671

EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

MONDAY, JULY 29, 1974

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

The committee met, pursuant to notice, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire and Percy; and Representative Brown.

Also present: John R. Karlik and Courtenay M. Slater, senior economists; William A. Cox, Lucy A. Falcone, Robert D. Hamrin, Sarah Jackson, Jerry J. Jasinowski, L. Douglas Lee, and Larry Yuspeh, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. The Joint Economic Committee opens this review of the economic situation amidst an atmosphere of great public concern about the basic health of the U.S. economy. Words like "crisis," "disaster," "intolerable," are heard with increasing frequency. The opinion polls tell us that the confidence of the public in the Government's ability to manage the economy is falling lower all the time. The stock market averages demonstrate the very low level of investor confidence.

I think there is a need to pause and ask: Why this discontent? How have we gotten into a situation which so many people feel can be described accurately as an economic crisis?

The U.S. economy has a fantastic productive machinery in place, both in agriculture and in manufacturing. We have a highly efficient national marketing and distribution system. We have a modern and sophisticated financial system. We have a vast wealth of natural resources. We have an educated, highly skilled, and hard-working labor force.

I made a speech on the floor of the Senate about what is right about our economy. And I was surprised, in working on that speech and developing it, to find out how many things are right about it.

I think we have a tremendously productive economy, and the fact is that, on the average, people, now, in real terms, after inflation, have 50 percent more disposable income than they had 15 years ago.

With all this wealth of advantages, why does our economy increasingly give the impression that it teeters on the brink of collapse? Why do we tolerate increasingly poor performance?

Back in mid-1971—just 3 years ago—we regarded a 3-percent growth rate and a 5-percent inflation rate as such a poor combination that emergency measures such as the price-wage freeze were introduced. At the moment, our real growth rate is essentially zero. The inflation rate is 9 percent, a far worse situation than we had in 1971. Yet, instead of taking action, the administration is putting out press releases pretending this is good news. A 9-percent inflation rate is described as a substantial improvement. A decline in real GNP indicates that the downtrend in production is being arrested. The President on national television tells us to be patient, to defer our consumption spending and increase our savings and all will be well.

The American people are concerned about complacency at the highest levels of Government which is creating a crisis of public confidence. Let's lay it on the line: a 9-percent inflation rate is not good news.

Two consecutive quarters of declining real output are a great disappointment to a public which was assured by the President less than 6 months ago that "there will be no recession in the United States of America." The American people are concerned about the 5.2 percent unemployment rate which, while not as high as many analysts had projected, is still far too high a rate of unemployment. And the poor GNP performance in the second quarter indicates that a further rise in unemployment may still lie ahead. They are concerned that the real value of the average weekly paycheck has declined nearly 5 percent in the past year.

It is hard to be patient when one's income is eroding steadily like that. It is hard for the average income family—earning about $12,000 per year—to envision saving more. Indeed many of these families must dig into the small savings they already have just to make ends meet. For the family earning even less than average—and 16 million families in this country have income below $8,000 a year—the plea to increase their savings can only arouse wonder and resentment.

A first requisite for improving the state of the economy is some evidence that Government officials understand the impact of inflation and unemployment on average citizens—that they understand, that they are concerned, and that they are willing to discuss the economic situation.

Finally, Mr. Rush, I cannot think of anything more irrelevant or lacking in real perspective and vision than to ignore the facts of life as we confront them at this tragic time.

You are the President's No. 1 adviser. There is no way this hearing can be relevant and useful unless we all squarely face the grim prospect that confronts this Nation this morning.

Many Members of Congress, many businessmen, many consumers now think President Nixon will in all likelihood be impeached by the House.

Suppose he survives that impeachment after a Senate trial. What can you tell us to indicate that President Nixon in that weakened, and at least partly discredited, posture can give this country the kind of confidence and unifying faith in our economic future that this country needs from its President to meet the serious inflation problem, the sky-high interest rates, the threatening unemployment increase, the threat of a super wage-price spiral—all of which require strong and unifying Government leadership.

And regardless of whether the President is tried and convicted and removed or not, what can you tell us about how economic policy is going to be conducted by the White House in the next traumatic and unsettled 4 to 5 months while this country is going through its ordeal?

One possibility, for example, is that the President might temporarily invoke the 25th amendment so he can let the Vice President move in as Acting President while President Nixon concentrates on his impeachment defense.

Or is there some way short of this in which stable, unifying executive leadership can be applied?

I am very pleased, Mr. Rush, that you decided to come before us and reverse your earlier decision. I think you have made a wise decision and a good decision, and I think you are serving the interest of the administration too in appearing at a hearing before us to explain the economic policies under these very trying circumstances.

Congressman Brown has an opening statement he would like to make, and perhaps Senator Percy would like to make an opening statement, too.

Opening Statement of Representative Brown

Representative Brown. Thank you, Mr. Vice Chairman.

I am delighted that we are having these hearings at last. I originally was in touch with you and the chairman of the Joint Economic Committee some 60 days ago asking that we have these hearings. We are now in the process of having them.

I also originally, I think, contacted you about that same time, suggesting that we have Mr. Rush as our first witness at these hearings. I was sorry to see his initial acceptance reversed on the grounds of executive privilege. I met with Mr. Rush to urge him to appear. But I also urged you, as you recall, to have these hearings even when he indicated that he was only willing to appear informally. And I am sorry that it has taken so long to get to these hearings with Mr. Rush as a formal witness.

Mr. Vice Chairman, I would like to make just a few brief remarks at this time with reference to the status of the economy.

What strikes me as we open these 1974 midyear hearings of the Joint Economic Committee is that these hearings are being held in what is perhaps the period of greatest uncertainty in our society since I entered public life about 9 years ago.

We are in the midst of the most serious inflation, both domestically and worldwide, of modern times. Many respected commentators are expressing grave fears about the ability of our domestic and international banking and financial system to survive under current conditions. We have been told to expect a substantial worsening in unemployment in the United States during the rest of 1974, but no guaranteed significant relief from the galloping inflation.

It appears that we have experienced economic recession in the first half of 1974, with rises in prices almost being matched by drops in real production, and with no strong assurance that the decline in real growth seen so far this year will be turned around during the rest of the year.

Over the longer term, we face grave problems in financing the business expansion and capital investment necessary to assure the availability of goods necessary to reduce inflationary pressures.

Compounding this problem are potential shortages and existing shortages, and large price rises for many of the raw materials which we import and which are so necessary to our industrial production.

However, I am not here merely to recite the problems to the other members of this committee, the witness, and the public. We are familiar with the magnitude of most of these problems. What we must focus on this week, and during the weeks ahead, are possible solutions. I only regret that we did not have these hearings earlier to get to those solutions earlier.

In listening to Mr. Rush and other witnesses through this week, and in the questioning later in this hearing, I would be most interested in discussing some of those possible solutions.

In the short term it is apparent to me that the soundest policy is one of carefully monitored fiscal restraint and monetary prudence. It is evident that monetary restraint has been a policy of the Fed and will continue to be a Fed policy if Mr. Burns' public statements are to be credited. However, I have a number of questions about fiscal restraint on the part of the Federal Government and what, if anything, is being done along these lines.

Whether we are to reduce the proposed Federal budget for fiscal year 1975 by $10 billion, as Mr. Burns has proposed, or by $5 billion, as Secretary of the Treasury Simon and President Nixon have advocated, is not the main question. To me, the main question is where these cuts will be administered, who is and will be making the authorized decisions in this regard.

Also, what other policies, other than general fiscal and monetary restraint, are necessary in appropriately combating inflation while maintaining an adequate level of economic activity.

Certainly I hope that we will not resort again to the type of wage and price policies which have proven to be so ineffective in the past.

I look forward with interest, Mr. Vice Chairman, to hearing Mr. Rush's testimony and the questions that the members of the committee will ask.

Thank you.

Senator PROXMIRE. Thank you, Congressman Brown.

Senator Percy.

OPENING STATEMENT OF SENATOR PERCY

Senator PERCY. Thank you, Mr. Vice Chairman. I also should like to join my colleagues in expressing my appreciation for Mr. Rush being here this morning.

As I mentioned to him, he is such an able witness and such a respected voice, and he has such a great responsibility now, that it would be wrong not to have the benefit of his testimony. And certainly we would not invade. and would not think of invading executive privilege, which certainly does not go into our province.

What you say to the President, Mr. Rush, and what the President says to you is not the question, but the question is the economy.

It is of such vital interest to every American family today to have this forum. Without any question, it is the No. 1 topic, although Watergate is of great interest. As I go through the country in Illinois, the economy outweighs all other subjects of inquiry as well as mail and telephone. And the deep conversations I heard all this weekend were about the economy and where is it going.

The uncertainty of the future is causing concern on Wall Street, and concern in the purchasing offices of major corporations, and the concern of millions of people today. And uncertainty is the thing that we are trying as best we can to remove. By having strong and effective, vigorous leadership at the national level in the executive branch of Government, I think, long before Watergate is behind us, we can reassure the Nation that we intend to tackle this problem.

One way we can do it is to have a very close cooperative effort between the legislative branch and the executive branch. This is not a position where we should be adversaries. We should be partners. The executive branch cannot fight this battle alone, and we would be foolish to just simply cast all the blame on that side and say it is the executive branch's fault when we retain many of the powers here and have appropriately those powers which can help remedy the situation.

These hearings, I think, can be extraordinarily useful, not only in imparting information, but also in citing those things that the executive branch can do and those things that the legislative branch can do.

I disagree very strongly with those in the legislative branch, and some of our leaders, who have indicated that Congress and the executive branch have done nothing to fight inflation. I think we have done a great deal just in the past 3 or 4 weeks to start the wheels going and remove some of the uncertainty that hangs over the economy.

Certainly we have to decide up or down the issue of wage or price controls. And we decisively decided to put this face of economic planning behind us, to recognize our total incompetence to plan and control and regulate the American economy, with the buying decisions that are being made day-by-day and week-after-week in the marketplace. We do not know how to run a controlled economy. We might just as well admit our utter incompetence. We totally failed to regulate and maintain a flow of supply in basic farm commodities. And we saw the impossibility of doing it for tens of thousands of other items.

The reason I disagree with the standby control proposal of the administration is, I do not know how anyone would price new products. They would always price them at the highest price rather than the lowest simply because of the uncertainty that wage and price controls would be slapped back on.

In talking with George Meany last week and Leonard Woodcock and other labor leaders, it was brought out that the uncertainty of wage controls and that power over their heads would drive them to do nothing but demand the most, rather than a sensible, reasonable wage increase that has some relationship to productivity.

So we removed that uncertainty over the opposition of many of my own colleagues. But that is out of the way now, and the free market is going to reign, and that uncertainty is gone.

I think the second uncertainty is the uncertainty about tax levels, as to whether or not, just because it is an election year, once again, as we have done every election year since Congressman Brown and I have been in the Congress at least—every election year we have reduced taxes. We are not going to do it this year—over the dead bodies of some of us, if it is going to be done.

When Senator Allen and I engaged together in a filibuster to stop a tax reduction, it is serious then. And there is a unanimity of opinion that that would have been a morally offensive thing for us to have done at that particular time, to have reduced personal income taxes, to feed the fires of inflation for millions of people. That decision I hope is decisively behind us. And the defeat that was handed to those who were proponents of it, I hope it was conclusive enough so that they will not try it again, because it would increase uncertainty again.

Do we mean it when we say we are going to try to be fiscally responsible? That is our job and our responsibiilty. We cannot blame the executive branch for it.

In the area of budget reform, as the President said a week ago Friday, this is the most significant action in budgetary control taken by the Congress in almost 200 years. That may be overreaching a little bit. A pretty good bill was passed in 1921, but nothing since then.

Now the question is, Can we live up to it, can we face our responsibilities, and can we implement in action what we said we intend to do? This takes cooperation.

The President said in his economic message, we can cut this budget $5 billion; that is, the fiscal 1975 budget. That, I think, is a significant move.

The proposal I have made for a $6.7 billion cut is within the ball park. We are all talking the same language. We are at least saying we can cut something, maybe not $10 or $15 billion, but you can go deeper than any of us thought a few months ago.

I also hope we can add some taxes and that we can add revenue. We ought to pick up $3 or $4 or $5 billion through additional revenue and additional taxes.

I have outlined my thoughts on it, but they are not sacrosanct at all. Many of us have other ideas as to where that revenue can come from. But just to say, beginning now in 1975 and 1976 we are going to have a balanced budget would have little effect on a trillion-dollars-plus economy. But psychologically it will mean a tremendous amount. And Arthur Burns is our best authority for that.

Lastly, the concept that all of us believe very deeply in is increasing the productivity of this country. George Meany pledged last Wednesday at lunch that organized labor will work in this respect providing it is not a show, a charade, a performance, but it has real substance to it and meaning behind it.

Again I believe that the National Commission on Productivity should be instilled with new life, new vigor, new backing, and support from the highest office in the land. Leadership should be given to that Commission.

We are in a condition today where I believe the administration asks for $2.5 million for a budget, and the House approved $2.5 million. The Senate has just cut it from $2.5 million to $1.5 million.

I intend to carry, I hope with the support of many of our colleagues—and I know how strongly our vice chairman feels about it—an amendment to the floor to bring that level up. I think it would be tragic at this particular time if we would try to cut down the only full-time Government activity to try to find ways to increase productivity, to introduce or stabilize units of productivity and have wage increases really meaningful and not just passing them off in the form of higher prices.

Here again is a cooperative effort. I am sorry that we have not used this particular instrument to do more in the Congress. But I hope between us we can battle this out and convince our colleagues on the floor of the Senate and the House that this is not the time to save a few pennies when tens of millions of dollars, hundreds of millions, in increased productivity are available.

Once again I want to thank you very much for being here, Mr. Rush. We respect your judgment a great deal and look forward to hearing you.

Senator PROXMIRE. Thank you, Senator Percy.

Mr. Rush, I would like to make two suggestions: Number one, this is your first appearance before this committee, of course, and it is your show, and you take whatever time you feel you should with your prepared statement. It is, however, a detailed prepared statement. The press has copies of it and the committee has been given copies of it, and you were very thoughtful to make those copies available in advance.

If you want to summarize it—it is a long prepared statement—that would be completely acceptable, and the entire prepared statement will be printed in full in the record.

The second suggestion is that you might want to respond, in this critical situation we have now, with a President who is under great duress, and where the country is looking for strong, unifying leadership from a President who has suffered already a very serious setback and may well be impeached, you might want to respond to that first, then get into your statement.

STATEMENT OF KENNETH RUSH, COUNSELOR TO THE PRESIDENT FOR ECONOMIC POLICY, ACCOMPANIED BY SIDNEY JONES, DEPUTY ASSISTANT TO THE COUNSELOR

Mr. RUSH. Thank you very much.

I am pleased to appear before this committee to review the status of the U.S. economy and the policies necessary to continue the process of stabilization following the serious disruptions caused by food, energy, materials, and capacity shortages.

As Counselor to the President for Economic Policy, I must carefully protect the privileged nature of my communications with him, but we can have a full and meaningful discussion of economic issues without violating that confidential relationship.

With regard to the point you made, I have been in my position since the end of May, and during that period of time I have seen the President in some cases daily, and have been in touch with him almost daily. I have devoted a vast amount of time to economic matters.

Many Presidents have been under very serious siege and have exercised leadership most effectively. I suppose we could go back to Abraham Lincoln in the Civil War, who had a victory in the Civil War despite, I suppose, the worst attacks that any President has ever had.

I remember in the days of Franklin D. Roosevelt there were some very bitter attacks on him, and on Mr. Truman. And Presidents are subject to very serious attacks, as President Nixon.

In my opinion, the American people are so deeply concerned about the economy, and they have so much at stake, that they are anxious to cooperate with the President, and with the administration, and to respond to leadership. In my opinion the Congress is very responsive, the Congress is anxious to improve the economy, and to fight against inflation, and they will cooperate with the President and with the administration, I am quite sure, to meet these very just challenges.

The President himself is exercising very strong leadership in this field. I feel that my colleagues are an extraordinarily able group of men.

So, I see no problem with regard to leadership. And I really do not see that there is any problem with regard to securing the cooperation of the Congress and of the people to fight inflation, which is the grave threat over our economy.

Going, then, to my prepared statement, which I will read in part and summarize in part. As you know, my appearance today will be followed by other administration officials who will discuss economic issues in greater detail. In my role as coordinator of economic policy, I will limit my comments to summarizing our program for moderating the unacceptable rate of inflation as a beginning point for achieving general progress in the U.S. economy. While policies must focus on the diverse goals of high employment, efficient production of goods and services, price stability, and international trade and investment, progress in reducing inflation is now the foremost need. And from the statements of Senator Proxmire and Congressman Brown and Senator Percy, I am sure that we all agree on this.

Our policy recommendations of fiscal and monetary restraint are widely recognized as the most reasonable approach available. Perhaps even more important, we intend to pursue these policies until the desired results are obtained. Gradual progress will require cooperative efforts within the Government and awareness in the private sector that current price and wage decisions should reflect long-term realities. My review of the economic outlook and our policies will hopefully contribute to these goals.

In 1973, housing demand and consumer durable goods spending softened following an extended period of rising real output. The unexpected oil embargo and extraordinary oil price increases aggravated this slowdown, and a decline in real growth occurred during the first quarter of 1974. Supply and capacity contraints further restricted production.

To summarize, what I am saying here is, during the first quarter we had a very serious decline in production of some 7 percent, and the deflator was 12.3 percent, which was most unacceptable.

In the second quarter one might say that the domestic economy was flat. The minus figure, 2.39, came about primarily because of an extraordinary circumstance with regard to the takeover of the stock of oil companies by producer countries. And another unexpected factor was a decline in spending by State and local governments.

