the growth of the labor force and certainly as to increases in productivity, that this would result in no reduction in unemployment: None, and as a matter of fact, perhaps an increase in unemployment.

Mr. CAGAN. No; the figures assume an increase in productivity and the labor force.

Chairman PROXMIRE. Let's take both of those. What increase do you assume in the labor force during this period?

Mr. CAGAN. The trend rate of growth of about 1.7 percent per year.

Chairman PROXMIRE. And what increase do you assume——

Mr. CAGAN. The median increase in productivity that occurred during previous cyclical recoveries. It is around 4 percent.

Chairman PROXMIRE. If you put those together, if you have a 1.7 percent increase in the work force, and productivity is increasing at 4 percent, doesn't that mean if your growth is 3 or 3.5 percent you have larger unemployment?

Mr. CAGAN. You have to take into account the change in hours.

Chairman PROXMIRE. Well, the changes in hours would make it even worse—the hours now are still far below normal. They are around 38, 38 and a fraction, which is quite low. The recovery, as it proceeds, the hours get longer, and that should aggravate this situation further.

Mr. CAGAN. I will send you the information which shows the calculations. I am sorry that I do not have them with me to give you the details now.

(The following information was subsequently supplied for the record:)

DERIVATION OF TARGET GROWTH IN REAL GNP FOR 1971

Earlier this year I made a study of recoveries from previous business recessions (published in *The Commercial and Financial Chronicle*, May 6, 1971). I examined the first year of recovery for the three previous recessions since World War II to see what typically happens to the components of GNP growth. (I excluded 1949 because its recovery was atypical with the outbreak of the Korean War.) These previous cycles indicate what is likely for a recovery from this latest recession which the National Bureau of Economic Research dates from a peak in November 1969 to a trough in November 1970. The end of the first year of recovery will be next November. The previous three recessions were deeper than this last one, and the speed of recovery depends upon the depth of the contraction. To allow for this dependence, I measured GNP growth from the cyclical peak to the end of the first year of recovery, combining the contraction and recovery period together. This brings out the similarity among these mild cycles. I estimated that a growth in real GNP of 3.5 percent per year for the *two-year* period since the business peak in the fourth quarter of 1969 would be consistent with the experience of past cycles and would also reduce unemployment to 5 percent and inflation to under 4 percent by the end of the year.

These figures were derived in my study as follows: Growth in real GNP can be expressed in terms of the labor supplied and its productivity; total growth is the sum of the percentage changes in real GNP per manhour, hours per worker, labor force, and the change in the unemployment rate. Let us take each in turn.

The median growth in real GNP per manhour for the three previous recessions was 3.4 percent per year, from the cyclical peak to the end of the first year of recovery. For hours per worker, the figure was —0.4 percent. These figures pertain to the private sector. Government workers are treated in the national income accounts as having little change in productivity, and they comprised 16 percent of those employed in 1970. If in addition their hours remain unchanged, we should reduce both figures by 16 percent.

For the labor force, projections of the Manpower Commission give an average growth of 1.7 percent per year between 1970 and 1975; this could be higher in a recovery year, but not by much.

Finally, for unemployment, I take a target of 5 percent for the end of this year as probably what policymakers would like to achieve, if they can. That still means a two-year increase of 1.4 percentage points measured from the 1969 peak of 3.6 percent, or a rise of 0.7 per year.

Adding up these components of real GNP, we arrive at an increase of 3.5 percent per year (or 7 percent in total for the two years together). Of course, if productivity or hours grow faster than this projection assumes, either real GNP will grow more or unemployment will end up higher.

The 3.5-percent target growth in real GNP can be translated into a growth in dollar GNP by adding the actual rise in prices in 1970, which was 5.3 percent, and the target rise for 1971 of 4 percent. The implied two-year growth in dollar GNP is 8.3 percent per year.

GROWTH IN REAL GNP

(Percent change per year since cyclical peak)

In summary:

Real GNP per Manhour (median) (Priv. sect.) 3.4 (1—.16) plus Hours per Worker (median) (Priv. sect.) —0.4 (1—.16) plus Labor Force (Projected) +1.7 minus Unemployment Rate (Target: 5% end of 1971) 0.7 equals Real GNP, 3.5%.

GROWTH IN DOLLAR GNP

Real (target) $(1.035)^2$. Prices: 1970 (actual) (1.053). 1971 (target) (1.05) equals 8.3% per year.

Chairman PROXMIRE. I would like to see all of those assumptions, increase in the work force, productivity, and the very important item that you suggest, of the probable increase in hours of work. It has been my conclusion that unless we have a substantially greater growth rate than 3 or 3.5 percent, we are going to be in serious trouble with rising unemployment.

Mr. CAGAN. I don't think that is the case.

Chairman PROXMIRE. Mr. Minsky, you implied that the financial structure of business is in danger. I think it is a very interesting statement that you present; that all of you gentlemen present. Your statement emphasized something that has not come to our attention. You say the excessive indebtedness may lead to cutbacks in investments. None of the previous witnesses before this committee have stressed that. What historic evidence do you have that the financial structure problem has caused a setback in the economy?

Mr. MINSKY. Well, the historical evidence which goes back to the interwar period, is that you have the same type of building up of liability structures and decreases in liquidity throughout the interwar period. That was documented in my study for the Commission on Money and Credit. Over the postwar period, we have the flow of funds data. The numbers are in the flow of funds data. We had one slight episode during the Eisenhower administration where this type of deficit financing by the corporate sector. We had another episode leading up to 1966 and a third episode leading up to 1970; the crunch and the squeeze.

What we have had—and Professor Cagan documented part of it—is the continuous rise in velocity over the postwar period. But the other side of the rise in velocity is people and corporations squeezing their portfolios. Corporations hold less cash and more substitute assets relative to their volume of activity.

My own view is that the thing that happens when you have a large boom, such as you had in 1968, 1969, and 1970, is that the economy becomes, as I called it, euphoric. At such times, we get our Jimmy Lings, with their asset redeployment, which is really putting out new debt, to take over other corporations. You have, on the margin, businessmen willing to finance increasing investments by heavier debt burdens. The stock market feeds back, by the rise in the stock market, giving implicitly greater value to the corporation, making them willing on the margin to invest by issuing more debt.

Yesterday in the Wall Street Journal, there was an article on the back page dealing with the current steel negotiations. In that article they emphasized, if I recall correctly, how the steel companies, debt ratio meant that they couldn't take a strike.

Chairman PROXMIRE. I noticed that article.

Mr. MINSKY. This is just another facet of what I am talking about, that you now have these cash flows due to debt, which constrain what you are going to do in the future.

As an example of what happened, the expectations in the airline industry of the 12-percent growth without limit led them to pile in these orders for new planes. And I made the comment at that time, when we had this great boom in chicken franchise shops, that the only way in which we could make both sets of investments pan out was if most of us spent most of our time flying, eating fried chicken.

You had these investment overshoots. But these are heavily debt financed. When profits didn't react, this became a burden, the burden which constrains the steel corporations now. Obviously, they are going to react in the future by attempting to cut their debt ratios, to decrease their breakeven point in operations, to increase their profit margin relative to out-of-pocket costs. And they will use—and in recessions historically, people have used——

Chairman PROXMIRE. Have you done some specific work with respect to the aircraft manufacturing airline area?

Mr. MINSKY. No; I have not. It is just common knowledge. I think you have been giving us a good deal of our information about that.

Chairman PROXMIRE. I just understood you had some opinions that were based on your work, opinions in Lockheed.

Mr. MINSKY. What?

Chairman PROXMIRE. Based on your recent work, I thought you might have opinions.

Mr. MINSKY. I have opinions on the Lockheed situation. I suppose everybody does.

Chairman PROXMIRE. If they are not relevant we had better move on over to some other things.

Mr. MINSKY. But in previous recessions, there was more evidence of cleaning up balance sheets than in this current recession, so that when you are thinking about the expansion, it is starting with sloppier balance sheets than earlier.

Chairman PROXMIRE. Business has been engaged in a record expansion of long-term debt this year, and in large part to refinance short-term liabilities. Do you consider this a good sign, that basic liquidity is improved?

Mr. MINSKY. That is one of my explanations for the sustained high interest rates. It is a good thing—but there is something which has to be pointed out. The present pace of investment means that they need $20 billion of deficit financing by current investment and it is only what they do in addition to that $20 billion that actually improves their balance sheets. And, of course, a good deal of what is happening is in the way of almost "bail-outs." This is what is happening with TWA going into the market for equity financing yesterday, or is it today. It is a poor balance sheet which is going in and trying to be bailed out by a new issue of equity. This is taking place at a very high price in terms of the proportion of the total equity, for——

Chairman PROXMIRE. For the disastrous years of losses?

Mr. MINSKY. Yes; and this means that they are not going to be in as good a position, or eager, to require new equipment and new facilities. So, I think, we are going to see a period of slack, for example, in airline orders.

Chairman PROXMIRE. That is very interesting and very relevant to what we are going to take up in a few minutes.

Mr. O'Neill, this was a very interesting conclusion you made on the size factor of housing. Frankly, I am ranking member of the Housing Subcommittee in the Senate and I have not had this called to my attention as vividly and dramatically as you did. What you are saying is if we want to reduce the cost of housing, it is the size of the housing. You are not talking about going to mobile homes. As a matter of fact, you have a dramatic statement where you say:

> Obviously, a careful statistical analysis of living expense can be made in favor of either mobiles or code-conforming dwelling units. Most observers, with no axe to grind, would settle for the generality that it costs a family as much to live in a mobile home, in a mobile home park, including the purchase price of the mobile, as it would cost them to buy and live in a new home costing two to three times as much.

You go on to add, "Furthermore, the realty would appreciate over time, while the mobile home would depreciate to zero value." So the 15 years after you bought the home it is worth more, not less, whereas 15 years after you bought the mobile home, it is worthless.

Mr. O'NEILL. Correct.

Chairman PROXMIRE. That is a factor that has not been brought up. Again and again HUD comes before our Housing Committee and says you have to recognize the great job we are doing for people by encouraging mobile homes. This is a very promising development, and I think it is an alternative that we should recognize. But at the same time, you point out the liability as far as the family is concerned. They have to pay more, considering what they get, and they end up with nothing instead of a home that has appreciated in value.

Could you give us your views on how well the President's effort to bring construction wages and price increases under control are working?

Mr. O'NEILL. I believe, Mr. Chairman, that the Construction Industry Stabilization Committee has some effect, but I think it is minor. I think the greatest effect on the recent dropoff in construction increases from, let us say, 16-percent increases last year to about 10 percent in this first half, is due more to unemployment and the fear of more unemployment in the construction industry than it is to any jawboning effect of the Construction Industry Stabilization Committee.

In our industry, which is a subcontract industry, subcontractors do not respond, nor do their journeymen, to jawboning. In other words, if an owner of an apartment project has to get the project finished to get his cash flow going by, say, October 1, he will pay double time or anything else he has to pay to get the job finished. But the construction industry finds unemployment running between 12 and 18 percent in different parts of the country and this has finally begun to spook the rank and file. In fact, they are beginning to realize that many of them have placed themselves out of certain markets where construction just stops, even commercial construction, and moves into areas where there are nonunion journeymen available, men who will in time become their own entrepreneurs or subcontractors, if you please, and are not interested in pricing themselves out of the market.