Personal consumption outlays in real terms strengthened in the second quarter. Consumer durable goods spending jumped at an annual rate of $2.3 billion in real terms—1958 dollars—and services outlays rose $900 million. Automobile sales have dropped well below the record levels reported in 1973, but purchases have strengthened in recent months and the outlook is improving.

As I summarize my prepared statement, the summary is not to be taken as the active presentation, but rather, the statement itself. So I trust that any quotations will come from the prepared statement. I am trying to save time by going through the prepared statement rather hurriedly.

One of the very strong features of the economy is, of course, industrial construction, which continued at a very high level.

Housing expenditures were off $600 million at a reasonable rate as expected during the first part of the year, but the bulk of the decline in housing outlays caused by the drop in new starts in late 1973 is now behind us. New housing starts have been holding steady since January, and a backup program of $10 billion in various mortgage financing aids has been created to help offset the disruptive effects of high interest rates and financial disintermediation.

The rate of inventory accumulation, stated in 1958 dollars, was $1.5 billion less in the second quarter than in the first 3 months of the year, but stocks did increase at an annual rate of $9.1 billion during the second quarter. Inventory-to-sales ratios remain relatively low and the backlog of orders is at a record level and rising.

We must, I feel, insure that the great strength of the economy in terms of producing goods, which is to be met by capital investment, continues at a high level, and that we provide economic incentive to assure expansion of capacity.

In terms of wages, there is no question but that wage earners are striving to recoup some of their real income lost to the large price increases we have been experiencing over the past year. Wage increases being paid are currently running at a national average rate of 9.6 percent, up from 6 percent in the first quarter. Settlements recently negotiated have been running well over 10 percent.

A sustained period of this level of wage increases is dangerous to the American economy because it builds in permanently escalating costs which add to inflation, and gradually remove the American economy from the competitive world market. Reasonable and responsible wage increases are desirable, just as are responsible and reasonable prices, but increases of the magnitude we have been experiencing lately are not healthy for the U.S. economy.

There is also more industrial strife now than at any time since the early fifties, with 528 strikes involving 235,399 workers. Most of this strike activity is associated directly with the end of wage and price controls and the sharp price rise in the cost of living. Fortunately, these strikes generally have been short in duration and at this point have not adversely affected the general industrial relations climate. This area will have to be watched closely to insure that harmonious long-term labor management relations are continued.

Our export picture is very good. In 1973 our merchandise exports increased 44 percent in value from $49.2 billion to $70.8 billion while imports rose only 24 percent from $55.6 billion to $69.1 billion. As a result, the merchandise trade account returned to surplus following 2 years of deficits. There were a variety of factors contributing to this improvement, including a surge of agricultural exports and strong demand for U.S.-manufactured products.

The realinement of currency exchange rates beginning in 1971 was a major factor in enhancing the competitive position of the United States and we expect this to be a continuing source of strength.

For the same reasons, U.S. exports continued to climb rapidly during the first half of 1974, and our imports have tapered off. In fact, when we strip away price increases and get down to the volume of trade, we find that our exports rose well over 10 percent and our imports actually declined.

This, of course, is very important to us, but, because of the great increase in the cost of oil, we are in a position of a slight deficit for the first 5 months.

But with regard to my policy recommendations, I want to emphasize that in spite of the underlying strength and resilience of the U.S. economy, particularly the stabilization in the second quarter despite the many domestic and international economic problems encountered, I am not trying to minimize either the virulence of the inflation pressures or the risks that unemployment may rise during the coming months as real output gains remain below the long-term target. The economy faces many real problems and responsible leaders should not attempt to gloss over the reality of how hard or how long the adjustment process will be.

But it would be an even greater fallacy to disrupt the policies of moderate restraint which are necessary to gradually reduce inflation without triggering unacceptable increases in unemployment. Some people will claim that this is only a policy of inactivity and an outmoded commitment to a dogmatic view of the economy.

On the contrary, these recommendations represent a conscious decision to sustain fundamental policies for a long enough period of time to achieve results. We will take whatever adjustment actions are necessary to improve the efficiency of the economy—such as the decision to release all available acreage to stimulate agricultural output.

Government policies often create marketplace distortions which discourage both efficiency and output needed to help moderate inflation, provide employment opportunities, and enhance the growth of real income. We are striving to identify and correct these problems. But our approach is based on the fundamental premise that certain fiscal and monetary actions are needed to get lasting results. There is also an explicit recognition that the adjustment process must not ignore the risks of unemployment during the transition stage.

For several weeks we have been making difficult decisions about the fiscal 1976 budget and what must be done to prevent fiscal 1975 outlays from drifting out of control. Trying to slow down the upward momentum of the Federal budget is not easy because it is usually more popular to respond to demands for increased spending, lower taxes, and easier credit.

We must cooperate. But I would urge that the Members of Congress who have been pressing upon us the need to reduce the budget consider their votes with regard to individual items of increase as they come up.

We are also greatly encouraged by the recent enactment of the Congressional Budget Impoundment Control Act, because it establishes a rigorous framework for Congress to use in approaching Government spending decisions. But we must make our actions conform to our rhetoric in many ways.

Coming now to my specific proposals, first, it is not the proper time to reduce tax receipts. What Senator Percy said I would like to second 100 percent, and I would not go into this further, but my prepared statement does so.

As to Federal expenditures, decisions must be made now to require at least a balancing of receipts and outlays in fiscal 1976. We have a leadtime of 11 months, and we must start now to slow down the leadtimes and make specific legislative adjustment in order to achieve a balanced budget for 1976.

With regard to 1975, my prepared statement goes into this. We hope to reduce—we are working to reduce the $305.4 billion of expenditures to a goal of $300 billion.

The President has very emphatically stated that he will veto any bills that go beyond his total recommendation of $305.4 billion.

There is legislation now in Congress which would rapidly escalate spending. And this must be resisted, and it must be resisted successfully, if we hope to come near a balanced budget for 1975.

With regard to monetary policy, my third recommendation is that we reaffirm the importance of achieving the moderate restraints of the Federal Reserve System. We feel that this policy is moderate, we feel that it is necessary to be continued, and we are in complete accord with Mr. Burns' recommendation.

My fourth recommendation is that the Government can and should make every effort to improve the productivity of the economic system so that output is increased without creating more inflationary cost pressures. The obvious beginning point is for the Government to eliminate, or at least reduce, the barriers to efficiency created by its own policies.

Examples of such actions include the decision to release some 60 million additional acres of idle cropland to stimulate farm output; the energy conservation and allocation programs for alleviating the physical distortions of the oil embargo; the Project Independence effort to provide reliable sources of energy at the lowest possible cost; proposals to rehabilitate the Nation's transportation system, including some needed deregulation to promote competition; recommendations for modernizing the existing system of financial institutions; and many other specific Government purchasing and regulatory actions which I will not list in this brief statement.

The President recently announced his intent to conduct a broad review of Government regulatory activities which may be disrupting the productivity of the economic system. In considering every piece of legislation, we must seriously consider the impact on future inflation, employment, and investment goals. And we shall certainly look at the National Commission on Productivity and hope to utilize that much more successfully than in the past.

I would like to join in urging that the Senate uphold the budget at the $2.5 billion level that has been proposed, and not cut it to a million and a half.

Fifth, I want to once again state our strong opposition to returning to wage and price controls. We will continue to meet with representatives of all sectors of the economy to discuss the importance of considering long term interests in making current wage and price decisions, but we do not believe that a program of controls would contribute to the real solution of our economic problems.

Finally, there are a number of important policy issues pertaining to international economic developments which strongly affect our own economy and which are therefore receiving priority attention.

We have taken the lead for many years in working for a more open and equitable world trading system, in the conviction that expanded exchange of goods and services among nations benefits all peoples. However, trade policy issues are sensitive matters for most nations, where important sectors of their domestic economies are affected, and difficult negotiations are ahead of us. The most important immediate task before us is the passage of the Trade Reform Act so that international negotiations can begin to reduce trade barriers and make better arrangements for managing trade relations.

As you know, the new round of GATT negotiations started in September of 1973 with a meeting of 105 nations in Tokyo. Other nations are anxious to proceed and are waiting for the United States to obtain authority for full participation in the negotiations. Passage of the pending trade legislation by the Senate before the end of this summer is a crucial part of our commitment to meaningful discussions.

I think this legislation is so vital to our national interest that it should be moved promptly through the legislative process. It should not be held up on grounds which have nothing directly to do with international trade.

There are other trade policy issues which are receiving our urgent attention, and I refer to those in my prepared statement.

Coming to a very important question, oil, we have been talking with the other major consumer nations in the Energy Coordinating Group [ECG]. The most important of the cooperative efforts discussed is a program to deter any future supply disruption and to protect ourselves if supply distortions return. Effort has also focused upon longer term cooperative solutions to the energy problem, such as research and development, as well as conservation and the accelerated development of conventional resources.

Consistent with the understandings reached with the other members of the ECG, we have also conducted some direct bilateral discussions with oil-producing countries. Our aim has been to keep production up and access to supplies open at reasonable prices. We have also sought ways of attracting requisite investment in oil, and have offered technical assistance for development of the economies of the oil-producing countries.

However, the crisis continues to be important and serious. While we are engaged in several efforts to adjust to this challenge, a fundamental problem is the high price. A number of severe problems would be alleviated if oil prices would come down. The current level of oil prices is creating serious problems for every nation and is making more difficult our own domestic efforts to combat inflation.

In this interdependent world we are also concerned with the problems of the less-fortunate countries. Working with other governments who are members of the World Bank and the International Monetary Fund, we are seeking a better international system to deal with the development problems of these countries, including the problems created by the major increases in oil prices and other commodities.

One of the most important and complex economic challenges facing us today is posed by the large flow of funds to the oil-producing countries resulting from higher oil prices. If we are to insure the continued willingness of the oil producers to export the quantities of oil needed by the western world, these earnings will have to be recycled.

We have also initiated an international effort designed to minimize the distortions caused by Government investment policies. Artificial incentives of barriers to investment can significantly alter the efficient use of resources and thus undermine world economic progress. Because such an effort will first have to be undertaken by the developed countries, we have concentrated our efforts in the OECD.

In the international monetary area, we have made considerable progress toward a new international framework. We took the initiative in bringing about more flexible and adaptable system which has been able to cope with the rapidly changing circumstances of the last few years. Because of the uncertainties caused by the oil price increases, our goal of restructuring the international system has been temporarily delayed. An international agreement, however, has been reached on the basic tenets of the system and on guidelines needed to help us through the current uncertain period.

I have attempted to summarize my view of current economic conditions and the short-term outlook. I believe the situation requires a sustained program of moderate fiscal and monetary restraint combined with specific Government actions to improve the productivity of our system.

It is also important that immediate Senate attention be given to the pending trade legislation. If we sustain this set of policies, I believe that the unsatisfactory rate of inflation will gradually moderate and that this goal can be achieved without experiencing an excessive increase in unemployment.

Thank you very much, Mr. Vice Chairman.

Senator PROXMIRE. Thank you, Mr. Rush.

[The prepared statement of Mr. Rush follows:]

PREPARED STATEMENT OF KENNETH RUSH

I am pleased to appear before this Committee to review the status of the U.S. economy and the policies necessary to continue the process of stabilization following the serious disruptions caused by food, energy, materials and capacity shortages. As Counsellor to the President for Economic Policy, I must carefully protect the privileged nature of my communications with him, but we can have a full and meaningful discussion of economic issues without violating that confidential relationship.

My appearance today will be followed by other Administration officials who will discuss economic issues in greater detail. In my role as coordinator of economic policy, I will limit my comments to summarizing our program for moderating the unacceptable rate of inflation as a beginning point for achieving general

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progress in the U.S. economy. While policies must focus on the diverse goals of high employment, efficient production of goods and services, price stability and international trade and investment, progress in reducing inflation is now the foremost need.

Our policy recommendations of fiscal and monetary restraint are widely recognized as the most reasonable approach available. Perhaps even more important, we intend to pursue these policies until the desired results are obtained. Gradual progress will require cooperative efforts within the Government and awareness in the private sector that current price and wage decisions should reflect long-term realities. My review of the economic outlook and our policies will hopefully contribute to these goals.

ECONOMIC CONDITIONS AND OUTLOOK

In 1973 housing demand and consumer durable goods spending softened following an extended period of rising real output. The unexpected oil embargo and extraordinary oil price increases aggravated this slowdown and a decline in real growth occurred during the first quarter of 1974. Supply and capacity constraints further restricted production. The preliminary figures for the second quarter indicate that the sharp drop in activity was not continued even though the real Gross National Product did decline at a seasonally adjusted annual rate of 1.2 percent after eliminating the effects of inflation. The pace of domestic business activity has stabilized and this is a major accomplishment given the risks of the economic transition and the severe distortions of various shortages. Employment gains have matched the moderate labor-force increases so the unemployment rate has remained stable in the 5.0 to 5.2 percent zone during the last six months. By June 1974, there were 744,000 more nonfarm jobs than in October 1973 when the oil embargo began. Total employment in June was 1.6 million higher than twelve months ago. The unemployment increases that occurred in late 1973 were largely associated with energy-related problems.

Despite the strengthening performance of the general economy in recent months, uncertainty about the near-term outlook persists. We believe that the economy will experience small, but steady, output gains over the next few months with relatively small unemployment increases, and that policies of moderate fiscal and monetary restraint should be pursued to gradually reduce the excessive rate of inflation. The GNP price deflator continued to rise at a seasonally adjusted annual rate of 8.8 percent in the second quarter, which is most unsatisfactory, even though the rate did drop from a level of 12.3 percent in the first quarter. The current improvement in food production and more stable world-wide prices for oil and some industrial materials will help moderate these inflationary pressures further. Nevertheless, inflation will persist at an unacceptable level unless a comprehensive program is sustained.

In planning for 1974, it was anticipated that a sharp decline in real output would occur and that the economy would then stabilize prior to gradually increasing the pace of activity as the year progressed. The preliminary figures for the second quarter are now available to evaluate the pattern of results so far.

Personal Consumption outlays in real terms strengthened in the second quarter. Consumer durable goods spending jumped at an annual rate of $2.3 billion in real terms (1958 dollars) and services outlays rose $900 million. Automobile sales have dropped well below the record levels reported in 1973, but purchases have strengthened in recent months and the outlook is improving. Spending for non-durable goods, such as gasoline, food and clothing, was off $600 million, but consumer demand remains strong, according to weekly reports now available, and retail store sales are rising. The key factor in stimulating this basic sector of the economy is to make real progress against inflation so that consumers can increase their real purchasing power.

Data on Gross Private Investment reflected a mixture of strengths and weaknesses last quarter. Constant-dollar housing expenditures were off $600 million at an annual rate, as expected, but the bulk of the decline in housing outlays caused by the drop in new starts in late 1974 is now behind us. New housing starts have been holding steady since January and a backup program of $10 billion in various mortgage financing aids has been created to help offset the disruptive effects of high interest rates and financial disintermediation. The rate of inventory accumulation, stated in 1958 dollars, was $1.5 billion less in the second quarter than in the first three months of the year, but stocks did increase at an annual rate of $9.1 billion during the second quarter. Inventory to sales ratios remain relatively low and the backlog of orders is at a record level and rising.

Measured in constant dollars, business investment for plant and equipment remained essentially flat in the second quarter, as a small increase in nonresidential construction spending was offset by a slight drop in producers' durable equipment spending. Despite the high level of interest rates and continued shortages in some industries, the sustained pace of business investment should be considered a major source of strength in the economic outlook. However, to meet the expanding demand for goods and services and to remain competitive in world markets, many basic industries require extensive capital investment. Continued business spending for plant and equipment is basic to the near-term and future strength of the economy, and to the ultimate control of inflation, but it will not occur automatically. Economic incentives must be available to assure expansion of capacity in the United States and massive amounts of capital will be required.

Total government spending, measured in 1958 dollars, declined at an annual rate of $700 million during the second quarter. The $600 million drop in State and local government spending reflects some slowdown in the pace of revenue sharing outlays.

In general, the domestic sector of the economy was essentially "flat" in the second quarter according to the preliminary GNP figures. For the rest of 1974, we expect small, but steady, gains in real output. While the pace of growth may not be as robust as anticipated at the beginning of the year, the gradual improvement should help to moderate possible unemployment increases and should help avoid a surge of unwanted inflationary pressures. Most important, the underlying strength and resiliency of the economy will justify our sustained policies of moderate fiscal and monetary restraint which are necessary for reducing inflation.

In terms of the wage side of the picture, as well as industrial relations, there is no question but that wage earners are striving to recoup some of their real income lost to the large price increases we have been experiencing over the past year. Wage increases being paid are currently running at a national average annual rate of 9.6%, up from 6% in the first quarter.[1] Settlements recently negotiated have been running well over 10%. A sustained period of this level of wage increases is dangerous to the American economy because it builds permanently escalating costs which add to inflation and gradually remove the American economy from the competitive world market. Reasonable and responsible wage increases are desirable, just as are responsible and reasonable prices, but increases of the magnitude we have been experiencing lately are not healthy for the U.S. economy.

There is also more industrial strife now then at any time since the early fifties, with 528 strikes involving 235,399 workers. Most of this strike activity is associated directly with the end of wage and price controls and the sharp price rise in the cost of living. However, these strikes generally have been short in duration and at this point have not adversely affected the general industrial relations climate. This will have to be watched closely to ensure harmonious long-term labor management relations are continued.

In the international economy, events aside from the oil situation appear to be following the desired course. In 1973 our merchandise exports increased 44 percent in value from $49.2 billion to $70.8 billion while imports rose only 24 percent from $55.6 billion to $69.1 billion. As a result, the merchandise trade account returned to surplus following two years of deficits. There were a variety of factors contributing to this improvement, including a surge of agricultural exports and strong demand for U.S. manufactured products. The realignment of currency exchange rates beginning in 1971 was a major factor in enhancing the competitive position of the United States and we expect this to be a continuing source of strength.