CISC does have some effect but I think it is very minimal. I think the rank and file sees the handwriting on the wall, they can go so far and then they pass beyond economic feasibility for the housing sector or even the building sector to use their services in certain geographic areas, and construction stops.

Chairman PROXMIRE. What you are saying, the economic factors are directing this rather than any particular policies of the administration?

Mr. O'NEILL. I think the construction industry wage rates particularly are highly economically determined, that they in fact do not respond very well to jawboning at all.

Now, that isn't to say they might respond a lot better and quickly to wage and price controls. They might. But you cannot put that just on the construction industry and not on the rest of the economy, because the price of materials in the construction industry would have to be priced the same for all other industries.

Chairman PROXMIRE. Taking a longer-run view, what steps should be taken to improve the structure of the construction industry or bring down the cost of housing?

Mr. O'NEILL. I am not sure we can bring down the cost of housing at all as long as the specification remains that it last the life of mortgages, that it provide all of the goodies we all expect of housing, and that it not erode the municipal tax base. I do not think there is any cheap way around that, except the reduction in size and land use, or allocation of shared land.

Chairman PROXMIRE. The European experience has been to build smaller homes on smaller lots; is that right?

Mr. O'NEILL. Yes; and with much lower level of amenity. That is where the economy rises. Not as many appliances, not as many fixtures, and not as good finish and hardware——

Chairman PROXMIRE. We can have the amenities, I take it from your statement, the amenities that most Americans now expect and require, with a far less expensive house, provided we reduced it in size?

Mr. O'NEILL. Right. We can do that and we can also lower the level of amenity. What we have done historically, or newcomers have done, is to concentrate on the shell of the unit. And the shell of the unit is only about 20 percent of the first price of the unit and in a typical situation to a buyer. Whether it is high rise or lower. If you build a high-rise structure and plug into it modules, the shell of the modules still would come in at less than 20 percent of the first price of a high-rise condominium unit to a buyer. When you concentrate on putting that on the assembly line and change the production system for just the shell, you might cut its price 15 percent, which then gives us a

3-percent cut in the price of the dwelling unit. But the monthly housing expense is over the double amortization of a mortgage, so there you have cut your 3-percent saving effect into 1.5 percent in a month, and inflation wipes that out.

Chairman PROXMIRE. It is beyond me why HUD and none of those many people interested in housing studied the size of housing—how big the bedroom should be, the living room, and so forth.

This gentleman over here, my administrative assistant, Howard Shuman, as you know, had a lot to do with the Douglas Commission report. You referred to that report. He said you had a most imaginative and interesting suggestion. Maybe it is not practical, but, at the same time, we certainly ought to consider it.

In automobiles, we find except for the foreign imports, which has made a big difference, we would still be probably with the enormous cars, weighing far more than they have to and costing far more than they should, and far too expensive to drive, for no very good reason.

Mr. O'NEILL. If you look at garden apartments and efficiency apartments, the way we house a lot of households in high-density areas, they are very small units. They are much smaller generally than single-family houses. So the size factor is important, very important.

One of the reasons why HUD sometimes misses some of these points is that the housing business is a most complex business and there is no easy way to approach it to know everything about it in nothing flat.

Chairman PROXMIRE. Before I leave, I would like to ask Mr. Swan, a question. As I understand your statement, Mr. Swan, you think the number of housing starts for the rest of this year will remain about where they are now, at a fairly high level and perhaps rising a bit to 2 million units. This also means, does it not, the level of housing starts will not be increasing significantly, will not be the same contribution to the overall level of economic growth, which there was last year when housing starts increased greatly by a half million? Is that correct?

Mr. SWAN. That would seem to be true, although looking only at starts is a bit misleading as measure of the impact of housing activity on employment and general economic activity. Starts measure when construction is initiated. The impact on employment and income comes as construction actually takes place and that occurs with a lag after starts. For example, even though there was a large runup in starts in 1970, the rate of new construction in 1970 was not much different than in 1969.

Chairman PROXMIRE. For 1972 the outlook might stay at about the present level but if interest rates rise and money tightens, there should be a sharp decline?

Mr. SWAN. Right.

Chairman PROXMIRE. What conditions would it take to keep the level of housing starts rising? My amendment in 1968 provided for a goal of 26 million in 10 years and we all know that goal is not being reached by a long shot. We want to get on 2.6 million housing starts very soon. We are reaching the half-way point in that decade.

Mr. SWAN. It is not so clear—I have not seen the President's third report, but if you look at the "President's Second Report on Housing

Goals" and if you count a mobile home as a housing start, it appears we are not so far off your goal. It should be remembered that a significant proportion of those 26 million starts included mobile homes.

Chairman PROXMIRE. I asked what you expected and you seemed to indicate that there wouldn't be much increase this year and we might have a drop next year.

Mr. SWAN. I do not think there will be much of a drop next year. Continued growth in the economy would in fact mean normal growth in savings and that would lead to some increase in housing starts. I do not have a long-range projection, although if credit conditions do not tighten, say interest rates remain at their current level with perhaps a small decline in long-term rates, I do not feel the President's goals are impossible.

Chairman PROXMIRE. Unfortunately, gentlemen, I have to go to that rollcall. I have not missed one in 5 years. I do not want to start now.

Thank you very much. Tomorrow there will be a hearing. The committee will hear Chairman Burns of the Federal Reserve Board, in room 1202, New Senate Office Building.

(Whereupon, at 11:20 a.m., the committee was adjourned, to reconvene at 10 a.m., Friday, July 23, 1971.)

THE 1971 MIDYEAR REVIEW OF THE ECONOMY

FRIDAY, JULY 23, 1971

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

The committee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Bentsen, and Javits; and Representative Conable.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Bander, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today we conclude our hearings on the midyear review of the economy as we hear from one of the most illustrious economists and public servants of our times, Mr. Arthur Burns. As Chairman of the Board of Governors of the Federal Reserve System, he carries a tremendous burden in setting monetary policy in these times when it appears that nothing seems to be working right—an engineered recession to get inflation under control but which failed to curb inflation and caused a rise of unemployment to an intolerably high level of 6 percent of the civilian labor force.

As a matter of fact, it is my understanding that this morning the CPI disclosed a rise in the cost of living at an annual rate of 6 percent which indicates once again that there is not much evidence that inflation is getting under control.

And yet, only a few days ago, the newly designated chief economic spokesman for the administration offers more of the same policies which have utterly failed in their stated objectives. The only program to which the administration referred at the start of the year which has been fully carried out—an expensive monetary policy—is the one over which the Executive had no control, since by law it is under the jurisdiction of Mr. Burns and the Federal Reserve Board.

I am sure Mr. Burns will provide us with a thoroughly competent analysis, not only in the area of monetary policy but in other major economic policy areas as well.

Mr. Burns, I may say that the private witnesses who have appeared before us in this midyear review have been almost unanimously pessimistic as to the outlook for the rest of this year and into 1972. As you can well imagine, proposed remedies for our unsatisfactory performance were varied. I hope that as a result of our discussion this morning, we shall be better able to establish some basic guidelines for Government actions to achieve in the near future a much more satisfactory performance.

Mr. Burns, please proceed in your own fashion. If you wish to summarize any part of your testimony, the complete statement will be printed in the record.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Burns. Thank you, Senator.

I am pleased to meet with you again today to report the views of the Board of Governors of the Federal Reserve System regarding the state of the economy at midyear.

Since I last appeared before this committee on February 19, it has become evident that a cyclical recovery of our economy has commenced. Indicators of future business activity, which were already rising in the latter part of 1970, have strengthened further. Comprehensive measures of current activity—such as the physical volume of industrial production, total employment, retail sales adjusted for price changes, and total real output of goods and services—have shown moderate improvement as the year has progressed. We are confident that this recovery process will continue and broaden in the months to come.

Nonetheless, some of the economic problems that have troubled us as a people over the recent past are still much in evidence. Large increases in wages and prices persist in the face of extensive unemployment of labor and capital. The international balance of payments remains unsatisfactory; indeed, our fragile export surplus has disappeared in recent months. In financial markets, interest rates are responding to fears of continued high rates of inflation by moving up again despite rapid monetary expansion. And while business profits have improved somewhat, they remain exceptionally low.

The cost-push inflation we are experiencing, and the widespread concern over continued rapid inflation, are a grave obstacle to the full economic improvement we all ardently seek. As long as inflation persists, consumers are likely to remain rather conservative in their spending plans, fearing the possibility of budgetary over-commitment. As long as inflation persists, businessmen are likely to remain cautious in their investment policies, apprehensive that profit margins may erode despite higher prices. As long as inflation persists, financial investors will remain reluctant to commit funds to long-term securities unless they are compensated by a higher interest rate. Expectations of inflation thus permeate the gamut of private decisions to spend and invest, and this is restraining the private efforts needed for vigorous and sustained economic recovery.

A year or two ago it was generally expected that extensive slack of resource use, such as we have been experiencing, would lead to significant moderation in the inflationary spiral. This has not happened, either here or abroad. The rules of economics are not working in quite the way they used to. Despite extensive unemployment in our country, wage rate increases have not moderated. Despite much idle industrial capacity, commodity prices continue to rise rapidly. And the experience of other industrial countries, particularly Canada and Great Britain, shouts warnings that even a long stretch of high and rising unemployment may not suffice to check the inflationary process.

I shall return to the causes and implications of this new rigidity in our economic structure at a later point. Let me turn first, however, to a brief review of economic developments during the first half of 1971, and to the supportive role that public policy has played—and will continue to play—in the evolving economic recovery.

RECENT ECONOMIC DEVELOPMENTS

The performance of the economy during the first half of 1971 is not easy to interpret because many crosscurrents are always present in the vicinity of a cyclical turning point. In addition, the rebound from the extended auto strike last fall, and the accumulation of steel inventories in anticipation of a possible strike this summer, have been distorting the underlying trend.

Abstracting from these transitory influences, the record of the first half of 1971 is one of gradual, but quickening, recovery. Late last year, only the construction industry exhibited significant strength, as the sharp recovery in residential building that began in the spring was joined by renewed expansion in the construction programs of State and local governments. Early this year consumer spending began to improve, with increases of sales spreading to a wide variety of consumer items. The sales of retailers other than automobile dealers rose at about a 10-percent annual rate in the second quarter—considerably more than normal and well above the rise in consumer goods prices. Recently, activity in our factories has also been stepped up, especially in consumer goods lines. The index of industrial production, adjusted to exclude autos and steel, rose at a 6-percent annual rate between March and June.

The improving trend of business is being supported by a faster rate of growth in personal incomes. During the 3 months from March through May, total personal income rose at an annual rate of 8 percent, compared with a 6 percent rate over the previous 6 months. Governmental transfer payments, which have been contributing to recent income growth, were particularly large during June when the retroactive increase in social security benefits was paid. The flow of private wage and salary payments has also quickened, in response to some gain in manhours worked as well as to continued large increases in wage rates. And while employers have not yet reentered the labor market for appreciable numbers of new employees, further business improvement should soon lead to faster employment growth also.

Inventory investment promises to supply an added source of economic impetus in the months ahead, after allowance for a probable rundown in steel stockpiles. Thus far in the recovery, there has been little accumulation of inventories, apart from the restocking by automobile dealers and strike-hedge buying by steel merchants and users. But with business sales rising, and the ratio of inventories to output and to sales declining in many lines, we are coming closer to the time when needs for larger inventories—of raw materials, work in process, and finished goods—will begin to express themselves. The adjustment of stocks to higher levels of activity will in turn generate further increases in output, employment, and incomes. This is a common element in cyclical recoveries, and I judge that we are approaching that point in the current recovery process.

There are grounds for concern, nonetheless, with regard to some features of the recovery now underway. First, there is little evidence as yet of any material strengthening in consumer or business confidence. Recent surveys of consumer attitudes show only modest improvement, while uneasiness appears to persist among many businessmen and investors regarding the effects of continuing rapid increases in labor costs on future profitability. Confidence is likely to strengthen with the passage of time. as sales and employment conditions improve. But there is a danger that hesitation and uncertainty will continue on an extensive scale until significant progress is made in moderating inflation. Greater success in the battle against inflation is probably the most important single prerequisite of more rapid and enduring economic expansion.

Second, our international competitive position appears to have deteriorated. In the first 5 months of 1971, imports spurted and our normal trade surplus vanished. This is a distressingly poor performance in an economy experiencing substantial underutilization of its resources of labor and capital. The problem is dramatized by the success of foreign manufacturers in capturing a rapidly expanding share of our automobile market. In the past 6 months, sales of foreign models have accounted for 16 percent of total U.S. sales and, in addition, close ot one-tenth of the American models sold were produced in Canada. It may be tempting to react to foreign competition by imposing added restrictions and quotas on imports, but such a policy would not serve our national interests. The constructive course is to bring inflation under control and to stimulate our businessmen to increase their penetration of the expanding markets abroad and to compete more effectively with foreign producers in our domestic markets. I would favor consideration of new Government incentives toward this end.

Third, there is as yet no evidence of resurgence in business capital spending programs. New orders for capital equipment show little—if any—recovery from the 1970 lows when allowance is made for rising prices. Construction contract footage for commercial and industrial buildings remains far below earlier highs. Official surveys of business spending plans for plant and equipment show no increase, even in dollar terms, for the remainder of this year. The hesitation in business investment may reflect the sizable amounts of unused capacity that presently exist. But it also results, I believe, from low business profits and uncertainty about the profit outlook. History indicates rather clearly that a vigorous, sustained economic recovery requires a strengthening trend in business capital investment.

We need to encourage business firms to undertake new capital investment; and I strongly supported, therefore, the liberalization of depreciation allowances recently adopted by the Treasury. I have also endorsed the general proposition that an investment tax credit be adopted permanently. At the moment, however, I am doubtful about the wisdom of restoring the investment tax credit—or of taking other stimulative fiscal actions—in view of the state of the Federal budget. In the fiscal year just ended, the budget deficit was in excess of $20 billion. It will remain very large in fiscal 1972. Many influential citizens in the business and financial community view this situation with alarm, so that these large budget deficits have become an important psychological factor contributing both to inflationary expectations and to high interest rates.

A large part of the budget deficit is, of course, attributable to the shortfall in tax receipts stemming from sluggishness in the economy. Some expenditures, notably on unemployment insurance and welfare, have risen for this same reason. Even taking these factors into account, however, the Federal budget is more stimulative now than a year or two ago. The President submitted in January a moderately expansive budget for fiscal 1972, and since then the net effect of congressional actions has been to make it more stimulative. Social security benefits have been liberalized, retroactive to the first of the year, and the scheduled increase in social security taxes postponed for a year. The public service employment bill has become law, and it appears probable that the military pay raise bill will be larger than the budget proposals. These and other actions, along with increases in the so-called uncontrollable items in the budget, as Chairman McCracken reported to you, have served to raise estimated expenditures $5 billion above those originally proposed for fiscal 1972, and to reduce estimated receipts by some $2 billion.

I would not want to rule out additional fiscal stimulus if the recovery in the economy should prove to be well below normal proportions, particularly if such a move were preceded or accompanied by a more effective incomes policy. But I would urge caution at the present time. Once confidence becomes stronger, we may find that there is enough fiscal stimulus already at work. And in any case, the fear of inflation is much too great, and its potential effect on private behavior too negative, to run the risk of taking new fiscal actions that would now seem imprudent.

MONETARY AND FINANCIAL DEVELOPMENTS

Let me turn next to monetary policy, and to the substantial contribution it has made to stimulating economic activity over the past year.

The shift toward monetary expansion early in 1970 was rather promptly followed by a resurgence in bank deposits and in the flow of funds to other financial intermediaries. As financial institutions rebuilt their liquidity, they became more eager lenders, the availability of credit increased greatly, and interest rates declined. As a result, housing starts rebounded and State and local government construction began to rise more briskly. More receptive credit markets also enabled our business corporations to issue new securities in record volume, thereby rebuilding their liquidity and putting themselves in a financial position to expand production and the capital investment that they may wish to carry forward later on.

Late last year, as this committee knows, there was a marked decline in the rate of expansion of the narrowly defined money supply—that is, currency plus demand deposits. In these circumstances, a brief period of more rapid expansion in the money supply to compensate for the fourth quarter shortfall seemed appropriate. The System, consequently, provided bank reserves liberally over the winter months, and interest rates—partly reflecting the increased supply of reserves—declined sharply further. Expansion of the narrowly defined money supply rose to a 9-percent annual rate during the first quarter of this year; but the average growth rate for the fourth and first quarters combined, being little more than 6 percent, remained very close to the earlier trend in 1970.

This March and April, the Federal Reserve System faced a dilemma. Information available at that time suggested that high rates of monetary growth might well persist under existing conditions in the money market. Interest rates, however, were already displaying a tendency to rise, and vigorous action to restrain monetary growth might have raised them sharply further. In view of the delicate state of the economic recovery, which was just getting underway, it seemed desirable to prevent the possible adverse effects of sharply higher interest rates on expenditure plans and public psychology. The Federal Open Market Committee decided, therefore, to move very cautiously toward restraining the growth of the monetary aggregates.

With the benefit of hindsight, I now feel that stronger action was warranted this spring. For, as matters turned out, we experienced even faster monetary growth in the second quarter than had been anticipated, while interest rates also moved substantially higher. Present estimates indicate that the narrowly defined money supply rose at an annual rate of 11 percent in the second quarter. However, growth in a more broadly defined money supply—that is, currency plus demand deposits, plus commercial bank time deposits other than large denomination CD's—receded from an annual rate of 18 percent in the first quarter to a rate of 13 percent in the next 3 months. It is worth noting also that bank credit expansion has been considerably more restrained than growth in any of the measures of the money supply. Total bank credit rose at a 12-percent annual rate during the first quarter and then dropped to a 7-percent rate in the second.

It may be that the recent high growth rates in money balances, besides being a lagged response to the lower interest rates of this past winter, reflect some of the uncertainties of the general public about the economic situation. To the extent that this is true, the inclination to hold unusually large money balances should subside as economic recovery becomes more evident. In any event, it is clear that recent monetary growth rates are higher than is necessary or desirable over any length of time to sustain healthy economic expansion. The Federal Reserve has, therefore, already taken some steps to reduce the growth rate of bank reserves and thereby promote a more moderate rate of monetary expansion.

These actions are partly responsible for the recent rise in interest rates—particularly interest rates on very short-term market securities.

But it should be kept carefully in mind that the rise in interest rates since March has occurred despite rapid rates of monetary growth and continuing large flows of savings funds to depository institutions. Factors other than monetary policy must therefore be primarily responsible for the upturn in interest rates this spring; they include, in addition to indications that a business recovery is developing, the prospect of very large Treasury financing needs, deepening concern about the unrelenting character of cost-push inflation, some apprehension over international financial developments, and not a little anticipatory borrowing in the capital market on top of that currently needed. The fear of inflation appears to have been especially important in the recent behavior of our money and capital markets, and a reversal of psychology may well be required to achieve a significant downward adjustment of interest rates.

The rise in short-term interest rates during recent months had the effect of putting the Federal Reserve discount rate, which had been reduced in a series of actions to 4.75 percent last February, well below the rates at which funds could be obtained by banks in the open market. The effect of this discrepancy in rates was to encourage member bank borrowing from the Reserve banks—borrowing which was rising rapidly and thereby providing reserves to support continued high rates of monetary expansion.

Accordingly, as you know, the Board last week approved increases in Federal Reserve bank discount rates to 5 percent by a unanimous vote of the five Board members present at the meeting. I participated by telephone in the discussion leading to this action, and I want you to know that I supported it fully. Our hope is that the higher discount rate will serve to moderate the demand for discounting at the Federal Reserve, that it will help prevent excessive growth of the monetary aggregates, and also impart a degree of stability to interest rate expectations.

I continue to feel that the country needs lower interest rates, and that lower rates—especially on mortgages and State and local government securities—would contribute a more vigorous economic recovery. But I am not hopeful that substantially lower interest rates can be achieved, until we as a nation make steady and meaningful progress in solving our inflation problem.

WAGES AND PRICES

The inflation we are confronted with has become deeply rooted since its beginnings in 1965. The forces of excess demand that originally led to price inflation disappeared well over a year ago. Nevertheless, strong and stubborn inflationary forces, emanating from rising costs, linger on. I wish I could report that we are making substantial progress in dampening the inflationary spiral: I cannot do so. Neither the behavior of prices nor the pattern of wage increases as yet provides evidence of any significant moderation in the advance of costs and prices. If growth in productivity accelerates with a quickening economy, some real moderation may well develop in the months ahead. Even so, the residual rate of inflation may well run above the characteristic level of previous cyclical upswings.

Let me cite some of the evidence that leads me to this view. Thus far in 1971, prices of newly produced goods and services in the private economy are still rising, on the average, at about a 5-percent annual rate—or at essentially the same rate as in 1969 and 1970. The rate of advance of consumer prices did diminish conspicuously during the first 5 months of 1971, but most of this improvement is attributable to the decline in mortgage interest rates. The wholesale price index for all commodities has increased at an annual rate of 5 percent thus far this year, or twice last year's rate. Wholesale prices of industrial commodities, moreover, have accelerated from a 3.5-percent increase last year to a 4-percent rate thus far in 1971.

Much the same picture emerges from a review of changes in wages and salaries—by far the most important component of business costs. Wages in the private nonfarm economy, adjusted for changes in industrial composition and for overtime work, rose at about a 7-percent annual rate in the first half of 1971—slightly more than in 1970 or 1969. This sustained sharp rise in wages during a period of substantial economic slack contrast markedly with our experience in earlier recessions, when the rate of advance in wages typically dropped sharply or actually ceased.

Nor is the picture more encouraging when one inspects the trend of new agreements reached in major collective bargaining settlements—agreements which tend to establish wage trends throughout industry. The wage increases agreed to, for example, in the automobile, can, and aluminum settlements, and most recently by A.T. & T., amount to 12 percent or more for the first year. The full extent of the increase contracted for later years is not yet known, since it will depend in part on the speed of future advances in the Consumer Price Index.

It is important to inquire into the reasons for this unusual behavior of wages and salaries. The answer is doubtless complex, involving a myriad of structural, psychological, and social changes. Ironically, our national commitment to high employment and economy prosperity, and our relative success in achieving these objectives, accounts for part of the problem. For a general expectation has developed on the part of both business and labor that recessions, if they occur at all, will prove brief and mild; and this expectation has influenced both the strength of wage demands and the willingness of management to accept them.