For the same reasons, U.S. exports continued to climb rapidly during the first half of 1974, and our imports have tapered off. In fact when we strip away price increases and get down to the volume of trade, we find that our exports rose well over 10% and our imports actually declined. This improving U.S. trade performance came at a crucial time, since it helped boost economic activity at home. The strength of our foreign trade sector has also helped maintain the dollar's international value. The market has taken into consideration that the United

[1] Adjusted average hourly earnings index.

States would have enjoyed an $8 billion trade surplus during the first half of 1974, but for the higher prices of imported oil. The near-quadrupling of petroleum prices, however, has caused a trade deficit for the last two months and I would anticipate that we will be in deficit these next few months.

Many other oil-consuming nations are also experiencing trading deficits which will create serious balance of payments problems. We believe that the developed countries should refrain from actions, either on the import or export side, designed to improve their trade balances with each other, as this does not reduce their overall deficit but creates additional tensions. As a first step, member nations of the OECD (Organization for Economic Cooperation and Development) have agreed to avoid such trade measures, and a similar proposal is now before the International Monetary Fund.

POLICY RECOMMENDATIONS

In emphasizing the underlying strength and resilience of the U.S. economy, particularly the stabilization in the second quarter despite the many domestic and international economic problems encountered, I am not trying to minimize either the virulence of the inflation pressures or the risks that unempolyment may rise during the coming months as real output gains remain below the long-term target. The economy faces many real problems and responsible leaders should not attempt to gloss over the reality of how hard or how long the adjustment process will be.

But, it would be an even greater fallacy to disrupt the policies of moderate restraint which are necessary to gradually reduce inflation without triggering unacceptable increases in unemployment. Some people will claim that this is only a policy of inactivity and an outmoded commitment to a dogmatic view of the economy.

On the contrary, these recommendations represent a conscious decision to sustain fundamental policies for a long enough period of time to achieve results. We will take whatever adjustment actions are necessary to improve the efficiency of the economy—such as the decision to release all available acreage to stimulate agricultural output. Government policies often create market-place distortions which discourage both efficiency and output needed to help moderate inflation, provide employment opportunities, and enhance the growth of real income. We are striving to identify and correct these problems. But our approach is based on the fundamental premise that certain fiscal and monetary actions are needed to get lasting results. There is also an explicit recognition that the adjustment process must not ignore the risks of unemployment during the transition stage.

For several weeks we have been making difficult decisions about the Fiscal 1976 budget and what must be done to prevent Fiscal 1975 outlays from drifting out of control. Trying to slow down the upward momentum of the Federal budget is not easy because it is usually more popular to respond to demands for increased spending, lower taxes and easier credit. In fiscal 1965 Federal outlays totaled $118 billion; in fiscal 1975 outlays of $305 billion have been proposed and there are constant pressures to move that figure even higher. This constant expansion of spending programs has already eroded budget planning flexibility and legislative commitments have been established far into the future.

The recent enactment of the Congressional Budget and Impoundment Control Act is encouraging because it establishes a rigorous framework for Congress to use in approaching Government spending decisions. But we must make our actions conform to our rhetoric in many ways.

First: This is not the proper time to reduce tax receipts. The additional consumption demands would further aggravate inflation. Even more important, such action would repeat earlier signals that the Government is unwilling to face the difficult challenges of necessary fiscal restraint. Taxes have already been cut three times since 1963 despite a long string of budget deficits reported in fourteen out of the last fifteen fiscal years.

Nor is this the right time to increase taxes even though the announcement effect might be dramatic. New capital investments in plant and equipment are particularly sensitive to tax increases and to uncertainties about future cash flows which are directly influenced by tax and capital consumption allowance rules.

Fundamental changes in the tax structure should occur only after long and careful analysis of the impact on investment incentives and the resulting fairness to all groups. Tax reform studies preceding new legislation can and will go forward and some significant adjustment may be necessary, but the basic tax structure should not be changed each time short-term economic distortions develop. That would be disruptive to consumers and business firms in making long-term savings and investment decisions.

Second: As to expenditures, decisions must now be made to require at least a balancing of receipts and outlays in Fiscal 1976. Since there is a lead time of eleven months, we can strive to slow down the rate of increase of outlays for existing programs and specific legislative adjustments can be identified and acted upon. We can also work to increase the productivity of government programs so that the same services can be provided at a lower cost. The Congressional budget reform measure may provide an effective procedure for cooperative efforts to achieve this basic goal.

Our flexibility in restraining Fiscal 1975 spending is somewhat more limited because the programs are already in place. The latest official estimates include budget outlays of $305.4 billion and receipts of $294.0 billion, which would result in a deficit of $11.4 billion during the current fiscal year. However, legislation currently pending before the Congress would rapidly escalate spending beyond the planned level. Our firm intent is not to allow the cumulative effects of pending legislation to push spending higher and to seek every possible way to reduce spending, using the figure of $300 billion as a target. I wish we could cut outlays even more, but we must be realistic in recognizing the accumulation of existing legislative requirements. The important thing now is to move forward on the two-pronged budget goal of achieving at least a balance in Fiscal 1976 while actively attempting to reduce Fiscal 1975 spending to below the current estimate of $305 billion rather than permitting outlays to drift upward in response to current legislative increases.

Third: As for monetary policy, I reaffirm the importance of achieving the moderate restraint goals of the Federal Reserve System. Careful examination of various statistics indicates that the Federal Reserve has sustained a supportive level of growth in the supply of credit while attempting to gradually stabilize the turbulent financial markets. The necessity of adding large inflation premiums and the intensity of loan demand in recent weeks have pushed interest rates to historically high levels, but both lenders and borrowers should consider the future course of the economy, particularly the slow acceleration of business activity and the gradual moderation of inflation pressures. While monetary policy must remain flexible and responsive to the changing needs of the economy, the current policy of moderate monetary restraint seems to be most appropriate for the current situation.

Fourth: The Government can and should make every effort to improve the productivity of the economic system so that output is increased without creating more inflationary cost pressures. The obvious beginning point is for the Government to eliminate, or at least reduce, the barriers to efficiency created by its own policies. Examples of such actions include the decision to release some 60 million additional acres of idle cropland to stimulate farm output; the energy conservation and allocation programs for alleviating the physical distortions of the oil embargo; the Project Independence effort to provide reliable sources of energy at the lowest possible cost; proposals to rehabilitate the Nation's transportation system, including some needed deregulation to promote competition; recommendations for modernizing the existing system of financial institutions; and many other specific Government purchasing and regulatory actions which I will not list in this brief statement.

The President recently announced his intent to conduct a broad review of Government regulatory activities which may be disrupting the productivity of the economic system. In considering every piece of legislation, we must seriously consider the impact on future inflation, employment and investment goals.

These specific actions can be important supplements to the basic fiscal and monetary policies in shaping the general economic environment. We are constantly seeking new ways whereby the Federal Government can improve productivity, both in its own activities and in the private sector. Various Cabinet officials have participated in the efforts of the National Commission on Productivity and we hope this group of labor, management, government leaders will continue to be active in the future development of incentives for productivity improvement.

Fifth: I want to once again state our strong opposition to returning to wage and price controls. We will continue to meet with representatives of all sectors of the economy to discuss the importance of considering long-term interests in making current wage and price decisions, but we do not believe that a program of controls would contribute to the real solution of our economic problems.

Finally, there are a number of important policy issues pertaining to international economic developments which strongly affect our own economy and which are therefore receiving priority attention.

We have taken the lead for many years in working for a more open and equitable world trading system, in the conviction that expanded exchange of goods and services among nations benefits all peoples. However, trade policy issues are sensitive matters for most nations, where important sectors of their domestic economies are affected, and difficult negotiations are ahead of us. The most important immediate task before us is the passage of the Trade Reform Act so that international negotiations can begin to reduce trade barriers and make better arrangements for managing trade relations. As you know, the new round of GATT negotiations started in September of 1973 with a meeting of 105 nations in Tokyo. Other nations are anxious to proceed and are waiting for the United States to obtain authority for full participation in the negotiations. Passage of the pending trade legislation by the Senate before the end of this summer is a crucial part of our commitment to meaningful discussions. I think this legislation is so vital to our national interest that it should be moved promptly through the legislative process. It should not be held up on grounds which have nothing directly to do with international trade.

There are other trade policy issues which are also receiving our urgent attention at a time of world-wide economic uncertainty, we must strive to maintain free and open markets by avoiding the tendency toward nationalism that has been demonstrated by some nations. At the moment, we are attempting to shape a more effective response to the problem of goods entering our markets with the advantage of government subsidies from the countries of origin. The products involved range from shoes to dairy products. We are hopeful that we can reach solutions with the nations involved that will meet their needs and avoid distortions of international commerce.

Dramatic fluctuations in world trade in agricultural commodities have had a disruptive impact all over the world. Our overall policy is to seek ways to ensure that food production is adequate to the world needs, and that reserves are accumulated to prevent severe shortages during years of poorer crop yields. Several specific issues command our immediate attention: the question of who should maintain reserves of agricultural commodities, the volume of reserves, and in what form; the relationship between our food assistance programs to the less developed countries of the world and today's high prices, in view of our needs to keep Federal budget expenditures down; the question of how to respond to the current beef glut, which has resulted in Japanese and European Community actions to close their borders to imported beef, thus causing hardships for producers in other nations, including our own.

All of these questions are under intensive study now by the relevant agencies in the government, under the coordination of my office, as we move toward the formulation of specific U.S. policy positions for the trade negotiations and for our role in the World Food Conference to be held at our initiative in Rome this November.

In seeking an international approach to the world energy problem, we have been talking with the other major consumer nations in the Energy Coordinating Group (ECG). The most important of the cooperative efforts discussed is a program to deter any future supply disruption and to protect ourselves if supply distortions return. Effort has also focused upon: longer terms cooperative solutions to the energy problem, such as research and development, as well as conventional resources. Consistent with the understandings reached with the other members of the ECG, we have also conducted some direct bilateral discussions with oil-producing countries. Our aim has been to keep production up and access to supplies open at reasonable prices. We have also sought ways of attracting requisite investment in oil, and have offered technical assistance for development of the economies of the oil-producing countries. However, the crisis continues to be important and serious.

While we are engaged in several efforts to adjust to this challenge, a fundamental problem is the high price. A number of severe problems would be alleviated if oil prices would come down. The current level of oil prices is creating serious problems for every nation and is making more difficult our own domestic efforts to combat inflation.

In this interdependent world we are also concerned with the problems of the less fortunate countries. Working with other governments who are members of the World Bank and the International Monetary Fund, we are seeking a better international system to deal with the development problems of these countries, including the problems created by the major increases in oil prices and other commodities.

One of the most important and complex economic challenges facing us today is posed by the large flow of funds to the oil-producing countries resulting from higher oil prices. If we are to ensure the continued willingness of the oil producers to export the quantities of oil needed by the Western World, these earnings will have to be recycled.

We have also initiated an international effort designed to minimize the distortions caused by government investment policies. Artificial incentives or barriers to investment can significantly alter the efficient use of resources and thus undermine world economic progress. Because such an effort will first have to be undertaken by the developed countries, we have concentrated our efforts in the OECD.

In the international monetary area, we have made considerable progress toward a new international framework. We took the initiative in bringing about a more flexible and adaptable system which has been able to cope with the rapidly changing circumstances of the last few years. Because of the uncertainties caused by the oil price increases, our goal of restructuring the international system has been temporarily delayed. An international agreement, however, has been reached on the basic tenets of the system and on guidelines needed to help us through the current uncertain period.

SUMMARY

I have attempted to summarize my view of current economic conditions and the short-term outlook. I believe the situation requires a sustained program of moderate fiscal and monetary restraint combined with specific Government actions to improve the productivity of our system. It is also important that immediate Senate attention be given to the pending trade legislation. If we sustain this set of policies, I believe that the unsatisfactory rate of inflation will gradually moderate and that this goal can be achieved without experiencing an excessive increase in unemployment.

Senator PROXMIRE. Mr. Rush, in your response to my opening statement you compared the criticism of the President to the criticism that was suffered by such great wartime Presidents as Lincoln, Franklin Roosevelt, Woodrow Wilson, and others. I see what you mean. But that is not what I am talking about. I am not talking about the level of public support for the President. What I am talking about is in the next month, just as in the past several days, the President's competence, his ability to control his subordinates in the executive branch, and especially his integrity, his honesty, whether he can be believed, is going to be under constant attack day after day.

That is the nature of the impeachment process, and under these circumstances it seems to me that it is very hard to expect that you can get a situation in which the business and the consumers, labor people and others, can have the kind of confidence in what they hear from the White House and feel any kind of unifying force that will help us solve the very serious economic problems that confront us.

Do you see what I mean?

Mr. RUSH. Yes, I understand what you are saying.

Mr. Vice Chairman, I have known President Nixon for a long time——

Senator PROXMIRE. Let me just interrupt to say, it is not that I do not think that the President does not have great strength and great force and intelligence and determination to do what he thinks is right. What I am saying is that these are circumstances that are now at this point beyond the control of the President to a very considerable extent.

And I think under those circumstances they require an extraordinary adaptation, which might be to have the Vice President step in, or there might be some other solution.

But it seems to me that in the next 4 or 5 months that are critical to our economy, his power under the threat of impeachment is seriously threatened.

Mr. RUSH. In my years of diplomacy before I went to the White House as an economist, I have noticed no lack of leadership. And frankly, in my present areas today I would say that there is as much unanimity of view among the financial advisers as one could ask for. We discuss things fully, we discuss them with the President, and the President makes the final decision. There is certainly a falling in behind him to carry out those decisions.

In my own executive experience—as you know, I have gone through life as a corporate executive as well as in my Government work—I would say that in the economic field the executive branch of the Government is working in a very satisfactory way under strong leadership. It would be, to me, extraordinarily disruptive if someone, not knowing the people, and not knowing the economy anywhere nearly as well, or understanding our policies as well, because no one could, since the President has been handling them and they have been formulated by him, should step in for a brief interim period. I think this would bring about uncertainty and would cause great harm.

Senator PROXMIRE. In all these things it is a matter of judgment, and it is true that changes in leadership are difficult. But it is true that we confront a situation that is so unparalleled and dangerous to us, to our economy, that it requires some consideration.

Let me go on to say that I think this prepared statement of yours frankly is a nothing program. You say on the first page, moderating the rate of inflation. But to moderate inflation, what do you propose? Nothing.

Consider: You recommend, No. 1, no tax change up or down, no tax reforms, and no specific incentives, except a generalized hint of more business tax reductions, and no equity improvements. This may or may not be right, but it is hardly a policy.

No. 2. no real spending change. You have mentioned a goal of a billion dollars cut, a goal—and you are very earnest about it when you say a goal—of a cut in spending in this fiscal year. You say, legislation now pending could push spending to $310 or $315 billion. And I get the impression that the administration really does not expect to moderate this fantastic $35 billion increase in spending over last year, a 13-percent increase, the biggest increase in the peacetime history of our country by far, one of the very biggest percentage increases that we have ever had, and this at a time of our worst inflation.

No. 3, you say no wage and price controls. I think that is right. But it is not a policy.

No. 4, you say not a word about antitrust action.

And No. 5, no mention of jawboning industry and labor to hold down price and wage increases.

You suggest no change in monetary policy, no strategy to reduce the outrageously high oil prices, and no prospective program to meet the tragic housing depression we suffer, and no proposal since last year to keep the threatened resurgence of food inflation, and only rhetoric on improving government productivity.

There is not a single suggestion, positive or negative, as to how we do this; no indication of a real, not token, program to lessen inflation by increasing productivity in the private sector; and especially and above all, no recognition of the crying need for a Government strong enough and tough enough to say no to the competing pressure groups that are pushing prices in the private sector, and the Government subsidies, and quotas, big steel, big trucking, big shipping, big highway builders, big military contractors, and all the rest.

So you have not given us, in my opinion, a reassuring picture.

Mr. RUSH. Let me say this: A policy can be presented in many ways. For instance, we say that we do not wish to have tax increases. You can have a policy of increasing taxes or decreasing taxes or keeping the tax structure as it is. Whichever one you choose is a possibility. Obviously, people in general say that if you do not adopt my policy, you have no policy. But in my opinion we have a very good policy and a very sound one.

Why do we not want to decrease taxes? Because we are feeding the fires of inflation very badly.

Why do we not want to increase taxes? Because if they come in with a tax increase bill, it brings an uncertainty into the economy.

What people need now is certainty. We have gone through, in my opinion, too many changes in the past several years. We try this and this and this. And I think what the American people need now is a period of feeling that we are on the right track, and we intend to stay on the right track, and that they can plan on this.

It might be of interest for me to review the fact that the President has been meeting with top members of industry, of banks, of insurance companies, of top economists of all kinds, and though with only one labor leader, I have been in touch with other labor leaders, and we have their input as best we can.

These meetings were designed to say, how can we cope with inflation.

The consensus from each of these meetings with these representative broad segments of society is that we are on the track, and that we do have a very good policy, and we hope we will stick to this policy and will not change.

Now, there were a few, a minority, who said that we should cut back, you have the group that said, cut taxes, prime the pump, and the like, which would of course feed inflation.

There are some others who go to the other extreme and say, why do we not cut the budget by $20 billion or $18 billion, impose rigid price controls and wage controls and profit controls, and whack them out from there. But these are the vast minority. And the moderate policies that we have adopted have been applauded at these meetings by top industrialists, top economists, top bankers, and top insurance people——

Senator PROXMIRE. Let me just interrupt to say that the problem is this: I do not agree with you that the situation is getting better. As you know, the Wall Street Journal reported on Friday—you may have more recent statistics—that:

> Wholesale price figures for July, coming out early next month, are likely to jump about 3.5 percent from June, equal to a yearly rate above 40 percent; farm prices are the villain once again. The increases will begin showing up at

retail within weeks. Statistics due out today will show a larger foreign-trade deficit for June than the big gap reported for May.