A second factor contributing materially to the sustained character of wage rate increases in the current situation is the intensity and duration of the previous phase of excess demand. Consumer prices have been rising steadily since 1965—much of the time at an accelerating rate. Continued substantial increases are now widely anticipated over the months and years ahead. In such an environment, workers naturally seek wage increases sufficiently large to compensate for the effects of past inflation on their real incomes, and to give some protection against future price advances—besides providing for a measure of improvement in living standards. Thoughtful employers are bound to have some sympathy with these efforts, all the more so when they reckon—as they now generally do—that cost increases can probably be passed on to buyers grown accustomed to inflation.

Other factors, too, have been at work. The increased militancy of workers, whether union or nonunion and whether in private or public service, has probably led to wider and faster diffusion of excessive wage rate increases through the economy. I cannot help but wonder, also, whether our recent experience with wage settlements in unionized industries may not reflect a gradual shift in the balance of power at the bargaining table.

Labor seems to have become more insistent, more vigorous, and more confident in pursuing its demands, while resistance of businessmen to these demands appears to have weakened—perhaps because they fear the loss of market position that would be caused by a long strike, or because they believe that their competitors too will give in to similar wage demands. More recently, the balance of power—so important to the outcome of wage bargaining—may have been influenced by expansion in the public welfare programs which can be called upon to help sustain a striking employee and his family, valid though these programs may be on social grounds. And the hand of labor may have been strengthened also by the evidence success that public sector employees have had in recent years in winning large wage increases, frequently with the use of illegal strikes against the Government.

In my judgment, and in the judgment of the Board as a whole, the present inflation in the midst of substantial unemployment poses a problem that traditional monetary and fiscal remedies cannot solve as quickly as the national interest demands. That is what has led me, on various occasions, to urge additional governmental actions involving wages and prices—actions that would serve, by moderating the inflationary trend, to free the American economy from the hesitations that are now restraining its great energy.

There has been some progress in this area over the past year or two. The President deserves credit for his efforts to deal with the special supply-demand problems that had developed in the lumber and petroleum industries, and for bringing together labor and business leaders in the steel industry for a discussion of basic economic issues at the outset of the current wage negotiations. The Construction Industry Stabilization Committee, formed earlier this spring, appears to be having some success in moderating the staggering trend of wage settlement in that industry. The periodic inflation alerts serve a useful function in stimulating public discussion of areas in which wage or price decisions do not seem to conform to ecnomic fundamentals. And the National Commission on Productivity may yet provide the basis for important improvements in the cost trends of our economy.

In the Board's judgment, these efforts need to be carried further—perhaps much further. The problem of cost-push inflation, in which escalating wages lead to escalating prices in a never-ending circle, is the most difficult economic issue of our time. It needs to be given top priority by our business and labor leaders as well as by the Government. There is much good will and statesmanship in the ranks of business and labor, and it would be wise for the Government to draw upon it more fully.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Burns, for your typically very competent and impressive analysis and for your remarkable bluntness and honesty.

I said earlier that witnesses had been uniformly pessimistic on the outcome, and I cannot construe your statement as being anything but exactly that. You seem to be telling us that the expansion of the economy, stimulus to the economy, must hinge on getting inflation under control. You also tell us that on the basis of the most recent available information, in your judgment, inflation is not getting under control, that there is little evidence that we will be able to reduce the rising cost of living over the next few months, and if we do not it means that we have built into our system a psychological attitude that keeps business costs high and makes it extremely difficult to engage in any kind of a responsible stimulus for the economy. Is that correct?

Mr. BURNS. Although I agree with much of what you say, I would describe my own attitude a little differently. I am cautiously optimistic, but I would be much more optimistic if we were making better headway against inflation.

Chairman PROXMIRE. How do you say you are cautiously optimistic when you tell us that we cannot stimulate the economy further until we get inflation under control and you indicate inflation is far from under control?

Mr. BURNS. I do not believe I said that. What I have tried to say is that the economy is expanding, and it is likely to continue to expand, but that our confidence in the vigor and the durability of the expansion would be considerably strengthened if we achieved more success——

Chairman PROXMIRE. The question is whether or not the economy's expansion is sufficient in the light of our available manpower resources, if we can do anything about unemployment, for example. It is my understanding that in the second quarter of this year, the real growth in the economy was 3.6 percent. Because of the distortion of the automobile strike, we cannot take the first quarter of this year or the fourth quarter of last year, but if you put them together, the growth is about the same, about 3.5 percent.

Now, 3.5 percent just will not cut it. If we continue with this expansion at 3.5 percent growth, in view of the increase in the labor supply of about 1.7 percent, in view of productivity increases as we go ahead, which may be 4 percent, and that means we will have increasingly more unemployment—not less—and we make no progress in getting unemployment under control. Isn't that correct?

Mr. BURNS. Certainly, if we are to make significant progress in reducing our present unemployment, the rate of real economic growth will have to be stepped up.

Chairman PROXMIRE. But you feel that in order for the Federal Government to play any role in stepping that up, we must first get inflation under control?

Mr. BURNS. I think that is our most urgent need; yes.

Chairman PROXMIRE. You would feel that any kind of stimulus, tax reductions, additional spending, cannot be supported until we do have a firmer control over inflation. I think you said, in the course of your statement, that you might have a different view if we had an income policy, for example. Is that correct?

Mr. BURNS. That is correct.

Chairman PROXMIRE. Now, let me get into that. With respect to the President's rather limited efforts to influence wages and prices, you say, and I quote:

"In the Board's judgment, these efforts need to be carried further—perhaps much further."

Would you elaborate on just what you think should be done?

Would you be calling for price controls; are you calling for wage-price review boards, what you called for in the past?

Mr. BURNS. I am not calling for price controls; this is a drastic remedy. The time may come when we need it, but I definitely do not think the time has come. We ought to try milder medicine before taking anything so drastic.

Now, as for actions that are needed, I outlined by views in an address I gave in California last December——

Chairman PROXMIRE. The Pepperdine speech?

Mr. BURNS. Yes; the Pepperdine speech. And you know my views.

Let me emphasize several things that I believe might be done in the near future. One is some kind of machinery—whether you call it a Wage and Price Review Board or an Anti-inflation Board does not matter to me—for reviewing prospective wage and price changes in major industries. I think that would help to inform the public and help to restrain excessive wage and price increases.

Chairman PROXMIRE. Do you think that would be adequate?

Mr. BURNS. It is hard to say. I must say, in all honesty to you, Senator, that I think a wage and price review board, had it been instituted a year or two ago, would have been more effective than it is likely to be today. But I would still try it. I would not be entirely confident of the outcome, but I would still try it. I think the effort is worth making. Then, we would know where we stand.

Second, there is something Senator Javits has worked on and discussed over many years and which I heartily endorse, and that is the establishment of local productivity councils. We tried that during World War II, and we had enormous success with it. These productivity councils would be established in individual communities and in individual establishments. In the last analysis, all of us, I think, are in favor of high wages, but with present high wages we need a faster rate of productivity growth. I think we ought to get on with that effort.

Next, I have reluctantly come to hold the view that in industries that are especially affected by a public interest, we will need to resort to compulsory arbitration. I hope that the Congress will consider this difficult and in many ways very disagreeable kind of legislation, for I think we have reached the stage when we probably need it.

My other views are contained in that Pepperdine speech, and if you wish the proposals there presented, it could be put in the record.

Chairman PROXMIRE. At the suggestion of Senator Javits, I think it is appropriate to put the Pepperdine speech in the record at this point so it will be available for those reviewing it.

(The speech referred to follows:)

THE BASIS FOR LASTING PROSPERITY

(Address by Hon. Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve System, in the Pepperdine College "Great Issues Series," at the Beverly Hilton Hotel, Los Angeles, Calif., Dec. 7, 1970)

Nearly three years ago, in a talk here in Los Angeles, I pointed out that once an economy becomes engulfed by inflation, economic policy makers no longer have any good choices. To regain a lasting prosperity, a nation must have the good sense and fortitude to come to grips with inflation. There is, however, no painless way of getting rid of the injustices, inefficiency, and international complications that normally accompany an inflation.

Events of the past several years have lent poignancy to these simple truths. Recent experience has demonstrated once again that the transition from an overheated economy to an economy of stable markets is a difficult process. Elimination of excess demand was an essential first step to the restoration of stability, but this step has brought with it a period of sluggish economic activity, slow income growth, and rising unemploymet. And while we have made some progress in moderating the rate of inflation, our people are still seeing the real value of their wages and savings eroded by rising prices.

The struggle to bring inflationary forces under control, and to return our labor and capital resources to reasonably full employment, is still going on. I am convinced, however, that corrective adjustments in the private sector over the past twelve to eighteen months are creating, in conjunction with governmental stabilization policies, the foundation on which a prolonged and stable prosperity can be constructed.

A cardinal fact about the current economic situation, and one that promises well for our nation's future, is that the imprudent policies and pratices pursued by the business and financial community during the latter half of the 1960's are being replaced by more sober and realistic economic judgments. In my remarks to you today, I want first to review some of the key developments that lead me to this conclusion. Then I shall turn to the tasks that must still be faced in order to enhance the prospects for an early resumption of growth in production and employment in an environment of reasonably stable prices.

The current inflation got under way in 1964. Perhaps the best single barometer of the extent to which it served to distort economic decisions and undermine the stability of the economy is found in the behavior of financial markets during the late 1960's. In 1968, well over 3 billion shares of stock exchanged hands on the New York Stock Exchange—about two and one-half times the volume of five years earlier. The prices of many stocks shot upward with little reference to actual or potential earnings. During the two years 1967 and 1968, the average price of a share of stock listed on the New York Exchange rose 40 per cent, while earnings of the listed companies rose only 12 per cent. On the American Exchange the average share price rose during the same two years more than 140 per cent on an earnings base that increased just 7 per cent.

A major source of the speculative ardor came from some parts of the mutual fund industry. Long-term investment in stocks of companies with proven earnings records became an outmoded concept for the new breed of "go-go" funds. The "smart money" was to go into issues of technologically oriented firms—no matter how they were meeting the test of profitability, or into the corporate conglomerates—no matter how eccentric their character.

This mood of speculative exuberance strongly reinforced the upsurge of corporate mergers which occurred during the middle years of the 1960's. No doubt many of these mergers could be justified on grounds of efficiency. But the financial history of mergers—including some of the great conglomerates—suggests that many businessmen became so preoccupied with acquiring new companies and promoting the conglomerate image that they lost sight of the primary business objective of seeking larger profits through improved technology, marketing, and management. When talented corporate executives devote their finest hours to arranging speculative maneuvers, the productivity of their businesses inevitably suffers and so too does the nation's productivity.

These speculative excesses had to end, and it is fortunate that they ended before bringing disaster to our nation. Equity values are now being appraised more realistically than a year or two ago. Investors are now more attentive to high quality stocks. Indeed, many of them have discovered or rediscovered that even bonds and time deposits are a fit use of their funds. Not a few of those responsible for the frantic search for "performance stocks" have shifted to other activities or joined the ranks of the unemployed; so also have numbers of security analyst and stock brokers. With speculation giving way to longer-term investment, the stock market is now channeling risk capital to business firms more efficiently.

A searching reappraisal of the economic philosophy of mergers is also underway. Merger activity has slowed materially since mid-1969. To some degree this is a response to the growing concern in governmental circles over the dangers that may inhere in large concentrations of economic power. But it stems mainly from the fact that businessmen are recognizing that time and energy can usually be spent more productively in searching for ways to increase the economic efficiency of their firm than in a scramble for corporate acquisitions.

Businessmen are also reconsidering the wisdom of financial practices that distorted their balance sheets during the late 1960's. In the manufacturing sector, the ratio of debt to equity—which had been approximately stable during the previous decade—began rising in 1964 and was half again as large by 1970. Liquid asset holdings of corporate businesses were trimmed to the bone. On the average, the ratio of prime liquid assets to current liabilities fell by nearly half during those six years. In permitting such a drastic decline in liquidity, many of our corporations openly courted trouble.

Perhaps the most ominous source of instability produced by these financial practices was the huge expansion of the commercial paper market. The volume of commercial paper issued by nonfinancial businesses increased eightfold between the end of 1964 and mid-1970, as an increasing number of firms—some of them with questionable credit standings—began to tap this market. The hazards inherent in the spreading reliance on commercial paper were taken much too lightly. After all, the relations between the buyer and seller of commercial paper are by their very nature distant and impersonal—unlike the close working relationship that normally develops between a bank and its business customers. The buyer—typically an industrial enterprise—rarely has the facilities or the experience to carry out a full investigation of the risks attaching to commercial paper. Moreover, the buyer regards his investment as temporary—to be withdrawn when cash is needed or when questions arise about the quality of the paper. The issuer, therefore, faces considerable uncertainty as to the amount of his maturing obligations that may be renewed on any given day. The risks facing the individual issuer and buyer inevitably pose a problem also for the nation's financial system, since the difficulties experienced by any large issuer of commercial paper may quickly spread to others.

These familiar truths were lost sight of in the inflationary aura of the late 1960's. It took the developments of last summer, when the threat of financial crisis hung for a time over the commercial paper market, to remind the business community that time-honored principles of sound finance are still relevant.

As a result of that experience and the testing of financial markets generally during the past two years, corporate financial policies are now more constructive than in the recent past. The year, new stock issues have continued at a high level—even in the face of unreceptive markets—as corporations have sought to stem the rise in debt-equity ratios. Of late, borrowing by corporations has been concentrated in long-term debt issues, and their rate of accumulation of liquid assets has risen. Liquidity positions of industrial and commercial firms are thus improving, though it will take some time yet to rectify fully the mistakes of the past.

These efforts to restore sound business finances are not without costs to the nation. For example, long-term interest rates, while below their peaks at the end of last year or last spring, are still at unusually high levels because of this year's extraordinary volume of new capital issues. But there can be no doubt that substantial adjustments in the financial practices of our nation's businesses were essential if the basis for a lasting and stable prosperity was to be re-established.

By and large, our major financial institutions conducted themselves with prudence during the years when lax practices were spreading in financial markets. There were, however, some individual institutions that overextended loan commitments relative to their resources, others that reduced liquidity positions to unduly low levels, still others that permitted a gradual deterioration in the quality of loan portfolios, and even a few that used funds of depositors to speculate in long-term municipal securities. Fortunately, such institutions were distinctly in the minority. When the chips were down, our major financial institutions proved to be strong and resilient. And they are stronger today. As monetary policy has eased, the liquidity of commercial banks has been increasing. Even so, loan applications are being screened with greater care. The emphasis on investment quality has also increased at other financial institutions, as is evidenced by the recent wide spread between the yields of high and lower grade bonds.

These corrective adjustments in private financial practices have materially improved the prospects for maintaining order and stability in financial markets.

But no less important to the establishment of a solid base for a stable and lasting prosperity have been the developments this year in the management of the industrial and commercial aspects of business enterprise.

During the latter half of the 1960's, business profit margins came under severe pressure. The ratio of profits after taxes to income originating in corporations had experienced a prolonged rise during the period of price stability in the early 1960's. But this vital ratio declined rather steadily from the last quarter of 1965 and this year reached its lowest point of the entire postwar period.

Until the autumn of 1969 or thereabouts, the decline in profit margins was widely ignored. This is one of the great perils of inflation. Underlying economic developments tend to be masked by rising prices and the state of euphoria that comes to pervade the business community. Though profit margins were falling and the cost of external funds was rising to astonishing levels, the upward surge of investment in business fixed capital continued. True, much of this investment was undertaken in the interest of economizing on labor costs. Simultaneously, however, serious efforts to bring operating costs under control became more and more rare, labor hoarding developed on a large scale, huge wage increases were granted with little resistance, and some business investments were undertaken in the expectation that inflationary developments would one way or another validate almost any business judgment. While the toll in economic efficiency taken by these loose managerial practices cannot be measured with precision, some notion of its significance can be gained by observing changes in the growth rate of productivity.

From 1947 through 1966, the average rate of advance in output per manhour in the private sector of the economy was about 3 per cent per year. In 1967, the rate of advance slowed to under 2 per cent, and gains in productivity ceased altogether from about the middle of 1968 through the first quarter of this year. The loss of output and the erosion of savings that resulted from this slowdown in productivity growth are frightfully high.

The elimination of excess demand, which the government's anti-inflationary policies brought about, is now forcing business firms to mend their ways. Decisions with regard to production and investment are no longer being made on the assumption that price advances will rectify all but the most imprudent business judgments. In the present environment of intense competition in product markets, business firms are weighing carefully the expected rate of return on capital outlays and the costs of financing. The rate of investment in plant and equipment has therefore flattened out, and advance indicators suggest that business fixed investment will remain moderate in 1971.

Business attitudes toward cost controls have of late also changed dramatically. A cost-cutting process that is more widespread and more intense than at any time in the postwar period is now underway in the business world. Advertising expenditures are being curtailed, unprofitable lines of production discontinued, less efficient offices closed, and research and development expenditures critically reappraised. Layers of superflous executive and supervisory personnel that were built up over a long period of lax managerial practices are being eliminated. Reductions in employment have occurred among all classes of workers—blue collar, white collar, and professional workers alike. Indeed, employment of so-called non-production workers in manufacturing has shown a decline since March that is unparalleled in the postwar period.

Because of these vigorous efforts to cut costs, the growth of productivity has resumed, after two years of stagnation. In the second quarter of this year, output per manhour in the private nonfarm economy rose at a 4 per cent annual rate, and the rate advanced to 5 per cent in the third quarter. These productivity gains have served as a sharp brake on the rise in unit labor costs, despite continued rapid increases in wage rates.

In my judgment, these widespread changes in business and financial practices are evidence that genuine progress is being made in the long and arduous task of bringing inflationary forces under control. We may now look forward with some confidence to a future when decisions in the business and financial community will be made more rationally, when managerial talents will be concentrated more intensively on efficiency in processes of production, and when participants in financial markets will avoid the speculative excesses of the recent past.

Let me invite your attention next to the role that government policies have played this year in fostering these and related adjustments in private policies and practices.

The fundamental objective of monetary and fiscal policies this year has been to maintain a climate in which inflationary pressures would continue to moderate, while providing sufficient stimulus to guard against cumulative weakness in economic activity. Inflationary expectations of businessmen and consumers had to be dampened; the American people had to be convinced that the government had no intention of letting inflation run rampant. But it was equally important to follow policies that would help to cushion declines in industrial production stemming from cutbacks in defense and reduced output of business equipment, and to set the economy on a course that would release the latent forces of expansion in our home-building industry and in state and local government construction. I believe we have found this middle course for both fiscal and monetary policy.

A substantial reduction in the degree of fiscal restraint has been accomplished this year with the phasing out of the income tax surcharge and the increase in social security benefits. These sources of stimulus provided support for consumer disposable incomes and spending at a time when manufacturing employment was declining and the length of the work-week was being cut back.

I do not like, but I also am not deeply troubled, by the deficit in the Federal budget during the current fiscal year. If the deficit had originated in a new explosion of governmental spending, I would fear its inflationary consequences. This, however, is not the present case. The deficit in fiscal 1971—though it will prove appreciably larger than originally anticipated—reflects in very large part the shortfall of revenues that has accompanied the recent sluggishness of economic activity. The Federal budget is thus cushioning the slowdown in the economy without releasing a new inflationary wave. The President's determination to keep spending under control is heartening, particularly his plea last July for a rigid legislative ceiling on expenditures that would apply to both the Executive and the Congress. However, pressures for much larger spending in fiscal 1972 are mounting and pose a threat to present fiscal policy.

Monetary policy this year has also demonstrated, I believe, that it could find a a middle course between the policy of extreme restraint followed in 1969 and the policies of aggressive ease pursued in some earlier years. Interest rates have come down, and liquidity positions of banks, other financial institutions, and nonfinancial businesses have been rebuilt—though not by amounts that threaten a reemergence of excess aggregate demand. A more tranquil atmosphere now prevails in financial markets. Market participants have come to realize that temporary stresses and strains in financial markets could be alleviated without resort to excessive rates of monetary expansion. Growth of the money supply thus far this year—averaging about a 5½ per cent annual rate—has been rather high by historical standards. This is not, however, an excessive rate for a period in which precautionary demands for liquidity have at times been quite strong.

The precautionary demands for liquidity that were in evidence earlier in 1970 reflected to a large degree the business and financial uncertainties on which I have already commented. It was the clear duty of the nation's central bank to accommodate such demands. Of particular importance were the actions of the Federal Reserve in connection with the commercial paper market last June. This market, following the announcement on Sunday, June 21, of the Penn Central's petition for relief under the Bankruptcy Act, posed a serious threat to financial stability. The firm in question had large amounts of maturing commercial paper that could not be renewed, and it could not obtain credit elsewhere. The danger existed that a wave of fear would pass through the financial community, engulf other issuers of commercial paper, and cast doubt on a wide range of other securities.

By Monday, June 22—the first business day following announcement of the bankruptcy petition—the Federal Reserve had already taken the virtually unprecedented step of advising the larger banks across the country that the discount window would be available to help the banks meet unusual borrowing requirements of firms that could not roll over their maturing commercial paper. In addition, the Board of Governors reviewed its regulations governing ceiling rates of interest on certificates of deposit, and on June 23 announced a suspension of ceilings in the maturity range in which most large certificates of deposit are sold. This action gave banks the freedom to bid for funds in the market and make loans available to necessitous borrowers.

As a result of these prompt actions, a sigh of relief passed through the financial and business communities. The actions, in themselves, did not provide automatic solutions to the many problems that arose in the ensuing days and weeks. But the financial community was reassured that the Federal Reserve understood the seriousness of the situation, and that it would stand ready to use its intellectual and financial resources, as well as its instruments of monetary policy, to assist the financial markets through any period of stress. Confidence was thus bolstered, with the country's large banks playing their part by mobilizing available funds to meet the needs of sound borrowers caught temporarily in a liquidity squeeze.

The role that confidence plays as a cornerstone of the foundation for prosperity cannot, I think, by overstressed. Much has been done over recent months by private businesses and by the government to strengthen this foundation. If we ask what tasks still lie ahead, the answer I believe must be: full restoration of confidence among consumers and businessmen that inflationary pressures will continue to moderate, while the awaited recovery in production and employment becomes a reality.