The unemployment rate, hovering about 5.2 percent for several months, is expected to shoot up soon. Gloomy White House economists expect joblessness to join inflation as a top public concern by Thanksgiving. Administration officials concede now that the gross national product will show a drop for all 1974, instead of the slim gain predicted earlier.

Also worrisome: Exploding wage rises, increasing strikes, supply bottlenecks, loan demand keeping interest rates up. 'It's going to be a long, hot summer for the economy,' one official says.

What I get from you is that we do not have any kind of a program to deal with that, and what we are doing now is just about right. I read in a column over the weekend that Mr. Stein, your top professional economist, is a man who never met a statistic that he did not like. It seems that you never met a policy that you do not like.

Mr. RUSH. On the contrary, before we recognize the seriousness of the situation we are in, I do not expect that we are going to get out of it scot-free. It is not something that has been created by us, it is something that has been created by factors which have been building up over a period of many years, which I shall be glad to review.

Senator PROXMIRE. Certainly I disagree with that. Certainly we had a big role—and by "we" I mean the President and the Congress—in creating inflation, something beyond——

Mr. RUSH. Certainly we contributed to it. But to carry on for just a moment with regard to your comment, I would say that you might have an analogy of Mr. Churchill and his blood, sweat, and tears policy. He was faced with a long war, and things looked very dark. The fact that you intend to stick with the course does not mean that you do not realize the seriousness of the fight or the seriousness of the challenge. We do.

We are on the course that we think will lead to victory. And it is because we are on that course, and we do have confidence in it, and we have every reason to have confidence, that we think it should not be changed. The fact that we are not making changes does not mean that we do not see the seriousness of the problem. Quite the reverse.

I think making the changes would make the problem more serious. I think we have made too many changes in these years.

Senator PROXMIRE. Now, let me just say—my time is about up—let me just say as I conclude, the problem is that the situation really is not bad for big business. Profits went up very sharply in the first quarter this year, when everything else was going down.

The second quarter, they are going right through the roof. The oil companies are really having a great situation. This is true right along the spectrum, making up for the automobile industry. Everywhere else the profits of big business are up. This is a good situation. They like it.

Now, the President's economic cabinet consists of Kenneth Rush. Who is he? The president of Union Carbide.

William Simon, partner in the Wall Street firm of Salomon Brothers.

Roy Ash, cofounder and president of Litton Industries.

Frederick Dent, president, Mayfair Mills Textile Co.

William D. Eberle, chairman of American Standard.

Jack Bennett, top executive of ESSO.

Coming aboard is Allan Greenspan, business economist, the first chairman of CEA ever to be a business economist.

Big businessmen are fine.

I think Chuck Percy is one of the finest Senators and one of the finest men I have ever met, and I think businessmen in this competitive world deserve to be heard. I think they ought to be listened to in our Government, and in a big way, but not entirely.

If you have the most radical kind of President in the world and he surrounds himself with people like this, of course, he might be inclined to favor policies that are favorable to big business to keep those profits up, and to do no jawboning down of prices, and to do nothing about antitrust action. And businessmen like that. Of course they do. Why should they not?

You see, this is the problem. The administration has lost credibility, and it is going to lose credibility very sharply over the next few months. And for an administration to be dominated by one sector of the economy is just as bad as if we had nothing but professors or nothing but labor leaders advising a president.

Mr. RUSH. Mr. Vice Chairman, of course, in addition to being in industry, I have been in diplomacy for 5 years. I have been a lawyer, and a professor. And I am not especially in favor of big business; in fact, I gave up a lot of it to go into Government.

But I would like to say this: The people we have been talking to are not just big business people. I have talked to many people in Government. They do not want price and wage controls. They do not want to increase taxes. They may want to reduce taxes. That may be the one part of our policy they do not like. Maybe they do not like our policy with regard to monetary restraint. But this is not a matter of big business or labor, this is a matter of the economy.

Big business cannot prosper in an economy where labor cannot prosper. Big business cannot operate in a vacuum. Big business is a part of the entire economy, and the problem of getting cash to build plans for big business poses many problems. The profits they are making are not going out in dividends, they are going into inventory to replace inventory that may cost four times as much, and to replace plants that have become obsolescent. So this is not a question of big business or labor or farmers against each other; this is a matter where the entire economy is seriously weakened by inflation.

I do not think any policy designed to conquer inflation in favor of big business is going to help big business any more than anybody else, or designed to help labor any more than anyone else. We are all in the boat together, and our policies are determined by what we think is best.

I think, without bias, the list of people you mentioned certainly is a very broad one. Mr. Simon, as you say, came from Wall Street. He is not big business.

Senator PROXMIRE. You are kidding. His income was $2 million a year before he came to the Government. If that is not big, what is? It makes the President look like small change.

Mr. RUSH. I think there are many people who have big incomes that are not big business.

Senator PROXMIRE. OK. My time is up.

Congressman Brown.

Representative BROWN. Mr. Vice Chairman, I am perhaps going to bring in a third viewpoint here. I share your concern about the idea that business has been the primary area in which the executive branch has leaned in its discussions on this economic problem.

Mr. Rush's own comment was that he has discussed the matter with the Congress, industrial banks, and the insurance companies. I am sure that is the basic problem, the problem of capital and finance.

That was referred to by Mr. Simon when he testified before the Bentsen subcommittee on June 26, where he—well, I should read it—said that 62 percent of our capital markets are preempted by the U.S. Government and its federally sponsored agencies.

Mr. McCracken, the former Council of Economic Advisers chairman, a few days later said that the figure was more like 6 percent. And, of course, what we are caught with here is the trap between big business and big government.

I suppose that if we get a veto through the next Congress, why then the American people's choices will be reduced to big business, big government, or big labor.

I would like to suggest something to this committee, Mr. Vice Chairman, and that is that perhaps we ought to give the average American a chance to participate in this discussion on the economy and see if we cannot get some recommendations put in from labor personalities that are not big labor, from business people who are not big business, from consumers, from the elderly to poor farmers, and others, about how we might find some solutions to this economic problem of the Nation. It it not just big business, big government, or big labor's problem, it is the problem, I think, of the average American citizen. Unless we get them all into the picture, we are not going to solve it.

I think it would be helpful perhaps if we do what I think the Government ought to bo whenever it is in trouble. That is, turn to the average citizen and ask for his or her assistance with this problem.

I would like to suggest, Mr. Vice Chairman, that now that we have finally gotten these hearings on the way, maybe we might spend a little time over the next few weeks going into the 10 Federal regions of the country to ask average citizens, small business people, consumers, and others, for their suggestions about how we resolve these problems.

Ask them what it is that they would be willing to give up in terms of this massive Federal budget that does wonderful things for people, but mostly to them, in a way of trying to cut back this Federal spending.

Is this a possibility, do you think, Mr. Vice Chairman, that we might be able to do this: Go out into the 10 regions of the country and have some Members of the Congress concerned about this problem, and who serve on the Joint Economic Committee, have some hearings on this matter?

Senator PROXMIRE. I think that is a very constructive suggestion.

Representative BROWN. I understand Senate concurrent resolution 93 has been introduced in the Senate to provide $100,000 to study the economy between now and the end of the year. We will take this up in the House this week.

I would like to suggest that those funds be used to get the opinions not of sophisticated economists or college professors, but of citizens who may have some judgment about what we ought to do.

Senator PROXMIRE. I think that is fine. We certainly ought to do that.

Representative BROWN. I am delighted, Mr. Vice Chairman. I hope that we will be able to implement that policy as soon as we can.

Now, if I can in the time remaining ask just a couple of questions about this issue of big government. It seems to me that we have had 62 percent of the capital formation overtaken by the Government because we have added over the years, deficit on deficit—and this is not a Republican policy; it is not, I guess, just a Democratic policy, it has been a governmental policy. Some of us have been very distressed by it for a number of years.

I cannot say that the policy of deficits originated with the Nixon administration. I think the policy of deficits started with the Johnson administration. But deficits began long before that.

Is there a way, Mr. Rush, that we can terminate this ever-increasing requirement of the Federal Government to go out and borrow money from the average American citizen?

I can understand why people take their money out of the savings and loan where you get 5, 6, or maybe 7 percent, if you are lucky—and I am talking about big money, because that is the kind of money we are talking about here—why they take it out of the savings and loan and why they take it out of the bank. When they take it out of the savings and loan, you have crippled the housing industry; when they take it out of the banks, you have crippled a lot of the small businesses.

I had one of my constituents this week ask me if small business could survive this experience. And I must say, I could not give him a terribly competent answer. But I am not sure that some big businesses cannot survive it either, because if they have to borrow money at 12 percent to increase the capacity to produce shortage goods, that 12 percent interest means that a 100 percent of whatever they borrow has to be replaced in a little over 6 years, based on cumulative rates.

The result is that they have to jack the price up pretty high to pay for that interest rate.

Now, the only reason that we have that high interest rate is because they are competing with the biggest borrower of all, and that is Uncle Sam. The reason that he borrows is because he has never paid back, he has the worst credit in the world, all he does is keep the money that he has borrowed and increase the interest rates so that he can get more money.

Now, when are we ever going to get away from that?

Is there a way to do that?

We sure cannot do that with a $305 billion budget that has an $11.4 billion deficit. We have to cut back. I do not see any other way. But is there any other way?

Mr. RUSH. The best way we could start cutting back is to start balancing the budget.

Representative BROWN. How can we do that?

Mr. RUSH. This can be done by the cooperation of the Congress and the President. This is something that we are aiming for in 1976, and I hope we can reach it.

Representative BROWN. In an election year, Mr. Bush, you are not going to get the Congress to go along with that unless you can also get the average citizen in the country to go along with it. If the average citizen comes to somebody and says, let's reduce taxes and let's spend more money and let's go deeper into debt, and he does not understand that that is laying the burden on the poor and the people on fixed incomes, the little man, the small businessman, and the average guy in this country. Big labor is going to survive, big industry is going to survive, and most of all, big government is going to survive, because they are the people who turn on the printing presses with the money.

I am not worried about the Government. It will be around, who ever is running it, but it will be doing things to harm people rather than help them if it responds improperly to this problem.

Now, the Congress will not respond properly unless there is, out in the countryside, some understanding of this difficulty.

Mr. RUSH. The 1976 budget, of course, will not be formed during this election year. We are working on it now, and it will be framed after the election.

The 1975 budget will to the degree that they get legislative action; we must get that legislative action soon. Perhaps we will not be able to get legislative action, but we can at least ask that the Congress——

Representative BROWN. We have not had much legislative action in the last few months because the Congress has been more concerned with another problem. But that can be done at the executive level then.

Mr. RUSH. The executive level, for one thing, for the 1975 budget is trying to work with the Congress so that the Congress will not increase the budget above the level. The great worry is that the budget will be increased substantially by congressional action, bills such as the agricultural bill which has just been passed, or which is just in the process of going through Congress now.

Representative BROWN. But if the fiscal problem of the country is the dominating issue, what specifically is being done with reference to having people meet with the Members of Congress, with the members of the public, these average citizens?

If the executive branch cannot do it or does not do it, then I would suggest that the Joint Economic Committee and the Congress do it. But what action is being taken to meet with the Members of Congress involved in these varying committees?

Mr. RUSH. Of course there is a continuing rapport, dialog, shall we say, going on between Members of Congress and the executive branch with regard to every bill that comes up before the Congress. This is not institutionalized perhaps, but it certainly is a continuing dialog. Most of the dialog is informal and not formal. And there must be a continuing dialog between the executive and the legislative which regard to legislation by Congress. But I was really referring to the point that you raised of the Government taking 62 percent of the total money available out of the money market which it is really recirculating.

Representative BROWN. By a simple necessity of borrowing money to keep going.

Mr. RUSH. This money in large measure consists of recirculating debt that is already out, recirculating the existing debt, refloating it, by independent agencies, establishments going out and borrowing money on their own.

Representative BROWN. By guaranteeing things like housing and student loans and all these wonderful things that the Government does for people which do rotten things to the economic situation in our country.

Mr. RUSH. The recent loan to cattlemen, for example, is another illustration, which was signed by the President and passed with a great majority by Congress.

Most of the programs that have been adopted in recent years that have pushed the budget up so heavily, this year's budget over 1974, is primarily because of social increases, welfare increases, veterans' benefits.

Representative BROWN. On the social security question, you know what worries a lot of people who are approaching social security age? That the system may soon become unsound because of the declining birth rate and the lack of enough people in the work force to be able to support those people on retirement.

Now, have we given any thought to what we are going to do with that problem? That is a long-range problem, and I really think it is not an appropriate subject for discussion in this session. But I can tell you that the average citizen back home is considerably worried about where the economy is going.

Mr. RUSH. When you look at the huge Federal budget and the huge expenditures and think in terms of a bloated bureaucracy, that is not where most of the money goes. The money goes in these large social programs, over 50 percent of it, in defense, some 26 percent of it, and in many other programs of that type. If we cut back, for example, personnel in Government, and we undoubtedly have too many, it still is only a drop in the bucket compared to the total budget of $305 billion. We have to think in terms of broad categories that are almost sancrosanct—social security, as you say, welfare.

Representative BROWN. But is there an agency at the Federal level, a group of people, a task force, a bunch of economic advisers, at the executive level, who are sitting down and trying to work through this $305 billion budget. Working through this budget, most of which has already been appropriated, to determine where it can be cut, how it can be reduced, how it can be brought into balance, so that the borrowing will be terminated based on this one year?

You are going to have to continue borrowing. I would like to see a surplus this year, because that means borrowing to meet last year's bloated budget would be reduced; in other words, you could pay some of that back, and that would leave some for business expansion or individual preferences in building a home, or buying new cars, or some appliance that otherwise would have to be financed. It would permit the borrowing of money at a somewhat reduced interest rate.

Is there a group that is meeting on this problem to make a determination, and could that group meet together with a similar group in the Congress, and with people in the general public, to say, here is how we are going to cut back, here is how we are going to get the Government under control?

Mr. RUSH. Yes. The way this would work, Congressman Brown is this: In the White House we have a group that meets every morning, which I chair. And it consists of the Secretary of the Treasury, the head of OMB, the Office of Management and Budget, the Chairman of the Economic Council, the head of the Energy Office, and the head of the CIEP. This meets every morning.

We also meet to consider the budget matters. And we also have Mr. Burns in on a lot of discussions.

Then the integrating offices in the White House for budget is, of course, the Office of Management and Budget, which we work very closely with, headed by Roy Ash. It works very closely with all of the departments which work up their own budget. They alone know their programs in real depth—HEW, Defense, the two biggest, and all the others. They know where the weak spots are, much better than you can know it just from the White House. And the process is one of not only the White House, but is is one involving all of these departments. And when you get into those departments you go on down from there. You have the Department of Defense, the DOD. You get into the various departments, the Air Force, the Army, and the entire thing really is brought together at the top of the officials of Management and Budget.

But we cannot sit on Olympian heights in the White House and say, you cut this and this. We can review, and we do review, and we can try to get the general policies and principles. But we need the cooperation of the departments who deal with the Congress, who get their budget from the Congress. We do not get their budget, they get it themselves from the Congress, and we work with them. We try to get their cooperation, and we try to review everything they do and try to suggest ways where they can cut their budgets. But that really is the way the process works.

Representative BROWN. Mr. Vice Chairman, my time for the moment is up, but I will commend to you the prospect of sitting down with that group and coming to the conclusion—I think the President said that in his speech the other night that you are going to cut that $11.4 billion worth of deficit out of the Federal budget this year. That is not a very big cut, just a little over 3 percent, about 3½ percent. I would commend you to come to the Congress and tell the Congress to do precisely the same thing, and then to get together and try to resolve those differences, and then finally to take that message out to the American people and say, hey, what 3½ percent are you going to give up? During World War II we asked people to buy bonds, we asked people to participate in the sacrifice that is required in that war. We are in as serious a war against inflation, or should be, as we faced with that foreign enemy at that time. And I would like to see us try to get the same kind of dedication going, the same kind of self-sacrifice going.

Mr. Rush, I really hope that that kind of approach, that word could go out through the Government that we must cut this out of Federal spending.

Mr. RUSH. I appreciate that very much, Congressman Brown. And I have great faith in the willingness of the American people to sacrifice when they see the real need to do so.

Senator PROXMIRE. Senator Percy.

Senator PERCY. Mr. Vice Chairman, I would like to comment first, on your remark on the big business people in the executive branch of

Government, and then on Congressman Brown's comment on what we can all do.

I think the one thing common to all the people, at least in the executive branch of the Government that you mentioned, is that they all have in common demonstrated proven success in virtually everything they have undertaken. Certainly, our witness today, whether it is in law, in diplomacy, or I hope, in dealing with economic matters, and certainly in industrial matters, has proven a success.

But I think, Mr. Rush, that there are certain problems involved in an administration that has been charged with being too business oriented. I would think at a time when we really want to bring the American people together, and all focus on this economy, that we should bring in other points of view such as notable exponents of the consumer's point of view, like Virginia Knauer or Esther Peterson. We should also include taxpayers federations and other citizen groups concerned about the way we spend our money, and national priorities. Also certainly labor participation.

I know that they were invited to a recent meeting but I think that only Mr. Fitzsimmons responded, but they were invited to participate at the west coast meeting. I think it would be reassuring to know that balancing out my friends and yours in business would be representatives of other segments of the economy all equally and deeply concerned about the economy.

With respect to what we can all do, I think we do have a feeling that we want to participate now, we want to be a party, we would all like to have a piece of the action. And it is no all-out war in military terms, but it is an all-out war against a common enemy that is ruining so many American families. And many would like to participate. And I would appreciate your advice as to whether it is advisable, now as we did in the war, to establish productivity councils in every factory and every office in America to get labor and management to work together to put people who are laborers, workers, and managers, down on the same side of the table to say, here is the problem, now, this is what we can do about it in our own sphere of economic activity.