The implications of this answer for the general course of monetary and fiscal policies over the near term seem to me clear. The thrust of monetary and fiscal policies must be sufficiently stimulative to assure a satisfactory recovery in production and employment. But we must be careful to avoid excessive monetary expansion or unduly stimulative fiscal policies. Past experience indicates that efforts to regain our full output potential overnight would almost surely be self-defeating. The improvements in productivity that we have struggled so hard to achieve would be lost if we found ourselves engulfed once again in the inflationary excesses that inevitably occur in an overheated economy.

As I look back on the latter years of the 1960's, and consider the havoc wrought by the inflation of that period, I am convinced that we as a people need to assign greater prominence to the goal of price stability in the hierarchy of stabilization objectives. I have recommended on earlier occasions that the Employment Act of 1946 be amended to include explicit reference to the objective of general price stability. Such a change in that law will not, of course, assure better economic policies. But it would call the nation's attention dramatically to the vital role of reasonable price stability in the maintenance of our national economic health.

At the present time, governmental efforts to achieve price stability continue to be thwarted by the continuance of wage increases substantially in excess of productivity gains. Unfortunately, the corrective adjustments in wage settlements that are needed to bring inflationary forces under control have yet to occur. The inflation that we are still experiencing is no longer due to excess demand. It rests rather on the upward push of costs—mainly, sharply rising wage rates.

Wage increases have not moderated. The average rate of increase of labor compensation per hour has been about 7 per cent this year—roughly the same as last year. Moreover, wage costs under new collective bargaining contracts have actually been accelerating despite the rise in unemployment. In the third quarter of this year, major collective bargaining agreements called for annual increases in wage rates averaging 10 per cent over the life of the contract. Negotiated settlements in the construction industry during the same three months provided for wage increases averaging 16 per cent over the life of the contract, and 22 per cent in the first year of the contract. Nor is the end of this explosive round of wage increases yet in sight. Next year, contracts expire in such major industries as steel, aluminum, copper, and cans. If contracts in those industries are patterned on recent agreements in the construction industry—or, for that matter, in the trucking and automobile industries—heavy upward pressures on prices will continue.

I fully understand the frustration of workers who have seen inflation erode the real value of past wage increases. But it is clearly in the interest of labor to recognize that economic recovery as well as the battle against inflation will be impeded by wage settlements that greatly exceed probable productivity gains.

In a society such as ours, which rightly values full employment, monetary and fiscal tools are inadequate for dealing with sources of price inflation such as are plaguing us now—that is, pressures on costs arising from excessive wage increases. As the experience of our neighbors to the north indicates, inflationary wage settlements may continue for extended periods even in the face of rising unemployment. In Canada, unemployment has been moving up since early 1966. New wage settlements in major industries, however, average in the 7 to 8 per cent range until the spring of 1969, then rose still further. This year, with unemployment moving above 6½ per cent, negotiated settlements have been in the 8 to 9 per cent range.

Many of our citizens, including some respected labor leaders, are troubled by the failure of collective bargaining settlements in the United States to respond to the anti-inflationary measures adopted to date. They have come to the conclusion, as I have, that it would be desirable to supplement our monetary and fiscal policies with an incomes policy, in the hope of thus shortening the period between suppression of excess demand and the restoration of reasonable relations of wages, productivity, and prices.

To make significant progress in slowing the rise in wages and prices, we should consider the scope of an incomes policy quite broadly. The essence of incomes policies is that they are market-oriented; in other words, their aim is to change the structure and functioning of commodity and labor markets in ways that reduce upward pressures on costs an prices.

The additional anti-inflationary measures announced by the President last Friday will make a constructive contribution to that end. The actions to increase the supply of oil will dampen the mounting cost of fuels, and the recommendations made by the President to improve the structure of collective bargaining in the construction industry strike at the heart of a serious source of our current inflationary problem.

I would hope that every citizen will support the President's stern warning to business and labor to exercise restraint in pricing and wage demands. A full measure of success in the effort to restore our nation's economic health is, I believe, within our grasp, once we as a people demonstrate a greater concern for the public interest in our private decisions.

If further steps should prove necessary to reduce upward pressures on costs and prices, numerous other measures might be taken to improve the functioning of our markets. For example, liberalization of import quotas on oil and other commodities would serve this purpose. So also would a more vigorous enforcement of the anti-trust laws, or an expansion of Federal training programs to increase the supply of skilled workers where wages are rising with exceptional rapidity, or the creation on a nation-wide scale of local productivity councils to seek ways of increasing efficiency, or a more aggressive pace in establishing computerized job banks, or the liberalization of depreciation allowances to stimulate plant modernization, or suspension of the Davis-Bacon Act to help restore order in the construction trades, or modification of the minimum wage laws in the interest of improving job opportunities for teenagers, or the establishment of national building codes to break down barriers to the adoption of modern production techniques in the construction industry, or compulsory arbitration of labor disputes in industries that vitally involve the public interest, and so on. We might bring under an incomes policy, also, the establishment of a high-level Price and Wage Review Board which, while lacking enforcement power, would have broad authority to investigate, advise, and recommend on price and wage changes.

Such additional measures as may be required can, of course, be determined best by the President and the Congress. What I see clearly is the need for our nation to recognize that we are dealing, practically speaking, with a new problem—namely, persistent inflation in the face of substantial unemployment—and that the classical remedies may not work well enough or fast enough in this case. Monetary and fiscal policies can readily cope with inflation alone or with recession alone; but, within the limits of our national patience, they cannot by themselves now be counted on to restore full employment, without at the same time releasing a new wave of inflation. We therefore need to explore with an open mind what steps beyond monetary and fiscal policies may need to be taken by government to strengthen confidence of consumers and businessmen in the nation's future.

I the past two years we have come a long way, I believe, towards the creation of a foundation for a lasting and stable prosperity. Confidence has been restored in financial markets. Businesses have turned away from the imprudent practices of the past. Productivity gains have resumed. Our balance of trade has improved. The stage has been set for a recovery in production and employment—a recovery in which our needs for housing and public construction can be more fully met.

To make this foundation firm, however, we must find ways to bring an end to the pressures of costs on prices. There are no easy choices open to us to accomplish this objective. But that, as I indicated at the outset, is the tough legacy of inflation.

Chairman PROXMIRE. Unfortunately, I have to leave in a couple of minutes to be on the floor; so, I would like to shift very quickly to just one other area.

I take it, Mr. Burns, you do not feel that the 9 percent or 10 percent rate of increase in the money supply which we have had in the first 6 months of this year, is stable. And what bothers me is the comment that the target for the year as a whole might be in the neighborhood of 6 or 7 percent. I am not asking you whether or not there is such a target but if there were, would this mean a very slow rise from here on to the end of the year?

And if we have had rising interest rates with money increasing at a 10 percent rate, what can we expect to happen when the monetary expansion is greatly reduced?

Mr. BURNS. Senator, your arithmetic is always excellent, but I can assure you that, while we at the Federal Reserve must not—and I trust will not—permit monetary growth to continue at a 10 percent rate, we will make sure that this Nation is sufficiently supplied with the money that it needs to support an expanding economy. Therefore, I would not worry, if I were you, about very low rates of monetary growth later this year. On the other hand, the very high rates we have had canot and must not be maintained.

Chairman PROXMIRE. Well, you indicate that the money supply would slow down but that there would be enough for expansion of the economy. What concerns me especially is the effect of this on housing. We know mortgage rates have already started to go up and it would seem to me just inevitable that if there is any slowdown in the increase in the money supply and there would be some; we must not expect to continue at this rate, or housing is in trouble. I am just wondering what we can do for the housing sector of the economy which has been perhaps the strongest sector in the first 5 months of this year and on which continued growth in the economy or improvement in the economy so heavily depends.

Mr. BURNS. Well, you are quite right. The housing industry has been, by far, the strongest sector of our economy during the past 6 months and during the past year. Mortgage rates have not risen appreciably as yet in the primary market. I believe that the average mortgage interest rate on conventional home mortgages has risen no more than 3 or 5 basis points this spring, as measured by the Federal Home Loan Bank series.

Chairman PROXMIRE. Does that take into account the points on mortgages?

Mr. BURNS. If I interpret the statistics correctly, the answer is "Yes."

Chairman PROXMIRE. In your statement you say:

"With the benefit of hindsight, I now feel that stronger action was warranted this spring."

What does that mean? Stronger action to hold interest rates down or stronger action to control the money supply?

Mr. BURNS. The latter.

Chairman PROXMIRE. Unfortunately, Mr. Burns, I am going to have to leave.

Again, I want to commend you on an excellent job, most useful and helpful.

Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

Mr. Burns, first, I appreciate very much your expression of support for the idea of local productivity controls. I think it is very distressing—has been to me for months—that this administration should not have picked up this opportunity as the framework already exists in the National Productivity Council.

I notice you say in your statement:

"And the National Commission on Productivity may yet provide the basis for important improvements in the cost trends of our economy."

Is that just what the lawyers call predicatory hope or is it something you know, that we do not know?

Mr. BURNS. I know no more than you do, Senator.

Senator JAVITS. Well, I must say that what I know does not inspire me with great confidence.

Mr. Burns, is this situation in which we find ourselves one in which, what you call in your statement, "traditional monetary and fiscal remedies" are not working and we, having had experience with them concede they are not working?

Mr. BURNS. They are not working as expected.

Senator JAVITS. Now, are the various places in which the administration has departed from the traditional monetary and fiscal remedies which you specify in your statement clearly differentiated as a different kind of a game plan in which they have made tentative approaches, to wit, the special supply demand problems of lumber and petroleum, bringing labor and business leaders in the steel industry together, the Construction Industry Stabilization Committee, the periodic Inflation Alerts—those sorts of things? Are we to differentiate those things as a different policy from the policy the administration is following, to wit, the traditional monetary and fiscal policy?

Mr. BURNS. Yes, I think so. The actions to which you refer are in the sphere of incomes policy. Perhaps it would be better to say they are in the sphere of wage and price policy.

Senator JAVITS. So that we now have a crisis, to wit, the crisis of the recovery which is too slow, brought on by two factors: (1) the failure to espouse a different set of remedies from the traditional fiscal and monetary policies and (2) the corollary probably of the first, the failure to inspire adequate confidence, either in management or business in the future of the economy. Would you agree with that?

Mr. BURNS. I would say there is a widespread feeling in the business and financial community, and there certainly is this feeling within the Federal Reserve Board, that greater emphasis on wage and price policy is vital at this stage of our Nation's history.

Senator JAVITS. Now, Mr. Burns, you have been saying this for months—perhaps even years. The question I would like to ask you is this: Is the remedy with which your name has been associated so prominently, to wit, some form of wage-price restraint essentially through publicity and the use of Government procurement, Government guarantees—that is, the inhibition which can be placed upon Government procurement, guarantees, loans, et cetera—has time passed that remedy by?

In other words, they might have worked but has inflation increased to the extent that the restraint imposed by traditional monetary and fiscal remedies are no longer sufficient and that we should have even more drastic remedies than the ones you have yourself been identified with?

Mr. BURNS. That is possible, Senator, but I am not prepared to travel that road at the present time. As I stated before, I do think that a Wage and Price Review Board would have had a better chance of success a year or two ago than it has now. I would still try it. I would give it a fair trial. And I would think of more stringent remedies only if I found that this milder course is not working out.

Senator JAVITS. Now, how much time do you think we have before we go to more drastic remedies?

And I ask you that for this reason: An effort has been made—I am stating this; not you. I am not trying in any way to wish this on you. An effort has been made to convince us that the progress of inflation is really not that bad and that various kinds of figures have been given to us both in confidence and publicly, that things are really moderating, and the game plan of the administration is catching hold.

You do not think so, do you? That is, do you not agree that inflation is still at a completely unacceptable and highly dangerous rate?

Mr. BURNS. I certainly agree that very little progress as yet has been made and that inflation is proceeding both at an unacceptable and a dangerous rate.

Senator JAVITS. And that inflation is now having the corrosive effects of being a major factor in the negotiations between management and labor so that labor is increasing its demands, just like people increase their demands for more interest under those conditions, when they lend money; and also that management is more ready to yield to those demands because its bargaining strength has been corroded. It is a very dangerous situation.

Mr. BURNS. I agree.

Senator JAVITS. Now, under those circumstances, how much time have we got to apply a relatively mild remedy of an incomes policy before we are really up against the gun and have to do something extremely drastic like wage and price controls enforced by law?

Mr. BURNS. I cannot answer the question with regard to time, but I do think this: Let's move to the milder measures—and not lose too much time doing that—and see how things work out.

Senator JAVITS. I thank you. I would just like to ask you one other question: Isn't it a fact, with all the soothing reports about the rate of inflation, that we face serious price increase problems this very fall in steel and automobiles and in fuel?

I do not know that we will have them, but we face that problem?

Mr. BURNS. Well, I will say that we face that problem on a still broader scale, Senator.

Senator JAVITS. Just one last question, Mr. Burns, and I think my time has expired. Could you specify for us—because it is a matter of great interest to me—the export incentive to buttress our export trade, which is refered to in your statement, either now or in a memorandum to the committee?

Mr. BURNS. I will be very glad to do that.

The Congress was presented last year with a bill—I do not think anything happened to it, and I do not believe it has been reintroduced in this session—which called for the establishment of domestic international sales corporations.

The purpose of that legislation would be to enable our business firms to establish subsidiaries, domestically, which would specialize in export trade and postpone their payment of taxes until profits are distributed to shareholders. This is a constructive suggestion. I am not ready to endorse the details of that bill, but I think a special tax concession—in the form of a lower rate to enterprises that make special energetic efforts in the field of exports trade—is well worth consideration.

Second, I think that the Congress ought to take another look at the Webb-Pomerene Act, which was passed in 1918. The purpose of that legislation was to enable business firms to establish corporations acting together without being subject to antitrust laws. These corporations were to engage in export trade. I believe that there is some question about the way in which the Justice Department has made its rulings as to the Webb-Pomerene Act corporations. In any event, they have not prospered recently; the number of such corporations has diminished, and the volume of trade they account for has fallen off. I think that it would be well worth taking a close look at the Webb-Pomerence Act and at other ways of promoting the original purpose of the Congress some 50 years ago.

Beyond that, of course, the most important thing that we can do to strengthen our exports trade and to limit our imports is to bring inflation under control.

There are also some specific things that Congress may want to consider, such as stimulation of research and development in export-oriented industries. And the Congress may want to take another look at the provisions of present law, and how they are working, with regard to providing adjustment assistance. Adjustment assistance perhaps ought to come into play at a much earlier stage, before an industry is in serious trouble, if the indications are that the industry is losing out in the domestic and international markets. That industry or firm might have to shift over to another line of activity, and generous credit on a long term basis perhaps ought to be provided for under new legislation.

There are some thoughts that come quickly to mind, although, I might say another word: I think, in handling our trade negotiations with other countries, we could be a little more vigorous than we have been in pressing the legitimate claims of American business.

Senator Javits. Thank you very much, Mr. Burns. My time is up. I have just one request, would you be kind enough to answer in writing, what analogies there are between our experience and the British experience and what we should learn from the rather drastic action just taken by the British Government, in order to deal with its own inflation and cost-push problems.

Mr. Burns. I will be very glad to do that. I spent a little time yesterday looking into that, and I want to look into it further on my own account. I would be very glad to insert a statement on this recent proposal and the way that industry and labor are responding to it.

Senator JAVITS. Without objection, that will be incorporated in the record at this point.

(The statement referred to follows:)

RECENT BRITISH MEASURE TO STIMULATE GROWTH AND RESTRICT PRICE RISES

There are two lessons to be learned from the recent behavior of the British economy. The first is, in essence, that slow growth and rising unemployment can go hand in hand for a prolonged period with excessive wage increases and price inflation. The second is that, where the inflationary pressure are essentially cost-push in character, fiscal and monetary policy alone may not be able either to prevent the phenomenon of lagging growth with inflation or to rectify it once it has emerged. In such circumstances, an incomes policy could prove helpful. The British government has now drawn this inference, as is indicated by the warm welcome that it accorded to a plan of the Confederation of British Industry (CBI) to impose an unofficial, but hopefully effective, 5 per cent ceiling on price increases in the next twelve months.

THE CHANCELLOR'S STATEMENT TO PARLIAMENT ON JULY 19

On July 19, Chancellor Anthony Barber announced the introduction by the Government of the United Kingdom of several measures intended both to stimulate lagging economic growth and simultaneously reduce a currently very rapid rate of inflation.

In presenting the program to Parliament, the Chancellor warmly endorsed a plan unveiled the previous week by the Confederation of British Industry—Britain's largest and most powerful trade association, whose membership accounts for about two-thirds of total manufacturing output in the U.K.—to limit price increases in the next 12 months to no more than 5 per cent. He also indicated that the government would see to it that Britain's nationalized industries likewise observed a 5 per cent ceiling on price rises.

The Chancellor's support for the CBI's initiative reflects a change in the government's attitude toward prices and incomes policy. Heretofore, the government has not supported even the recommendation of upper limits on price increases (though in April, it compelled the British Steel Corporation to restrict a price increase to 7 per cent despite the Corporation's original intention of raising the price of steel by 14 per cent). Now, though, the government evidently believes that applying broad pressure to observe specifically stated limits to price rises may be a necessary, or at least helpful, move in order to slow inflation while at the same time creating conditions for a revival of growth in real output.

THE GOVERNMENT'S REFLATIONARY PACKAGE

The principal elements in the government's reflationary package were the elimination of minimum downpayment requirements and maximum permissible repayment period for installment purchases of consumer goods and, most important, an across-the-board cut of 18 per cent in the purchase tax. The latter is levied, at the wholsale level, on a broad array of consumer goods. There are four separate rates—since the cut, 11¼, 18, 30 and 45 per cent—applied to different groups of goods.

The power to vary indirect tax rates, effective immediately and subject only to subsequent Parliamentary approval, is particularly advantageous at the present time, when Britain faces the twin problems of inflation and recession. The reduction in the purchase tax on July 19 is expected to provide a substantial stimulus to consumer demand, while simultaneously *lowering* the level of consumer prices by ¾ of a percentage point below what it otherwise would have been. Price cuts on many consumer goods have already been made.

Another step taken by the government on July 19 was to liberalize some of the rules governing the write-off of capital expenditures, in order to spur investment.

The announced objective of the expansionary measures of July 19 is to reduce the current rate of unemployment to more acceptable levels by raising the rate of growth of real GNP from the first half of 1971 to the first half of 1972 to 4 to 4½ per cent from the 3 per cent rate anticipated in the absence of these measures. The government's budget for 1971–72 (which began April 1), presented to Parliament at the end of March, included several reflationary measures designed to boost growth from under 2 per cent to about 3 per cent a year. But GNP in the first half was far below the expectations which prevailed in March, so that growth will have to be on the order of 4½ per cent in order to reach the level of GNP in the first half of 1972 that the government forecast in March.

The gravity of the unemployment situation was made particularly clear last Friday, with the release of the unemployment statistics for July. They showed a record post-war joblessness rate of 3.4 per cent. From 1954 through 1966, the average rate was only 1.5 per cent, and even in recent years when more generous unemployment benefits have made higher rates of unemployment more acceptable, the average rate was considerably lower—in 1967–70, only 2.3 per cent.

The need to reduce the rate of inflation has become equally clear. Despite the large margin of unused capacity, retail prices in Britain rose by about 6½ per cent in the first six months this year and in June were over 10 per cent higher than a year earlier.

THE CBI PROPOSAL FOR CURBING PRICE INCREASES

The CBI proposal which the government has welcomed calls upon all its members to increase prices in the next year only where such increases are "unavoidable" and then by no more than 5 per cent. The CBI has specifically asked its 200 largest members—all of them employing at least 5,000 persons and accounting for perhaps as much as 75 to 80 per cent of the total employment provided by the CBI's 11,500 members—to sign a declaration promising adherence to the CBI's proposal. Signers of the declaration would commit themselves for the year ending July 31, 1972 to "avoid raising prices of products/services supplied in the United Kingdom; to limit any unavoidable increase in any of our prices to 5 per cent and, if possible, less; and, where larger increases are unavoidable, to limit the weighted average of price changes in the relevant range of products to 5 per cent or less." The interval between any price rises should be at least a year.

The CBI intends to police the actions of the firms that sign the declaration. Firms which subsequently find that special circumstances, such as steep rises in prices of their inputs, make adherence to the declaration untenable will be expected to consult with the CBI before raising prices.

The CBI is optimistic that a high proportion of the 200 firms will sign the declaration and that this will give the plan a very good chance of succeeding, not only because these firms account for a substantial amount of output but also because their size and power will enable them to exert great pressure on their suppliers to keep price increases within the 5 per cent ceiling. As already noted, the government has in effect promised that the nationalizd industries would cooperate.

Absolutely critical to the success of the CBI initiative, of course, is the cooperation of Britain's labor unions. The root cause of Britain's severe inflation is the wage explosion which began in the latter half of 1969; and, while wages are no longer advancing at the rate of almost 14 per cent a year, as they did from the end of 1969 to the end of 1970, the rate of increase is still far too rapid to be compatible with even an average rise in prices of 5 per cent annually.

To date, though the Trades Union Congress—the counterpart in labor of the CBI in industry—has not issued an official statement on the CBI initiative, the General Secretary of the TUC and other spokesmen for the British labor movement have expressed at least qualified approval. However, they have given no indication that labor will set wage ceilings or guidelines to parallel the 5 per cent limit on price rises instituted by the CBI.

Nevertheless, the prospects of a slowing in wage increases have improved. With their plea for both reflationary action and price restraint measures now met, the unions are under great pressure to moderate their wage demands. Furthermore, union leaders now will run less risk of losing the support of their members if they adopt a more temperate line in wage negotiations than they did when the present government's incomes policy was confined to urging employers to resist wage demands considered excessive even if such resistance led to long and costly strikes. Some union leaders may even welcome the opportunity to take a more moderate approach, since there seems to have been a correlation in the last year between rising unemployment and rising wages, with large wage increases leading to dishoarding of labor by employers unable to meet the higher wage bills.

REFLATION AND THE BALANCE OF PAYMENTS

From the standpoint of the British balance of payments, this is an opportune time to take reflationary action. The current account, which has been in the black since early 1969, showed a very substantial surplus during the first half of 1971—about 600 million pounds, or about $1.4 billion, at an annual rate. It would thus appear that there is considerable room for domestic expansion without risk to Britain's external financial position.