George Meany assured me Wednesday that organized labor would participate. But I think the initiative really must come from management in this regard, because it is harder for organized labor or labor which is unorganized to take the initiative in a plant or an office. What can Government do to stimulate this kind of activity, which is authorized by law as a matter of national policy? A bill has been engineered or initiated by the Congress and signed by the President, and yet only the steelworkers and the steel industry have gotten off the ground and created these counsels that I know of.

What do you think can be done that is feasible and desirable to get these activities underway as a means of getting everyone involved?

Mr. Rush. I certainly think, Senator Percy, that we need to have the cooperation of labor and management to bring this about. I have had some talks with labor, and I intend to have other talks. I have not publicized them at the request of labor. But I intend to maintain a very close relationship with labor. And my interest is solely in how to improve the economy and fight inflation more successfully.

Certainly, I know of no one with whom you have associated, and certainly as far as I am concerned, who thinks that inflation is a nonclass thing. It is a thing that hurts everyone across the board. And we want the input of every single segment of society. I feel that management and labor, with the help of Government, can do a great deal on productivity, for example, if they work together and work together in depth. And steel is doing that. And it is being done in some other industry. And I would think that we would want to encourage that, and it would be a very important factor with regard to getting prices down.

And the antitrust laws which the vice chairman mentions, are—I did not go into that in my prepared statement, because that is a very broad subject. But the best way to get prices down is competition. And the best way to have competition is to have an excess of supply over demand.

It is very difficult to have competitive prices when demand far exceeds supply. The urge is just not there, the economic need is just not there. And your entire drive is, how can we increase product and productivity—the product gets into the product price, but the product gets by increased productivity, by the building of new plants, but the development of new processes, and all those things. And these must be encouraged, and we may come to Congress for help on that. But I certainly intend to try to get, as far as I am concerned, input from every segment of society. And I have no bias against or for anybody.

Senator PERCY. Again, as an economic counselor and coordinator, your role can be extraordinarily valuable. Not only George Meany, but Mr. Fitzsimmons and Mr. Woodcock have told me that labor will cooperate. I met recently with the new president of the Communications Workers. He is anxious to start an innovative new career, and he does not just want to start it on a strike note. He would like to be creative. And he will cooperate. In your contacts with NAM and the U.S. Chamber I just feel that you can be the catalyst to get a lot of this started. And you have a staff and agency behind you in the National Productivity Commission on which labor and management both serve.

From the standpoint of cutting the budget to symbolize that we intend to balance our outgo with income and not have Federal Government feed the inflation through deficit financing now, could you clarify what the President really intends to do now if the budget is a $305 billion budget? As I understand, he intends to cut it to $300 billion, a $5-billion cut that he will go after cooperatively with the Congress. What if the budget does go up to $312 billion, and expenditures expands? Does that mean the President will cut back $12 billion?

Mr. RUSH. The ability of the President to cut back the budget is very limited. As you know, the impoundment effort was not very successful, and met with a great deal of resistance, and is now of course, eliminated under the budget bill, and under the legislation. So the ability of the President to act alone is very limited. The ability of the President and the Congress to act together——

Senator PERCY. Inflation is more powerful than any other human being on the budget. And he has to assert what he is going to do then.

Mr. RUSH. He intends to veto any bills that would take the budget for 1975 over the amount asked for. He intends to drive toward reducing the budget to $300 billion. Whether this can be done without asking for legislation is questionable, because of the very limited nature of the executive to operate unilaterally with regard to this. It may be that in order to reduce it to $300 billion the President would have to ask for legislation. Unfortunately, as you know, Senator Percy, we are all in favor of reducing the budget and of a balanced budget, but when it comes to our particular program it means something else again. And I am not saying this critically, I am saying this just as a fact of life. So that we run into great resistance whenever we bring up some concept for asking a legislative action with regard to this program or that program or the other program, because most of these programs——

Senator PERCY. The budget sent up had an $11-billion deficit in it. Now we are processing it. Let us resubmit that budget. And I think you have probably seen the specific proposal that I made to cut the deficit by $10 billion. Others are thinking in terms of other things, but all we are saying is for the President to take the initiative now and say specifically where he would cut.

Mr. RUSH. We think that the $294 billion of receipts—just as last year the receipts were underestimated by $12 billions, we think they are underestimated this year, and they might be more than that, or $300 billion. If we get the budget down to $300 billion we might be able then to come near a balance, we do not know. That is yet to be seen. But the President does intend to come up to work toward this goal that I mentioned. Whether we will have to confer with Congress to see whether or not we can successfully ask for a legislative retreat from the budget that he has asked, I do not know.

Senator PERCY. It is my feeling that we have available $5 billion of added revenue. It would not be as easy as picking apples off a tree, but I think with the combined effort of the executive and legislative branch, and some strong determined leadership, I think we can in the oil industry, without discouraging production, and without discouraging output, or exploration and development, which would be self-defeating, I think we can pick that added revenue up. Can we expect some proposals for some increases in revenue to help us insure that we are actually going to balance revenue with income in fiscal 1975?

Mr. RUSH. We have none ready for proposal now. Whether we will be able to come up with any, I do not know.

I would like to put in a caveat. The policy of restraints on fiscal and monetary policy, and how long they should continue before you go too far into a recession, are pretty thin. If we should see a downturn in consumer demand, for example, and if the economy should start down, then there would be a great demand for increased outlays by Government, not for decreased outlays. And we must move now, not with a blunderbuss, but carefully. And we want to move very carefully, so that we are able to moderate the inflationary pressures, so that we are able to increase production, and at the same time so that we do not go too far to start on the downward side toward a recession. This is a very tricky thing.

Senator PERCY. My time is up, Mr. Vice Chairman.

Senator PROXMIRE. Mr. Rush, I want to be a little specific now in indicating why I think the orientation of the administration can be highly inflationary when the advice is concentrated, as it is in people with a single viewpoint.

President Nixon, in last week's speech on the economy, placed a large part of the blame for inflation on the increases in prices of oil, but he said that those prices are now stabilizing. However, as you know, there is strong evidence that we may be in for another round of oil price increases. I understand that you and other Government officials met at San Clemente recently with officers of Gulf Oil Corp. in an attempt to persuade them to resist pressures from the Government of Kuwait to hike the price of crude oil. I also understand that Gulf refused and is going along with the price hike. Is this true?

Mr. RUSH. I had a meeting with the chairman of Gulf Oil along the lines you suggested; yes.

Senator PROXMIRE. Will you give us the date of your meeting with Gulf and tell us the names of the other Government officials present?

Mr. RUSH. The date of the meeting was—I will have to look at my calendar—it was a week ago Saturday, as I mention it.

Senator PROXMIRE. A week ago Sunday?

Mr. RUSH. Saturday. And the other persons there—the people there were Mr. Sawhill, Mr. Dorsey, and me.

Senator PROXMIRE. You are reported to have said at this meeting, according to a July 23d McGraw-Hill newsletter, that while you would like Gulf to resist the price increase you did not want Gulf "to do anything that would hurt their stockholders." That statement, if true, would be a clear invitation for Gulf to go along with the price hike. Did you or anyone else at the meeting make such a statement?

Mr. RUSH. Not in that context. As I remember, what Mr. Dorsey told me was—and this is a confidential classification which I think I should tell you off the record, and not betray the confidence of Mr. Dorsey. But obviously, if Gulf Oil's property is not internationalized because of this action on their part, they might be subject to stockholders' reaction because of harming the company.

Now, I was not interested in the stockholders at all. What I am interested in is keeping the price of oil down. And the interest of Gulf stockholders as such, was not something I considered.

Senator PROXMIRE. So you counseled him to give in, to give in to the threatened Kuwait price hike?

Mr. RUSH. No, I counseled him not to do so.

Senator PROXMIRE. You counseled him not to?

Mr. RUSH. Yes. That was the purpose of the meeting.

Senator PROXMIRE. At any rate, what was Gulf's position? They went along with the price hike, did they not?

Mr. RUSH. They went along with it despite my meeting with them.

Senator PROXMIRE. Do you know whether other producing countries, such as Saudi Arabia, are now planning to follow Kuwait's lead and increase their prices?

Mr. RUSH. I think the two situations are entirely different. I believe that Gulf has always wanted to keep their supplies away from Aramco as a competitor, of course. And if they did not have a supply from Kuwait they would have to buy it from Aramco, which they did not want to do.

Senator PROXMIRE. Does the administration plan to take any steps to stop this new wave of oil price increases from hitting the American consumer, and if so, what steps are you taking?

Mr. RUSH. We are very anxious to see decreases in oil prices.

Senator PROXMIRE. I know you are anxious to, we are all anxious to, but what steps are you taking to achieve that?

Mr. RUSH. We are taking steps which I do not think I can publicly discuss.

Senator PROXMIRE. Mr. Rush, I want to read a portion of a White House tape that recently became public, and then I have a question.

These are excerpts from a House Judiciary Committee released transcript of a conversation on April 19, 1971, between the President, Treasury Secretary Shultz, and John Ehrlichman and later a phone conversation with Richard Kleindienst.

First the President is talking to Mr. Ehrlichman and Mr. Shultz.

The PRESIDENT. I don't want to know about Geneen. I've met him and I don't know. I don't know whether ITT is bad, good or indifferent. But there is not going to be any more antitrust action as long as I am in this chair * * * God damn it, we're going to stop it. I have nothing to do with them, and I want something clearly understood, and, if it is not understood, McLaren's ass is to be out within one hour. The I.T. & T. thing—stay the hell out of it. Is that clear? That's an order.

And then the President said:

The order is to leave the God damned thing alone. Now, I've said this, Dick, a number of times, and you fellows apparently don't get the me—, the message over there. I do not want McLaren to run around prosecuting people, raising hell about conglomerates, stirring things up at this point. Now you keep him the hell out of that. Is that clear?

The President said later:

Or either he resigns. I'd rather have him out anyway. I don't like the son-of-a-bitch.

And the President later says to Shultz:

This is the problem. The problem is McLaren's a nice little fellow who's a good little antitrust lawyer out in Chicago. Now he comes in and all these bright little bastards that worked for the Antitrust Department for years and years and years and who hate business with a passion—any business—have taken him over. They haven't taken him over. Then, of course, McLaren is the man. They go into Kleindienst, who is busy appointing judges; Mitchell is busy doing other things, so they're afraid to overrule him.

I mean the point is that on this antitrust they had deliberately gone into a number of areas which have no relationship with each other, to—whether it's a question of operating more, more efficiently than the rest. There's simply a question of tactically, they've gone off a kick, that'll make them big God damn trust busters. That was all right fifty years ago. Fifty years ago maybe it was a good thing for the country. It's not a good thing for the country today.

And later the President said:

Oh, I know what McLaren's, he believes this * * * And he's not going to stay another minute, not a minute, because he's going after everybody.

The reason that I read from this transcript is that the statements were made 3 years ago. I think there is considerable evidenec of price fixing, and of unjustified price hikes. And I want to ask you, in the light of the fact that 3 years have transpired since these statements were made, does the administration now recognize, in view of the sharp recent increases in prices, the consumers are paying a terrific price because of price fixing and price gouging tactics of the concentrated industries, do you plan to do anything to curb these sharp practices?

Mr. RUSH. If there is price fixing, Mr. Vice Chairman, the Antitrust Division is obviously not doing its job properly.

Senator PROXMIRE. How are they doing their job properly if you get this kind of message telling him to stop antitrust activity from the President?

If I were Attorney General in charge of the Antitrust Division I would sure get the message clearly.

Mr. RUSH. As I understand it, the issue has not been decided yet to this day as to whether or not bigness per se is a violation of the antitrust laws. That was the issue. It wasn't a matter of price fixing. Price fixing is per se a violation of the antitrust laws, there is no question about it. And for anyone to engage in price fixing is a form of criminal action.

Senator PROXMIRE. Let me read from a statement that was made just 2 or 3 years ago by Federal Trade Commissioner Mayo Thompson. He said:

> In a period of devastating inflation such as the one currently being experienced in the United States, surely there is no better way this agency could spend its resources than by trying to roll back some of these illegally inflated prices.

In a second memorandum Thompson said the steel companies which make up the third largest manufacturing industry in the United States were overcharging the public at least $1.25 billion a year through price fixing and should be the subject of a concentrated commission effort.

Later Mr. Thompson said a conservative estimate was that at least $100 billion worth of goods or services "are sold in the country each year at prices set by collusion rather than competition" resulting in "an aggregate consumer loss here of some $10 billion or more per year."

Concerning steel, the Commissioner said his analysis of what the steel companies charged over the last few decades indicated that the industry's pricing behavior "bears no resemblance to that expected under the laws of supply and demand as understood in even moderately competitive industries."

Mr. Thompson argued that because steel was part of so many different products, inflated costs here because of price fixing had a major impact throughout the economy.

Mr. RUSH. First of all, Mr. Vice Chairman, the Congress is very emphatic by its action. They said that they did want price and wage control, but they refused to give us standby authority for price and wage controls. So I think our position with Congress with regard to price and wage controls is the same.

Senator PROXMIRE. I am not talking about price and wage controls, I am talking about violation of the antitrust laws, and I am talking about price collusion, price fixing.

Mr. RUSH. The question of price fixing, which is illegal per se, and price collusion, which is illegal per se, is something that I have nothing to do with, because this is a criminal matter, it is under the control of the Antitrust Division of the Federal Trade Commission.

Senator PROXMIRE. Mr. Rush, I recognize that you are not a Commissioner of the Federal Trade Commission and you are not in charge of antitrust. But you are the principal economic adviser. And certainly one of the very important elements of an anti-inflation program is to make sure that there isn't price fixing at a high level by corporations.

Mr. RUSH. I would advise anyone who asks that if the Antitrust Division and the Federal Trade Commission is not definitely pursuing any price collusion, any price fixing they are not doing the job. I do not enforce the criminal laws of the country. And I am completely opposed to any violation of them, price fixing of any kind. I have nothing to do with that.

Senator PROXMIRE. In President Nixon's speech on Thursday night he said nothing about antitrust action. And in your prepared statement here today you said nothing about antitrust action, and in the transcript here that I read the President's position on antitrust seems to be about as negative as anything could be, and it is very clear.

How could we possibly expect to have effective antitrust action with that kind of Presidential action?

Mr. RUSH. I will say this about antitrust action. The antitrust law should be vigorously enforced. I think that it goes without my saying so that I strongly back the antitrust laws. The President strongly backs the enforcement of the antitrust laws. This has nothing to do with an analysis of the economy. What we are trying to do, and what I have said repeatedly is this. We are trying to insure that production and supply exceeds demand. Then you have the full forces of competition working.

Senator PROXMIRE. Where you don't have them working—and I can indicate an instance in just a couple of minutes of an important industry where they have all kinds of productive capacity and they are cutting back and raising their capacity at the same time. Steel has done this for years, and oil is doing it now.

Mr. RUSH. I think that all of these cases should be turned over to the Antitrust Division, and promptly.

Senator PROXMIRE. Let me just point this out. Mr. Fred Scherer, who is a distinguished economist, did an extensive analysis of market structure and economic performance and he found that the consumer was being forced to pay a heavy price for industrial concentration. He found a close correlation between the concentrated industries and losses of efficiency due to (1) resource misallocation, (2) pricing distortions, (3) deficient cost control among firms insulated from competition and among defense and space contractors, (4) wasteful promotional efforts, (5) excess and inefficient capacity, and so forth. Mr. Scherer then calculates the total losses due to market power concentration at a whopping 6.2 percent of the gross national product.

Another way of saying it is that when the consumer buys his hamburger or TV set or shoes for his children, he has an additional 6-percent sales tax because the antitrust laws are not being effectively enforced and because of the concentration.

Do you have any grounds for disputing that analysis?

Mr. RUSH. I would say this, Mr. Vice Chairman, that I remember back about 1939 this same issue was the subject of considerable study, and the Congress created the National Economic Council to deal with this. This constituted elimination of the competition. This is in the power of Congress to create the language. And it is within the powers of the Antitrust Division of the Federal Trade Commission to enforce the law. I believe it should do so fully. If the Congress wishes to review the subject of, does concentration in itself constitute an elimination of competition, I think that is an important subject. And Congress has looked in it many times, and they should do it again.

Senator PROXMIRE. My time is up, Mr. Rush. But what I am telling you is that when you hear the President's words to his Attorney General, emphatic as they are, against antitrust action, when you get absolutely no assertion now whatsoever from either you this morning or the President in your prepared statements calling for antitrust action, and when you have people in the administration, the top policymakers in the administration, from the biggest businesses and the concentrated industries, it is no wonder that we have that viewpoint represented.

It is not pleasant to have vigorous competition if you are in business. It is not pleasant to you individually. You may favor the principle philosophically, but from the industry standpoint it is one of the worst things that can happen. If you have a competitor and your competitor cuts his price, you are in trouble. No wonder big business opposes it. But that is why the President should not represent big business the way he does and surround himself exclusively and completely with big business advice.

Mr. Rush. I would say, Mr. Vice Chairman, that the worst thing for big business or little business or something else is not to have vigorous competition. I think vigorous competition is absolutely essential for the well-being of any size business no matter what it is. And I fully endorse vigorous competition. And I fully endorse enforcing the antitrust laws.

In a speech by the President to the Nation he tried to concentrate on the things that seem completely relevant. Frankly, I thought for him to go off into a labor-management relations, antitrust, and various factors of the competition, would not have been appropriate. He might make a speech about that.

But I do not think it is good for big business, little business, or any business not to have very vigorous competition. I think it rounds them.

Senator Proxmire. That is fine, but I would like to see some action.

Mr. Rush. What can I do?

Senator Proxmire. You and the President, too, can publicly call for it—you have done it this morning in response to my questions—but when you make these speeches, when the President makes them, he could say, I am directing my Attorney General and the head of the Antitrust Division to vigorously enforce the Antitrust Act on this $10 billion that the customer is paying for high prices, or the 6 percent of the gross national product on the basis of another competent analysis.

Mr. Rush. It seems to me that the items you are reading, Mr. Vice Chairman, are more argumentative than fact. Other people will argue either way. These are economic arguments. I myself will go with the one that says, we want vigorous competition, and the antitrust laws must be vigorously enforced. And the lack of competition is the worst thing in the world for any business. And maybe it is bad for the Government.

Senator Proxmire. Congressman Brown.

Representative Brown. I would like to take up the competition theme.

Mr. Vice Chairman and Mr. Rush, I have recently written the administration about the pricing practices in the meat industry because we have had a decline in the level of the price of beef on the hoof, or the carcass price of beef, without a consequent decline in beef at the supermarket level.

But having said that—and I think the FTC and the Justice Department ought to look into that and find out if we have a problem in that area—having said that, however, I would like to differ a little bit with the vice chairman. I realize that it is not a very popular comment to make, but in 1971 when these comments were quoted we were facing a rather sharp decline in our balance of international trade. The countries that were doing rather well in international trade at that time were two countries that encourage national monopolies, the Japanese and the Germans.

Now, if we become an international trading nation—and we seem to be on the way toward doing that—our traditional attitudes about competitive practices as they apply to international affairs may have to be changed. Our competition is coming from abroad in many of these fields. We have lost a good many of our industries, which means a good many jobs, not because we didn't have competition in this country—I can give you the electronics industry—but because our competition came from abroad, and the competitive industry in this country was just simply put to the wall because we had foreign competition without doubling. With reference to the steel industry—and I have an interest in the steel industry because of the nature of it in Ohio, and the contribution it makes to the Ohio economy—it seems to me that we have had a terrific growth in the steel industry abroad, but not a great deal of growth or improvement in the steel industry in the United States. It is an industry with one of the lowest margins in terms of profit in this country.

You can beat it around if you want to, but if you want to see us in trouble as a society, maybe the thing we should do is let the Government take over the steel industry.

I think some of these arguments are arguments of the past. And it seems to me that this is why we need to get this effort out into the country and find out what is going on in terms of our economy now, and where we are headed as a national economy.

If we can't compete in the world it won't make any difference whether we compete among ourselves unless we want to be back in the 1890 and 1920 economic era in the United States. I think we have to face the world as it is.

Mr. Vice Chairman, I would like to change the subject just briefly if I can. I have one industry, which is a declining industry in this country because of world competition, that recently was threatened by removal from the scene by the Federal Government because it didn't conform with some of the new legislation that we passed in both the environmental and the occupational safety and health area. The administrative decision was in the process of being made to require industry within 2 years to replicate, repeat, duplicate its entire fiscal investment of the last 100 years.

The President in his comments talked about the legislation in environmental controls and some of these other areas which require nonproductive investment. I gather that he meant nonproductive investment in the environmental area, and such things as the requirement in the printing and publishing indutry, of which I have some knowledge, to invest a billion dollars to take care of the noise problem. I assume that that won't produce any more goods or services or provide any more jobs, except for those people who provide the suppressant material or equipment.

Now, there are none of us, I think, who want to continue to live off the rape of the environment such as we have had in this country for the last 190-some years. But on the other hand, are we moving too fast or too slow in this area? What is the approach that was behind the comment about nonproductive investment in the speech the other evening?

I like the idea that we all ought to breathe clean air. I wouldn't like anybody to starve to death in it for lack of a job. Those two things seem to have some conflict in some of the areas in which we are involved, and I must say frankly I am not sure where rationale stands in that field.

Can you give me some comment on that?

Mr. RUSH. Yes.

Congressman Brown, you have put your finger on it. Basically there are various objectives that we wish to achieve. We do want to improve our environment, our air, our water. We do want safety. We don't want people to be killed in automobiles, and we want them to be as safe as possible.

Representative BROWN. I might say, incidentally, the statistics that I see about the billion dollars investment in the printing and publishing industry to take care of the noise problem is about two-thirds of the total annual investment in that industry, which is a rather significant part of the productive investment. And that is why I have some concern about it, you see.

Mr. RUSH. We do want to get ahead of this terrible inflation problem. We want to increase production. We do want to see the interest rate on money go down.

Now, these things are in conflict, because much of the money and a lot of the labor and much of the productive capacity is going for nonproductive things, for environmental control, and for safety. And what the President was saying was, we must have a balance between these various things. We can't go all out, for example, on environmental control on automobiles, which means so many more pounds of steel in every automobile, so much more additional cost for every automobile, so much more productive capacity going into nonproductive things, or in the case of a chemical plant—you can get down to a point, for example, where it may be prohibitive and the plants close down, as some have, and people lose their jobs, the plants stop operating. Then it takes new money to build a new, much more expensive plant to put in the environmental equipment and that kind of thing.

Now, all of these are very worthy things. But you have to have a balance. You have some choices. And the essence of what we are saying is, a moderate program of choices, doesn't go all out on any one particular thing.

Representative BROWN. I might say in one instance in which a company was going to be put out of business we did get the people in the Government to agree to a phased schedule, where over a period of, I think, 6 or 7 years when we finally settled it, rather than 2 years. In that time the company would modernize all of its equipment, and so forth, and we saved the jobs in that case. We are talking about jobs here, and I guess in the long run, the cost of production and so forth.

Mr. RUSH. The taconite controversy in the Mesabi Range is a good illustration.

They are closed down right now. All those people are out of work. And we have started importing iron ore, or started cutting back on steel production, take your choice, and less jobs. The question is, Shall we face it or, or what shall we do?

Representative BROWN. It would be nice not to make those choices.

Mr. RUSH. We have to make those choices.

Representative BROWN. We have to get to a point where we make some rational choices.

In giving you the opportunity to expound on that for a moment, I will ask you a question which I was asked when I was in my district and I had to admit I could not answer it. Given our economic problems—and you have a background both in the business and now the economic field and also foreign diplomacy—what was the authority by which the President gave one of the Arab States that $4 million airplane?

Mr. RUSH. That was part of the AID program.

Representative BROWN. Had the Congress yielded up to him the right just to give that to some head of state, and the parts, and so forth, that went with it?

Mr. RUSH. It really, I think, is a question of whether it was a Government program, whether it just went as part of the AID program and was not mentioned as a gift, that sort of thing.

Representative BROWN. Was it in effect given with the authority that had been yielded up by the Congress to present aid to that country?

Mr. RUSH. That is my understanding. Of course, obviously, he did not go out and buy it with his own money and give it, and he did not give it with money not legally to be used for that purpose. I think that is the answer. But I will be glad to go into it further.

Representative BROWN. I wonder if there is an economic advantage to us of giving away to some head of a state a $4 million airplane—if we are going to cut back I would like to ask the Arabs to cut back too.

Mr. RUSH. We, of course, are trying to develop a new and better relationship with the Arab countries, which is highly important, as we saw when the oil embargo was in effect.

Representative BROWN. I would like them a lot better if they had not jacked up the price of oil four times. Maybe we could be better to them if they would be nicer to us.

Mr. RUSH. Well, they have the oil.

Representative BROWN. That is a good point.

Senator PERCY. And we have the airplanes.

Mr. RUSH. We have the airplanes.

Representative BROWN. My time is up, Mr. Vice Chairman.

Senator PROXMIRE. Senator Percy.

Senator PERCY. I will just comment on that from the standpoint of the appearances also.

I think it is technically justified, particularly in the light of all these gifts and aid and things of that kind going back and forth. I had hoped that there would be enough sophistication in the world now to recognize that that kind of AID money really cannot any longer be justified, and should be ruled out. I think we will all be a lot happier when that comes about. But it has gone on for a long time under many different administrations, whether it is airplanes or whatever it may be. I just hope as one aftermath of Watergate that we get a lot of that behind us, and we will have less embarrassment as a result of that.

Representative BROWN. Maybe somebody could bake them cookies. [Laughter.]

Senator PERCY. Or send them Illinois corn. [Laughter.]

I would like to ask about food prices. As you know, Mr. Rush, through the years of our periodic reviews of the economy, it has been of great value to review our views and take a look back at things. The administration has told the American people that we are now over the hump on food prices. And yet, something that we cannot be responsible for is weather. And weather has been a major factor this year. Too much rain in the Midwest to start with, fields that were washed out, and plantings that were just inundated and destroyed. And then now very, very hot weather and drought conditions, so much so that U.S. corn production is off at least 3 to 5 percent nationwide, and Illinois corn off 10 percent from last year. And I have seen this weekend the very serious effects of weather out there.

When we consider what the estimates for this year's crop currently are—I think I have got some figures here some place—would be as against the original estimates, I am worried; 6.7 billion bushels of corn was the original estimate, but the estimate as of last Thursday was 5.95 to 6.22 billion bushels. Private industry's estimate, from the best information I can get, comes down to 5.7 to 5.9. That would be almost a 15-percent shrinkage from estimates originally. And that means higher prices. And that affects livestock and everything else. Does the administration still hold to the original estimates that we are over the hump on food prices?

Mr. RUSH. Senator Percy, I was in Chicago Friday. And I heard some very somber reports also from members of the audience there with regard to the weather situation. I have not been in touch with Mr. Butz since I returned, so I do not know.

May I ask my associate, Mr. Jones?

Mr. JONES. It now appears that the wheat crop is supposed to be up 20 percent, and corn and soybeans and some of the other crops will be in greater difficulty this year. I think the administration's estimate on food prices for the immediate future is that there would be some amelioration from the 1972 and 1973 runups, but not as much as had been originally anticipated at the beginning of the year. These estimates will, of course, have to be borne out by the actual crop results over the next month or two. The weather has been such, as you pointed out, that we are still uncertain about it. But there will be some amelioration, perhaps not as much as has been anticipated.

Senator PERCY. I think constantly updating these estimates would be helpful.

In your prepared statement you said: "Such as the decision to release all available acreage to stimulate agricultural output." Obviously, when it is released is crucial, because of the planting time. Is there any implication here that it is possible to release acreage now being held out of production to somehow bring more supply on stream, and to have, therefore, an affect on prices, and could it be done now?

Mr. RUSH. We are doing everything we can now to release acreage, set aside, so that we can have maximum agricultural production.

Senator PERCY. I would again hope we would not be too cautious, because timing is so important on those decisions, as you so well know. Anything that can be done now to bring downward pressures on those prices and compensate for farmers' reduced income through increased production I think would be highly desirable.

At the annual hearings last February the administration said it was basing its opinions for recovery during the second quarter on upturns in housing and automobiles. The figures on sales in mid-July for automobile production were down 26 percent from a year earlier, though there seems to be on the demand side a firming up in recent weeks that I have detected. Could you comment on that? And also could you comment on housing?

We know that a new housing program was introduced not too long ago with respect to federally aided homes. How much progress is expected in privately financed dwellings as long as there is such a dearth of mortgage money? Do you not think it is time the administration told us what those contingency plans are that were alluded to last February, and how soon they can be put into effect?

Mr. RUSH. With regard to automobile production, we were told by Mr. Chrisberger and other leaders in the automobile industry that they are optimistic of it with regard to the coming fiscal year. And we expect an upturn in automobile production.

With regard to the housing situation, as you know, it has plateaued off at something over a million and a half units. And it was up 8 percent last month. And we expect it to continue roughly along the same line, until mortgage money eases and the situation improves.

The President has a program of some $10 billion of additional mortgage money for housing.

Senator PERCY. On the subject of unemployment, Mr. Rush, there has been stability in those figures, but we see also a buildup in inventory which could mean larger unemployment figures later if we decide to eat into that inventory. Does the administration have standby plans to deal with unemployment if it gets to any higher levels than right now? And certainly any higher levels would be unacceptable.

Mr. RUSH. The unemployment, as you know, as I mentioned in my prepared statement, total unemployment has been mounting during the last year, and in fact since the oil embargo first went into effect. But the unemployment figure this year has been going up about 5 percent, and it has been staying in the 5.2-percent range. We anticipate it will go up as a result of the current policies to perhaps between 5½- to 6-percent area. And we consider that this is a price that we do not like to pay, it will be necessary to pay it in order to help get inflation under better control. We do not anticipate that it will go back to the 6-percent level.

Senator PERCY. I have talked with Arthur Burns, and he is strongly of the opinion, as I am, that one of the best ways and the quickest ways to deal with this problem is to have standby authority for more public service jobs. It gets right to the heart of the unemployment. Public spending and public works and that sort of thing dribble down and very seldom get to that unemployed person soon enough to do anything.

Senator Long and I were working on a piece of legislation which would create more jobs, but also at the same time finance them through an increase through removing deductibility of State and local taxes on gasoline, which would bring in about $600 million. And so it is a Washington deal. You pay for it with one revenue bill, and we had the standby authority prepaid far ahead of time for the administration to use. Is that something that makes sense to you and that you think the administration could support?

Mr. RUSH. Well, the purpose of our present policy is, of course, to bring demand down somewhat. And of necessity there would be some additional unemployment. And we feel that this is essential. Now, if we then start pumping the economy with new money which creates additional demand, then it is self-defeating.

Senator PERCY. Lastly, a question right down your line on a subject you have dealt with all your life, productivity. And this is one of the most honest figures that I have seen, and one of the most discouraging figures. It reverses a trend in the greatest economy in the world. Our greatest reduction in productivity is this year. It declined 6.2 percent in the first quarter of this year, following a 3.3-percent decline in the last quarter of 1974. Improved productivity would make a significant contribution to the Nation's attempt to combat inflation. What are the things the administration is planning on doing to reverse this trend and increase the country's productivity?

Mr. RUSH. As you know, Senator Percy, productivity in large measure consists not in labor working more, but really in labor having to work less. What you do to increase productivity is to substitute machines for men, new processes, and otherwise get much more productivity out of the facilities that you have. Now, in a situation where there is an excess of demand over supply the incentive to perhaps lose production in order to get more productivity, or to have to lose production for just a brief period of time, is not acceptable. And accordingly, almost all facilities, including some that are quite high-cost, as in the steel industry, are put back into operation in order to get the maximum quantity output rather than to have maximum low cost. And I should think, frankly, that our productivity advances will not return until we do reach a situation where you have demand exceeding supply, and where management is looking everywhere as to how we bring cost down per unit rather than how can we get the maximum unit out? We are, however, going—and I want to very wholeheartedly endorse, as I did earlier while you were out, your suggestion that you restore the funds that we requested for the Productivity Commission. And we intend to use that as a vehicle to further this productivity approach and to increase productivity to the fullest extent possible. That is going to be the next turn of the economic field, in my opinion.

Senator PERCY. I regret that I cannot stay further because of Mr. Watson's funeral. But I do express gratitude for the valuable testimony.

Mr. RUSH. Thank you very much.

Senator PROXMIRE. I make this point, Mr. Rush, for a real reason, not just because I want to call attention to higher profits, because I think what the oil industry is doing with respect to those higher profits is very interesting. As I understand it, in the second quarter there was an enormous increase in oil profits, 82 percent. And I run down some of the companies. Atlantic-Richfield enjoyed a 104-percent increase. Continental, 49 percent. The biggest of all, Exxon, the biggest companies, enjoyed a 67-percent increase, their earnings in the quarter were $850 million. And I understand they have a special reserve, and if they added to that, it would go over $1 billion for the quarter, and I do not think any company in history has ever done that in only 3 months.

Getty, 167 percent; Marathon, 140 percent; Occidental, 293 percent; Phillips, 167 percent; Skelly, 199 percent; and Standard, 131 percent. Now, when the public reads this—and they are concerned about the price that they have to pay for gasoline and oil, with the enormous increase they have suffered in the last year, and then they hear that the President's principal economic adviser made one strong pitch in his statement this morning, and that was that wage increases might get out of line, nothing about oil profits, he did not say a word about that, or about steel profits or other profits, and then you read in the New York Times, Monday, on the front page, it says:

> Despite plentiful supplies of crude oil, the nation's major oil companies in recent weeks have reduced their production of gasoline and have operated their refineries six to seven percent below the capacity they were utilizing a year ago.
>
> Industry critics say the companies are deliberately restraining production to avert price wars, that would erode their record profits.
>
> The production cuts come at a time when inventories of gasoline held by the big companies have jumped nine to ten percent above year earlier levels.
>
> As long as they (the major companies) can keep the supply of gasoline relatively tight, they can keep gas away from the dealers who would cut prices and pass on savings to the public.

That is the statement of Fred Alvine of the Georgia Institute of Technology, a specialist in the oil industry.

Now, in the light of this, and in the light of the fact that here is one industry where you do have price controls, where you do have the capacity to hold down prices, why is the administration so passive in permitting this kind of situation to develop? As I say, they are operating below capacity now, far below what they were last year. And their profits are, as one Senator indicated, disgusting.

Mr. RUSH. In my prepared statement, and repeatedly in my public statements, Mr. Vice Chairman, I have called for industry, management and labor, and industry in general, to exercise restraint with regard to effective bargaining, with regard to wage increases, and with regard to price increases. I have directed my words toward both. There has been some very severe criticism of prices, and some of wages, strictly in the construction area. So that I am deeply interested in both.

Now, the Government does have price control over oil. It does not have price control over——

Senator PROXMIRE. There is where the least justifiable price increases occurred. I can understand it in new oil. Even if the price is very high, you understand, for new oil, you open up new wells and there is an incentive to increase production. But old oil is there. There is no reason for an increase. They should require a strict accounting. And officials of the Energy Administration have told me they are on very weak grounds there, they admit it, privately they will say, that increase from $4.45 to $5.25 per barrel just could not be justified, there is no cost justification, it was simply a gouging of the consumer. And there is a very big inflationary factor.

Mr. RUSH. I think you might well want to have the oil people in just to explain their profits. I do not want to be in the position of explaining their profits or the justification for it.