Senator JAVITS. I yield to Senator Bentsen.

Senator BENTSEN. Senator Javits, thank you very much.

Senator Javits has touched on a point that is of particular concern to me, and that is of our position in foreign trade. Now, we are in something of a dilemma here when we have a substantial amount of unused capacity, I question if some of this is not noncompetitive use capacity that we have in relation to our foreign competition. I am wondering what we could do to get additional capital investment in advanced technology to try to make our industry more productive.

We have looked at the accelerated depreciation schedules which you state you support. But I wonder if, in a time of low profits, this is really an incentive to professional management. Professional management has the problem of trying to show an increase in earnings to its stockholders and keeping its price earnings ratio in line for its investors.

Can you afford them accelerated depreciation?

All that they have really given is accelerated cash flow that does not translate to the bottom line.

Now, you stated in your comments here that you had supported the investment tax credit on a permanent basis. But couldn't we have had a more immediate effect in the way of capital investments if we had established the investment tax credit rather than the accelerated depreciation?

Mr. BURNS. My answer to that is an unqualified "Yes"; but one seemed to be manageable in the political arena at the time and the other seemed far more difficult.

Senator BENTSEN. Your candor is very refreshing, Mr. Burns.

Let's take this to another step, then. Do you feel that we have reached the point where we should move into another round of trade talks?

You touched on the point that we really ought to make this bilateral, our negotiations, instead of, I suppose, having a group of "favored" nations, we ought to have "fair" nations in our negotiations.

Mr. BURNS. If you mean by "trade talks" on a global international scale, involving 100-odd nations of the world, I would be very skeptical about that. You see, our trade difficulties can be localized. Take our trade with Canada. Until 1968, we had a substantial trade surplus. Since then we have run up a huge and growing deficit. Take our trade with Japan. Until 1965, we had a sizable surplus; since then our trade deficit has been growing by leaps and bounds. We also have a trade problem with the European Economic Community, largely in the field of agricultural products.

I think that I would engage in vigorous conservations with other countries on trade, but I would do it with a number of individual countries, rather than in a large international conclave where the deliberations would be long and of uncertain consequences.

Senator BENTSEN. Would you stand on your point on the 7-percent tax credit on a permanent basis as opposed to being utilized in a process of trying to manage the economy of the Nation?

Mr. BURNS. Well, Senator, you may recall—I believe it was in late 1966—that the investment tax credit was suspended. Then, if my recollection is correct, 4 months and 4 days after the suspension became effective, President Johnson asked the Congress for a reinstatement of the investment tax credit. That created a great deal of unhappiness and confusion, both in congressional and business circles.

In 1969, the Congress was in a reformist mood, and the investment tax credit was dropped. This meant a very heavy additional burden on our corporations.

Senator, one of the troubles we have at the present time is the remarkably low rate of profit in our economy. Corporate profit margins have been lower during the past year than they have been at anytime since the end of World War II. I looked up recently the figures on corporate profits in relation to our gross national product. I found that during the past year, and thus far this year, the ratio of corporate profits to the gross national product has been lower than in any year since about 1938 or 1939.

We have had a vast increase since 1965 in the dollar value of our gross national product, but there has been deterioration in corporate profits.

The eventual restoration of the investment tax credit on a permanent basis would improve the picture of profitability. I think it would stimulate businessmen to undertake new capital investments, to modernize their equipment. I think this would help us domestically and also help us in our foreign trade. If we fiddle around with the investment tax credit, the Congress will not want to touch it for a number of years. Therefore, it should be made a permanent part of our tax structure.

We might, of course, be able to devise methods or machinery whereby the rate of the investment tax credit would vary over time. If we could do that, this would help a great deal, because the amount of stimulation that you need at one time may be very different from the amount that you need at another time. In 1959, for example, I think it would have been wiser to reduce the investment tax credit than to eliminate it.

I would urge the Congress at the appropriate time to consider very seriously not only the reinstatement of the investment tax credit, but to put it on the statute books and leave it there.

Senator BENTSEN. Mr. Burns, that is the first time I have heard the idea espoused as a formula by which it would be applied, and I assume that would be something related to the state of the economy.

Mr. BURNS. That is correct.

Senator BENTSEN. I think that is an intriguing proposal, and I would certainly concur with you, that we need something to encourage manufacturers to improve their technology in order that we may be more competitive in the world market today, and I think the investment tax credit really does that.

When you were before the committee before, Mr. Burns, you advised us that you would have a housing study before long.

When may we expect that report?

Mr. BURNS. Well, I continue to believe that that will be presented to the Congress before the month of September comes to an end.

Senator BENTSEN. Could you give the committee a better understanding as to the cause of the disparity we have seen between short-term and long-term rates, which has moderated some recently?

Mr. BURNS. There are many influences that play on our money and capital markets. Short-term rates have recently risen whereas long-term rates have risen very much less. In the past few weeks there has been almost no movement in long-term rates.

Capital issues in the long term market have been on a less abundant scale in the past few weeks than previously, and that is one influence in that part of the market. A number of factors have played on the short term market, including some recent steps on the part of the Federal Reserve. The most important influences on the short term market in recent months, I think, are those which I enumerated in my statement: The indications that a business recovery is developing, the prospect of large Treasury financing needs, the expectation that much of that would be handled through the issue of short-dated securities, deepening concern about inflation, and some apprehension over international financial developments. I think these have been the more important influences that have served to raise interest rates in the short term markets.

Senator BENTSEN. Thank you, Mr. Burns.

I believe that completes my time. I yield to Congressman Conable.

Representative CONABLE. Thank you.

Good morning, Mr. Burns. I would like to ask you what investment tax credit can accomplish which cannot be accomplished by accelerated depreciation except, perhaps, a greater temptation by Government to try to fine tune the economy in ways which will be destructive to business planning?

Mr. BURNS. Fine tuning will enter the picture only if you try to vary the investment tax credit rate. If you leave it at 7 percent or 10 percent or 5 percent there will be no attempt at fine tuning. So, I do not think fine tuning is a necessary part of this question.

Over the long run, the difference between the investment tax credit and accelerated depreciation may be quite small. In the short run, particularly under circumstances such as the present, I do agree with Senator Bentsen that the investment tax credit would be a more potent, positive influence. I think the Senator put his finger on the reason. The accelerated depreciation increases cash flow; that is good, but the calculation of profit yields a lower profit figure. At a time when profits are as low as they are today, corporations may not be very happy about taking advantage of accelerated depreciation. My guess is that the estimates that have been made about the loss of Treasury revenue are exaggerated. Many corporate managers and boards of directors may decide not to resort to it because they want to put out a better profit statement for their stockholders. I think that is essentially the difference, as I see it.

Representative CONABLE. Don't you think, however, that under some circumstances, the manipulation of the investment tax credit can result in a businessman making marginal decisions for tax purposes rather than for sound economic reasons?

Mr. BURNS. Well, you speak of manipulation. Once, again, you apparently—unless I misunderstand you—are thinking of variations in the rate of the investment tax credit.

Representative CONABLE. That is something you advocated, sir.

Mr. BURNS. Well, it is something that I suggested the Congress think about. I am not ready to advocate it as yet, because I would first want to work out a plan and test its practicability. It would be a very difficult thing to achieve in practice; so, I am not ready to advocate it. But I do believe that all of us will do well to think about it.

Representative CONABLE. I am interested in your comments on this, because some of the same people who have been saying the accelerated depreciation is a business giveaway are advocating reinstating the investment tax credit, and, apparently, your feeling is that the investment tax credit would have a more direct impact on corporate profits. From this it appears to me that if anything happens to be a "business giveaway," it is the investment tax credit rather than the accelerated depreciation.

Mr. BURNS. Let me put it this way: I would not think of either the one or the other as a business giveaway. And in the kind of world I think we need to have, we should have both accelerated depreciation and an investment tax credit.

Now, Mr. Conable, let me say that I hope my remarks have not cast doubt on accelerated depreciation. That is very far from my purpose. I was addressing myself to Senator Bentsen's question, comparing accelerated depreciation with the investment tax credit in the immediate economic situation, assuming that you can have the one or the other. The fact of the matter is that we do have accelerated depreciation and it is not at all clear that we would have or can have the investment tax credit in the near future.

Let me say something else. Quite apart from the investment tax credit, the case for accelerated depreciation, in my judgment, is very strong, not only for the reasons that have played such a large role in public discussion, but because of the inflation that we are having. In a period of inflation, depreciation for tax purposes should, in principle, be reckoned not on a historical cost basis but on a replacement cost basis; and accelerated depreciation in a crude way recognizes this need. Our profits figures, because of the inflation, are overstating what is actually happening in the sphere of profits. So, I am entirely in favor of accelerated depreciation, as I noted in my statement. I support it strongly.

Representative CONABLE. Mr. Burns, I notice in your statement the recurrence of two identical villains: One is inflationary expectations and the other, I believe, would have to be described as lack of confidence. I am impressed, by my service on this committee, with the extent to which psychology is the daily grist of the economist. I am wondering what impact you think constant political talks of recurring crises, of the discussions on the ineffectiveness of policies, have? Does this have some impact on these two villains? Do we find people losing confidence because they listen to the denunciating voices ringing from the Congress, or do you think these are largely incredible, because businessmen have to look at hard facts and not at political commentary?

Mr. BURNS. Mr. Conable, first of all, I would not say there was a lack of confidence in the economy. I think there is a good deal of confidence in the economy today, and it is well justified. I would say, however, that confidence could be stronger, and as it strengthens in time the effect will be constructive. I have emphasized, as others have, psychological factors, as you rightly indicate.

The criticisms of economic policy coming from the Congress may have some influence, yes. They undoubtedly do have some influence on opinion and on psychology. But I would counterbalance that with the praise that comes from governmental sources and from business people who also are competent.

After all, ours is a free society and it must remain that way. What each of us must do—and I am sure you men in the Congress try to do your best—is to view the evidence, study the evidence, and then express his thinking. In the crucible of public discussion we eventually work out political compromises which I hope—and I am reasonably confident this will be the case now—will serve our national interests well.

Representative CONABLE. I take it you do not feel we are in a crisis at this point?

Mr. BURNS. Oh, no; definitely not.

Representative CONABLE. One crisis of confidence that pretty much concerns me has to do with our continuing imbalance of payments in trade. It has been suggested, from high sources recently, that a border tax might be a short term device that would improve our situation, and apparently there is some thought this could be legally done on the basis of our serious imbalance of payments. I would like to know if you have had any consideration of that, sir. What about the possible impact of a border tax?

Mr. BURNS. This would be a generalized tax?

Representative CONABLE. Yes.

Mr. BURNS. This would be a generalized tax on imports?

Well, I have not studied that proposal, and I would hesitate to express a definite view on such a far-reaching proposal at this point.

Representative CONABLE. My time is up. I yield to Senator Bentsen.

Senator BENTSEN. Mr. Burns, this concludes our midyear hearings on the economy. You have been a very fitting witness to cap off the hearings. We are most appreciative of the testimony you have given to us.

The committee will be coming out with a report shortly, making its recommendations to the Congress, as to what steps should be taken legislative wise on the economy.

Thank you very much.

Mr. BURNS. Thank you, Senator.

(Whereupon, at 11:25 a.m., the committee adjourned, subject to the call of the Chair.)

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