Senator PROXMIRE. I started off the round of questioning with the observation that you not only have the price fixing, but you have also the very inflationary aspect of the influence of big business on priorities in the budget. I think this budget could be cut, and should be cut, if the President had the will to cut military spending, space spending, and other spending that could be postponed. I am convinced that the reason that the cutback is so anemic, only $5 billion instead of $10 billion, as Mr. Burns and I have suggested—and the Senate passed my amendment 74 to 12 to cut spending by $10 billion, there is an overwhelming approval in the Senate—is because these are sacred cows, and this is where your controllable spending really is. Now, would you feel that you could make and you will make a reduction of a substantial amount in the military budget, say, $3 or $4 or $5 billion dollars?

Mr. RUSH. I would be very much opposed to it, Mr. Vice Chairman. We have in the last 5 years reduced the number of men under arms by one-third, we have gone from 4½ million to about 2 million.

Senator PROXMIRE. We were fighting a big war 5 years ago.

Mr. RUSH. Meanwhile, the Soviet Union has increased theirs by a few hundred thousand. The Soviet budget today is much higher than ours. At the same time——

Senator PROXMIRE. May I just interrupt to say that the CIA testified before this committee. And we have released their sanitized testimony. And we find that the increase in spending by the Soviet Union has been really very modest, around 3 percent in real terms?

Mr. RUSH. We do know this, that in terms of strategic weapons they now have far more than we. Their throw-weight is much greater than ours.

Senator PROXMIRE. They have more tonnage, we have more accuracy, greater reliability, far more warheads and 41 Poseidon submarines, any one of which can wipe out every single Russian city. And as Secretary Kissinger said, "What in the name of God do you do with nuclear superiority?" We have got even to a point where we can wipe them out, devastate them a couple of times over. How many times do we have to do it?

Mr. RUSH. We are getting into a very controversial subject. But in my opinion, for us to allow the Soviet Union to have marked nuclear superiority over us, and marked superiority in strategic weapons over us, would have a marked effect on our relations with our allies and the ability of the allies to stand up to the demands of the Soviet Union in their bargaining posture. And in my opinion, this could result in a great weakening of our Western Alliance.

Senator PROXMIRE. Let us leave the strategic side of it aside, I think we could argue about that, but let us assume that we should maintain our strategic expenditures. And there are many other areas where cuts could be made. Let me just mention a few.

Supposing we postponed the starting date for the B-1 bomber. That is not going to come on for a number of years anyway. We have four times as many long-range bombers as the Soviet Union has anyway. Supposing we postponed any expenditure for new aircraft carriers. We have 16 carriers, and they have none. And we may have one conventional that is coming along, but we have an enormous superiority. What would be the damage to our military posture if we did that? We have to make these decisions. I realize that nobody is fully competent except maybe some unusual general or admiral, but we have to make these decisions, we have to say yes or no to them, with our imperfect knowledge.

Mr. RUSH. The Soviets have gone one way with regard to their strategic weapons and we have gone another. We have decided to go, as you know, toward the bombers with emphasis on SLBM's and we emphasize in a large measure ICBM's. The Soviets have in the past emphasized ICBM's, and we have emphasized warheads. And they have emphasized megatons, throw-weight. A part of our force structure is the bomber, the Trident, the new submarines coming along for the future. They have emphasized on the other side their new missiles, the S-16, 17, 18 and 19, the new ones which may well be MIRV'ed. And this means more additional warheads for them.

So that overall it is a matter of our force structure, and the B-1 is a very important part of our force structure.

Senator PROXMIRE. Could we not slow down military spending in other areas? We asked—and it was hard to get because nobody knew for a while—how much we provided in foreign military and economic aid, and we found it was over $10 billion. It was quite shocking. We send military equipment to over 60 nations. We spend far more than the Soviet Union does. Is this not an area where we could relieve the pressure of inflation if it were not a sacred cow of the administration?

Mr. RUSH. Military assistance, of course, includes military assistance to Israel, which is very large, and runs around $5 billion.

Senator PROXMIRE. I hesitate to interrupt you, but the fact is that if you take what is in the Defense budget and in other budgets—and I asked the GAO to make a study of this, and they did—to me foreign aid is at least $10 billion. And $6 billion of that is military aid not reported as such. As a matter of fact, the GAO found that nobody knew how much the foreign aid was because the military were not keeping a record a couple of years ago as to how much they were giving away of military equipment. But if you take all the foreign aid, and $6 billion of it is military assistance, that is not $5 billion, it is over $10 billion.

Mr. RUSH. I would like to see those figures.

Senator PROXMIRE. I would be glad to document them.

Anyway, could you now slow down the building of highways, public works, the Space Shuttle? Why do we need the Space Shuttle? We have another space program that costs tens of millions of dollars to enable us to see the end of the universe. The universe is going to be there a long time. Why do we have to spend that money in this year, with the worst inflation we have had in our history, is beyond my understanding. It is projects of this kind, it seems to me, that we could slown down billions of dollars by Congressional action. If the President asked the Congress to pass a resolution so that he would not have to go to the impoundment route, I am convinced that the Congress would be willing to do that if he labeled it as an anti-inflation resolution and said, these are postponable expenditures, they are not a matter of providing human needs or meeting urgent social needs, they can be postponed. Why cannot the President give us leadership in that area?

Mr. RUSH. Senator Proxmire, I am sure that many of your ideas are worthy of very serious consideration, and I should like to consider all of them very carefully. I am sure that we will not agree with everything, but I do want to cooperate with you, because I have a very high regard for your sincere effort to cut the budget.

Senator PROXMIRE. I hope you will consider abolishing immediately the Selective Service System. They have done anything but play bridge over there. They have not inducted anybody for 2 years. And they cost $47 million a year. And this is not much, but it is an indication that we never let an agency die.

Congressman Brown.

Representative BROWN. I would like to talk about shortages for a moment, Mr. Rush. Do we have any idea how many jobs are lost or are currently not being filled, or how much lack of productivity exists in the country because of shortages of raw materials, parts, and so forth? I have an International Harvester truck plant in my district, and currently we have 1,200 people out of work, not because the truck orders do not exist—there are many of them from overseas—but because we do not have the parts for the manufacture of those trucks, because the plant that supplies the parts is also running way behind. Now, I am sure that is the result of the lack of a product, or it results in lack of product. Do we know how many jobs are lost in that way?

Mr. RUSH. Certainly the question of shortages as a restriction on production is a very serious one. And we have shortages in the basic elements like steel and chemicals and the like. One does not really know just how many shortages there are until you have an ample supply. But through my own experience I know that when there are shortages the demand seems to be far greater than it actually turns out to be when the demand is caught up with.

Representative BROWN. Does everybody backorder or double order, or order to store and save?

Mr. RUSH. Exactly.

Representative BROWN. So that they do not have their production interrupted on account of shortages of materials.

Mr. RUSH. Exactly.

Representative BROWN. I think it would be helpful if there were some way that the administration, as we did during the war, could figure out some agencies that could be put together to make determinations about those shortages and give our attention to those particular areas.

Mr. RUSH. We had that in this new committee created by Congress, as you know, on the shortages. And that committee is in the process of being organized. And we will have representatives on it from the public and from the Congress and from the executive. And I hope that that committee will be able to produce some very constructive work.

Representative BROWN. You and the vice chairman were discussing our military expenditures with reference to strategic arms. I support the concern about the degree of strategic arms investment that we ought to be making at this time, or at any time. I gather that one of the administration's approaches is to negotiate strategic arms limitations both in defensive weapons and other weapons limitations, so that we can reduce our military expenditures consonant with reductions or limitations in military expenditures by our adversaries or potential adversaries. I think that is a good way to go about it, the negotiation method, and I would like to see us have as many bargaining chips in that kind of negotiation as we can have.

Now, that brings me back to the shortage area again. It seems to me that we have some problems—we had testimony before the Economic Growth Subcommittee of this committee just last week about Alcoa, about the fact that they are paying much heavier taxes, for instance, to the Jamaicans for obtaining bauxite, which has raised the cost of aluminum in this country. Should the Federal Government be negotiating? Should it be involved in direct negotiations with foreign countries that have raw materials which we find in shortage here or which we need for the expansion of our industrial needs? Shortages that create other shortages that create the kind of nonproductive unemployment that I am talking about at the truck plant. Should we use as our negoiating bargaining chip some of the things that we are able to do well, such as the production of food? Is that part of our national policy, or should it not be?

Mr. RUSH. That is not part of our national policy overall. Now, in the case of Jamaica, for example, of course, the aluminum companies were negotiating. We tried to have moderation prevail in those negotiations. If we take over these negotiations on a government-to-government basis, this represents a rather forward step in controlling the costs of the aluminum companies themselves. And it eliminates an important factor of competition. And there are other competitive sources for bauxite. For example, the aluminum companies can develop plants and extract almost limitless amounts of bauxite from the clays of Georgia and other sources. But if our Government takes over the raw material aspects, then it becomes responsible in essence, for a major element of competition. And it becomes a worldwide thing, because once we have a government-to-government deal with one country, then that is apt to prevail otherwise.

Representative BROWN. I would like to see us develop our national resources—and we have enormous resources—so that we are not jeopardized by the pressures brought on by other nations because of this circumstance or the circumstances in war time. But it seems to me that there are also some negotiating chips that we might use with other nations. I think of food as one of those negotiating chips. I am told that we are in a position to supply some surplus food if we can escape this serious drought that we currently have in the Midwest. I am hopeful that the Lord will be on our side if nothing else, in this problem.

But we have some other shortages, and we have other nations in the world where they may need food and we may need some of their raw materials. Can we not use that as a better weapon than we are using it, or are we using it to the maximum of our potential?

Mr. Rush. I think overall, Congressman Brown, we are trying to use our diplomatic efforts. The diplomatic efforts include, of course, the various methods that we have to carry out our diplomatic objectives. And certainly, I think that it is really to our interest to try to keep the price of imported raw materials down, to prevent these excessive prices from being levied on the American consumer. Diplomatically we should exercise our best efforts to prevent these very exorbitant demands in some cases, or unreasonable price increases from being opposed. Now, that should be, I think, in conjunction with the bargaining efforts of private industry as they pursue their objectives. For example, the other government itself would have to deal with us. And if they do not want to, they do not have to, because their agreements are with private industry they are not with the American Government.

Representative Brown. I understand that, Mr. Rush. But I wish you would use your considerable background in business, in economics, in government, and particularly in international affairs, to encourage our more effective cooperation between American business and American Government to resolving some of these shortage problems we have had by that kind of negotiation for meeting the needs and raw materials that we may have from abroad. At the same time, we can meet their needs in such areas as food supplies.

I do want to thank you for being here. I join my colleagues, I think, in the expression that this has been productive, and helpful to the extent that we can get some of our thoughts across to the administration. The time in which we find ourselves at this moment may preclude a most successful relationship between the administration and the Congress, the Republican administration and the Democratic Congress in resolving this problem. But I would hope that at least within the congressional area we can develop some bipartisanship in terms of addressing this rather formidable problem on a nonpolitical basis, and one this is sound economically. If you can divorce economics from the passion that exists in the other area of confrontation between the Democratic and the Republican administration, perhaps we can get to some rational and productive solutions for the future of the American economy and maybe for the world economy.

Thank you very much, Mr. Vice Chairman. We have a quorum call in the House, and I have to leave.

Senator Proxmire. Thank you very much, Congressman Brown.

The President sent up that $305 billion budget request, a $35 billion, 13 percent increase, it is his budget, Congress did not ask for it, it was at his initiative. I think we ought to make that clear.

In the President's economic address last Thursday he said in reference to his proposed 1975 budget of $304.4 billion: "A variety of forces, the most important being pending Congressional legislation in excess of the budget, threaten to raise this to $312 billion."

Would you elaborate on the $7½ billion difference? Exactly which programs now pending before Congress threaten to add $7½ billion to the budget?

Does this $7½ billion increase include requests that the administration has made for spending above the original $304.4 billion such as:

An amendment to the Department of Defense appropriation which would add over $1 billion to 1975 budget authority and increase outlays by $873 million?

An additional $200 million in budget authority for housing programs?

An administration requested extension of unemployment benefits?

It is my experience as a member of the Appropriations Committee for 10 years that the increases over the original budget are almost always because of supplementary requests made by the administration. And seldom do we honor a request unless the administration favors it itself, and seldom are we able to get it through. And these really are the President's requests.

Mr. RUSH. I will submit that, Mr. Chairman.

Senator PROXMIRE. Is it your understanding that any significant part of this is an independent congressional initiative? Is not this almost entirely an administration supplemental?

Mr. RUSH. I have not gone into this in detail, but my understanding is that this is almost entirely congressional initiative. But I would be glad to elucidate.

Senator PROXMIRE. I would strongly disagree with that. Would you agree that the billion dollars I mentioned in the supplemental is a request made by the administration?

Mr. RUSH. I am not sure that that is included in the figures submitted. I would be glad to talk to Mr. Ash and get you an answer on that.

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

(Prepared by the Office of Management and Budget)

In noting that a variety of forces threaten to increase the budget to $312 billion, President Nixon's statement of July 25 used $305 billion as a base figure. That base figure reflected the latest estimate of 1975 outlays of $305.4 billion publicly announced in the supplemental summary of the budget sent to the Congress on June 3, 1974, and subsequently discussed in testimony on the public debt limitation. The estimate of $305.4 billion includes $800 million for the administration's legislative proposal to extend unemployment benefits. This amount was identified specifically in the June 3, 1974, report to the Congress. A budget amendment for HUD community development programs for $200 million of budget authority was transmitted after the $305.4 billion estimate was compiled, but resulting outlays were absorbed within existing budget totals along with most other amendments transmitted since our latest estimate.

The following table identifies the derivation of the $312 billion used in the July 25 statement in terms of changes from the $305.4 billion base:

Outlays

	Billions
June estimate	$305.4
Completed congressional actions:	
Appropriation bills—second supplemental, 1974 and special energy R. & D	—0.2
Mandatory authorizations requiring subsequent appropriation requests:	
Child nutrition and school lunch (P.L. 93–326)	0.2
Two year extension of veterans education (P.L. 93–377)	0.6
Other (P.L. 93–347, 328, 350, and 314)	0.1
Pending congressional actions:	
Appropriation bills:	
Defense (based on expected House cut of $4 billion)	—2.0
Labor-HEW (estimated possible increase)	2.0
Other pending appropriation bills, net	-------
Mandatory authorizations requiring subsequent appropriation requests:	
Veterans readjustment benefits (H.R. 12628, S. 2784)	1.3
Comprehensive housing legislation (S. 3066)	0.8
Trade reform act worker readjustment benefits (S. 3331)	0.6
Small Business Administration amendments (S. 3331)	0.4
Operating subsidies for mass transit (S. 386)	0.2
Full Civil Service annuities with survivor benefits (S. 628)	0.2
Relocation assistance	0.2
Other	(1)
Inaction on proposed budget reductions:	
Agriculture-Commodity Credit Corporation—repeal of disaster payments authorization for feed grain	0.2
Health, Education, and Welfare:	
Public assistance—reduce calculation for work expenses and end Federal matching for adult dental care	0.3
Social security trust funds—eliminate certain optional payment procedures under OASDI	0.3
Veterans' Administration—medical care-private insurers	0.1
Administration initiatives:	
Defense—effect of $1.5 billion supplemental for defense	0.9
DOT—release of $500 million of Federal aid highway reserves	0.2
Veterans' Administration—urgent 1974 supplemental for cost-of-living and man-on-campus, etc	0.1
Total	311.9

[1] $50,000,000.

Senator PROXMIRE. Now, the administration went through one of these exercises analyzing all the possible expenditures that Congress might make and adding up all possible decreases that Congress might make, and 10 regular appropriation bills which have been acted on by the House where cuts below the President's request for a total of $1 billion. Now, Congress also will cut at least $3½ billion, and I think up to $6 billion, from the Defense budget. And Congress also will cut the foreign aid budget. And this year it is very big, and this year I would expect Congress to cut that by $2 billion. Is this $6½ billion to $10 billion cut included in your $10 billion figure?

Mr. RUSH. I do not know. I will submit an answer to you analyzing that.

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

(Prepared by the Office of Management and Budget)

In the estimates in question, the administration took into account a reduction of $2 billion in Defense outlays, based on expected House action reducing budget authority by $4 billion. Because no congressional action has been taken with regard to the Foreign aid appropriation awaiting action on items in the bill requiring authorization, no reduction in that area was included in the estimate.

As of this date, both the House and Senate have acted on Defense appropriations. Senate action would reduce 1975 appropriations by $5.5 billion, a $1.4 billion larger reduction than the House cut of $4.1 billion. Because Defense appropriations often spend over a period of years rather than immediately, the effect on 1975 outlays of the $5.5 billion Senate reduction is $2.9 billion, $0.9 billion more than assumed in the $312 billion estimate. Conference action will, of course, determine the eventual reduction.

There has still been no action on Foreign aid appropriations. Outlays for Foreign aid appropriations spend slowly over a period of years. The affect, therefore, of a $2 billion cut in appropriations (a 40-percent cut) would be to reduce 1975 spending by no more than $400–$500 million.

Senator PROXMIRE. Now, in the President's address, he said that in 1975, "I am determined to cut below $305 billion toward a goal of $300 billion." If this goal is reached, it will mean significant reductions in some areas of the budget. You have already said you would be opposed to cutting the defense budget.

Mr. RUSH. Yes—no, I would be opposed to cutting our defense strength.

Senator PROXMIRE. So would I.

Mr. RUSH. And there are other things that can be done in defense budget and bring about a better economy that might give us greater strength. For example, some military bases can be closed down, and we will strengthen the military, not weaken it.

Senator PROXMIRE. You are absolutely right. I am so happy you said that.

Mr. RUSH. And there are other things that can be done in Defense where we will strengthen and not weaken it. So I think we can reduce the defense budget.

Senator PROXMIRE. That is the most encouraging thing I have heard this morning. Does that mean that any significant part of the $5 billion cut will come from defense?

Mr. RUSH. I think so.

Senator PROXMIRE. How much? $1 or $2 billion?

Mr. RUSH. The reason we said that we are going toward $1,300 million is that we do not have a good estimate of what we can get out of the budget. What we have to do is to go out in all departments and impress on them that this is our goal and see if we can come up with it.

Senator PROXMIRE. After all, the Defense Secretary conceded that at least a billion—and very able people in the House said it is up to $5 billion—in the Defense budget is for economic purposes, because they anticipated a possibility of unemployment. Unemployment, of course, is serious, but the inflation is so overwhelming now that I would think, if this is the case, that the Secretary might acquiesce in a postponement of some military spending, recognizing that the economic situation now calls for a Defense cut. There should be no place in the budget for inflationary Defense spending.

Mr. RUSH. I would like to discuss that with the Secretary of Defense and see what he is talking about.

Senator PROXMIRE. What other areas would you cut? The Defense budget is by far the largest controllable item that you have.

Mr. RUSH. Of course, $5 billion in a $305 billion budget is only about 1¾ percent.

Senator PROXMIRE. That is right. But there is only about $30 billion outside of Defense that is controllable; maybe less than that.

Mr. RUSH. That is the problem.

Senator PROXMIRE. Can you give us some indication of where you would look for reductions?

Mr. RUSH. This we are searching for some now. I do not have the figures. We will prepare an answer for you.

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

(Prepared by the Office of Management and Budget)

In order to hold down Federal outlays in 1975, the administration has asked for congressional support in several important areas. First, the President has announced a plan to defer the Federal pay raise for 3 months and to cut Federal personnel by 40,000. Together, these two actions will reduce 1975 outlays by $1 billion. Second, the President is sending to the Congress a special message on budget rescissions and deferrals. Failure to support these actions would increase 1975 spending by about $600 million. In addition, it is essential that the Congress enact proposals in the budget that would reduce spending by about $700 million. Finally, the Congress should avoid passing legislation that adds to the 1975 spending total.

These actions are necessary first steps if we are to reach the President's target of holding 1975 outlays to below $300 billion. They are, however, only first steps and additional actions will be necessary. The administration has, therefore, initiated discussions with the Congress on additional ways to reduce 1975 spending. There will be no list of specific cuts until agreement is reached with Members of the Congress.

Senator PROXMIRE. Could you cut in Health, Education, and Welfare, and independent areas?

Mr. RUSH. We can by reducing personnel by some 40,000 as the President mentioned.

Senator PROXMIRE. But that is only $300 million, as I understand it, and it will be over a year. It seems to me that you could cut three times that much in the civilian component in the Pentagon alone. You have got almost a million civilians over there.

Mr. RUSH. $300 million for the fiscal year, because we would only achieve about half the savings.

Senator PROXMIRE. This is a drop in the bucket.

Mr. RUSH. Yes. But I think we have to get drops from the bucket across the board. Tackling a big program and trying to get a cut in that is very difficult. It will call for legislative action.

Senator PROXMIRE. In the President's address he said:

For the 1976 fiscal year * * * I shall submit a budget that will not only be in balance, but that will actually reduce the rate of growth of Federal spending.

Since the current estimate for Federal spending is for a 13-percent increase from 1974 to 1975, an equivalent rate of increase from 1975 to 1976 would mean a budget in the 1976 fiscal year of over $346 billion. Is it a correct interpretation of the President's statement to say that we can expect fiscal 1976 spending to be below $346 billion?

Mr. RUSH. Yes.

Senator PROXMIRE. I am somewhat troubled by the positiveness of the President's statement that the 1976 budget will be balanced. This must mean one of two things:

One, you have a very good idea of how much Federal revenues will be collected, and you feel that an equivalent amount of spending represents the appropriate fiscal policy; or two, this administration has no fiscal policy. Which is it, Mr. Rush?

Mr. RUSH. We have estimates of what will be collected, and we intend to keep the budget within that figure.

Senator PROXMIRE. So that it may well be $346 billion, unless you are going to raise taxes?

Mr. RUSH. We intend to have it well below $346 billion.

Senator PROXMIRE. The President in his speech last Thursday night said:

I shall use every influence of the Presidency to bring about healthful voluntary restraint on the part of both business and labor.

Of course, we are all for that sentiment. But let us see what it means. Will the President personally be willing to meet with labor leaders?

Mr. RUSH. He will personally meet with them.

Senator PROXMIRE. How much interest and enthusiasm have labor leaders shown as to meeting with the President? Besides Mr. Fitzsimmons, are any of them willing to do it?

Mr. RUSH. I would not want to express the degrees of enthusiasm of labor leaders. I would prefer that they express that themselves.

Senator PROXMIRE. Do you have any assurance from labor leaders that they would meet with the President?

Mr. RUSH. Some would, but I am not sure.

Senator PROXMIRE. In addition to Mr. Fitzsimmons?

Mr. RUSH. I have not canvassed them.

Senator PROXMIRE. You have not canvassed them, but that is your guess, is that right?

Mr. RUSH. I would prefer not to guess.

Senator PROXMIRE. Do you think there is a need for price and wage guidelines of the kind that were developed in the Kennedy administration? You do not need legislation for that. Or do you have in mind a more ad hoc case-by-case?

Mr. RUSH. I would say that we have more in mind than the educational process of the levels of not exercising restraint. I do not have in mind as of now guidelines.

Senator PROXMIRE. Without a specific goal—and that was the great advantage of the Kennedy guidelines, they worked very well for several years, and they were killed in 1967 with the impact of fiscal policy and monetary policy of the Vietnam war. For years we held inflation down very well. We had marvelous cooperation from labor. We had an increase in wages that was not inflationary, and we had a very limited inflation, 1 or 2 percent.

Mr. RUSH. Yes. That was a continuation of the very low inflation rate of the Eisenhower years. But it started up very dramatically, as you remember, in 1965.

Senator PROXMIRE. One of the interesting aspects of that—I do not want to be partisan about it, and you do not either—was that all during this period we had a climbing rate of employment, and we had a long period of prosperity. We had very little inflation. We had modest wage increases, but they were sufficient to permit the increase in real income.

Mr. RUSH. We had a very low inflation rate throughout the Eisenhower years, following, of course, inflation during the Korean war period. And then during the Kennedy period, which was less than 3 years, the official rate also continued to be fairly low. But it started up again in 1965, and, of course, it increased rather rapidly.

Senator PROXMIRE. So far the inflation problem has been all on the price side. Until recently wage settlements were modest. And now we have a problem. The results have been that the workers real earnings have fallen. Why should anyone expect workers to cooperate with a further program of restraint? What right does the Government have to even ask their cooperation unless there can be some assurance of an equitable program, a real crackdown in area where prices have gone up unjustifiably? I have cited the oil industry, and I think we have got a pretty good documentation there. And the steel industry has had an enormous increase in prices, 31 percent in the last year. How can you expect labor to stand still when they see these profits going through the roof, and executive compensation at enormous levels?

Mr. RUSH. I would say, Mr. Vice Chairman, that one could impose price controls and wage controls, and thereby expect industry management to cooperate. But we found that that did not work well, and it has caused many of the dislocations that we have had. Price controls without wage controls obviously do not work. Otherwise, all we can do on prices is to have industry exercise moderation and to go back to an economy of real competition which you and I have been talking about earlier.

Senator PROXMIRE. And I think it would be a lot better if the President were more vigorous in trying to encourage it than trying to gut it.

In June you met with representatives of the meat industry. And following the meeting you refused to make a judgment on whether their profit margins were too high. So it would seem to me to be the mildest kind of jawboning and the mildest kind of educational effort. You were reported as saying: "We are not in the profit control business."

Without getting into the particular question of profit in the meat industry, how are we going to have an effective program of price restraints if you are not willing to look at and talk about profit margins? Ford Motor Co. has raised its price $300 on new models in terms of the prices on the 1974 models. And U.S. Steel has increased its price 24 percent since controls ended. How can you evaluate these and other price increases unless you talk about costs and profits, how can you say that a particular industry has had a profit that is too high? I do not call that profit controls, but you can have price controls, and at least make the assertion so that there is some public pressure, some pressure that the responsible and effective people in our Government could hold prices that are unjustifiable down.

Mr. RUSH. As you know, what is a profit is a nebulous thing, depending on accounting and so forth.

Second, industry may be low profit, and somebody in the industry is making very high profits while others are losing money.

Senator PROXMIRE. Take the oil industry as an example. Here is an industry that is making colossal profits. They reduced their production and their operating flow capacity. How can that possibly come about?

Mr. RUSH. I would not want to justify or condemn the oil industry without analyzing it much more carefully. I do know one thing that is quite obvious. One is that they have to replace inventory at four times the cost, and unless they make profits they cannot replace the inventory.

And a second thing is that they have a tremendous expansion of refineries and other things which are going to cost far more than the refineries in the past. How much of this so-called profit is going in dividends and how much is needed to replace inventory for new construction and new exploration and development, which is absolutely essential, only they can say. I do know, and we all know, that the costs of doing these things have gone up tremendously, and that there must be money for them.

Senator PROXMIRE. Sure, the cost of doing these things have gone up tremendously, but the measure whether the cost reflects that price is the profit, if the profit margin is high, obviously there is something else at work.

Mr. RUSH. I would prefer to have them explain this for themselves.

Senator PROXMIRE. Let me ask now about the statement that the New York Times quoted Mr. Jones, your assistant, as making:

> A high administration economist conceded today that he hoped consumers would not take President Nixon's request in last night's economic address literally and save an additional 1.5 percent of their income.

And I think Mr. Jones' position may be well taken. A 1½-percent additional saving could mean a recession. It could certainly mean that a kind of drop in consumer spending which could be very, very bad news for much business, and it could mean a substantial increase in unemployment, and it could mean that the inventories according to the manufacturers most recent newsletter, now look top heavy and a lot worse.

Mr. Stein seemed to agree with Mr. Jones to some extent in saying that he felt the President after all, did not say everybody should save 1½ percent. But then, he disagreed too.

Now, as Mr. Jones' boss, and as the President's principal economic adviser, who is right?

Mr. RUSH. I would say that they are both right.

Senator PROXMIRE. You are really a diplomat.

Mr. RUSH. Mr. Stein is the author of that language in the President's speech. And what it was was in essence a plea by the President that people use some discretion in a period where demand exceeds supply, that people use discretion with regard to their purchases.

Secondly, at a time when we have very high interest rates, where savings are at a very low level, and where you can have more money for productive purposes as against just purchases by people saving rather than by spending willy-nilly, he was asking that they use some discretion. And he gave an illustration of this. You could have savings of $12 billion, which would be the same thing as a $12 million cut in the budget.

Now, a $12 million cut in the budget, some people are saying would be a very serious thing to your economy, because it would give us less employment. On the other hand, some other people say a $12 million cut in our budget is a very desirable thing. The reason why Government expenditures, I will agree with you, should be carefully watched, including defense expenditures, is because generally they are not productive, they agree with the demand——

Senator PROXMIRE. That is true with some Government expenditures, but not others. I do not think it is true with manpower expenditures, or educational expenditures, or housing expenditures, but it certainly is true with military expenditures, and it is certainly true with space spending and many other categories. But I think it is better to cut these areas where you do not get economic results.

Mr. RUSH. Yes. And the President gave that illustration, you can cut the budget and save money. And there are various ways in which we can all cooperate to get the economy better in balance.

Now, what Mr. Jones said, as I read it, was that we do not want a consumer boycott. No one wants a consumer boycott. If we had a consumer boycott, and the consumer spending went way down, obviously we would go into a recession.

Senator PROXMIRE. I would like to see a consumer boycott where the prices are too much, or where they think they are.

Mr. RUSH. Where prices are unjustified because of a shortage of supply as compared to demand is where they do go up.

Senator PROXMIRE. It would be very helpful if the Government were more specific in this kind of an area. That is why I think it would be a good idea for you to speak up when you think that prices are too high and profits are too high and cannot be justified. And then I think the consumer can get a signal as to how he can react. If he feels that the prices in industry are high and he has not any discretion—and in many cases he does not, if he has any discretion, he may choose not to buy, and it may have a very wholesome effect.

Mr. RUSH. I understand your point, Mr. Vice Chairman. And I think there is much to be said for it. The other side of the coin is that one must look at these things in some detail to be sure that they are right. And where the Government speaks it should be a very strong voice. For example, this morning I could very easily have attacked oil-company profits. But I have not gone into their needs enough to know just what their profits should be. I know they are very high, based on any historical basis.

Senator PROXMIRE. Every indication that I have seen, Mr. Rush, has been that their cash flow will substantially exceed any kind of investment plans they have. We know that some of these oil companies are buying unrelated businesses, whether they bid for circuses or Montgomery Ward or whatever, they are getting into unrelated fields. So that in terms of need it is very hard to demonstrate. And Heaven knows you cannot justify it on equity grounds in view of the colossal increase in profits that they have.

Mr. RUSH. As I say, I cannot criticize their profits without knowing what their cash needs are. And I have not seen their figures. I do not know what their exploration and development needs are, their inventory replacement needs, and their refinery construction requirements, their capital needs overall.

Senator PROXMIRE. I respect that kind of care and that kind of concern for being fair. But I do think that the administration just has been pussyfooting in respect to profits. I think they ought to crack down and crack down hard. And I think that that is the kind of effort that at the very least the American consumer should expect, because the Government will find out and make it a point to find out where price increases are not justified, and at least say so. And I am not talking about price controls, and I am not talking about any other kind of discipline. I am not even talking at this point, although I favor it, about antitrust action. But at least we could have a public announcement by the President that this is exorbitant, unjustified, and let the consumer know about it. In the oil industry I hope that you will get informed on that as soon as you can so that you can speak out.

Mr. RUSH. The view of the Congress, as I understand it, was that not only was Congress very strongly opposed to wage and price controls——

Senator PROXMIRE. I was one of the leading ones who opposed price controls.

Mr. RUSH. I mean, the moderating agency——

Senator PROXMIRE. There was no time that we indicated that we did not want the Government to jawbone or step in and point out unjustified price increases.

Mr. RUSH. Perhaps I misinterpreted it.

Senator PROXMIRE. Furthermore, the President vetoed the congressionally passed legislation, which I supported and overwhelming majority of the Senate supported it, to roll back the price of old oil, the President vetoed it. We were going to give him that power.

Mr. RUSH. Yes.

Senator PROXMIRE. I have, just have a couple of more questions in the area.

In the first half of this year real output declined at about a 4-percent rate and prices rose at a 10-percent rate. What do you expect for the second half?

Mr. RUSH. In my prepared statement, Mr. Vice Chairman, I said that:

For the rest of 1974, we expect small, but steady, gains in real output. While the pace of growth may not be as robust as anticipated at the beginning of the year, the gradual improvement should help to moderate possible unemployment increases and should help avoid a surge of unwanted inflationary pressures. Most important, the underlying strength and resiliency of the economy will justify our sustained policies of moderate fiscal and monetary restraint which are necessary for reducing inflation.

I could not add to that, because we have no definite features.

Senator PROXMIRE. We have a very substantial drop in the first half, of 7 percent in the first quarter, and another percent or so in the second quarter. Do you expect for the whole year that there will be an increase in production, or a reduction?

Mr. RUSH. For the domestic economy, I would not wish to estimate on that, I would not on the present basis estimate the rate of real growth that we will have for the last half of the year. We think it will be slow but steady, whether it will equal the decline in the first half.

Senator PROXMIRE. Hobart Rowen, the columnist for the Washington Post, quoted a top government economist as saying: "We could well have another drop in the third quarter," meaning a further drop in real output. Can you tell us who said that?

Mr. RUSH. I do not know who that was.

Senator PROXMIRE. Evidently you do not agree, since the statement said you expect a small rise in GNP in the second half.

Mr. RUSH. And my prepared statement represents the considered judgment of what we call the troika.

Senator PROXMIRE. I take it that that was a considered judgment that you made 2 weeks ago when you said that there would be a rise in output in the second quarter.

Mr. RUSH. This was the flash that I had at that time, yes.

Senator PROXMIRE. That was the what?

Mr. RUSH. A flash bit of news that I had at that time, that was our estimate at that time.

Senator PROXMIRE. What about unemployment? What would you expect the unemployment rate to be at the end of the year?

Mr. RUSH. I would expect it to be between 5½ or 6 percent, possibly as high as 6 percent.

Senator PROXMIRE. The main thing which has caused the inflation rate to diminish slightly in the past few months has been the drop in farm prices and the tapering off of oil price increases, at a very high level. Industrial prices are continuing to rise at a really alarming rate. I quoted the wholesale price increase at 3½ percent as the expectation for the rise in July, in 1 month. And workers are getting increasingly restive and more determined in their demands for the wage increases that will keep wages in line with price increases. In view of these continuing inflationary trends, what do you expect inflation to be in the second half?

Mr. RUSH. We would expect it to by the end of the year to be in the range of—we think it will be nearer 7 and 8 percent, is our best estimate. There is naturally a variation. But I would estimate that it would be nearer 7 percent by the end of the year. Now, there are lower estimates than that. I notice the First National City Bank and many economists it is between 6 and 7 percent by the end of the year. Ours is a bit higher than that.

Senator PROXMIRE. So that you would expect inflation to continue at about the present rate at about 8 percent?

Mr. RUSH. It was 8 percent in the second quarter.

Senator PROXMIRE. And it would moderate just a little?

Mr. RUSH. By the last quarter.

Senator PROXMIRE. Does that include the recognition that there is likely to be a big increase in wholesale prices in July?

Mr. RUSH. Yes, that does include that.

Senator PROXMIRE. I want to thank you very, very much, Mr. Rush. You are a very fine gentleman, and a very decent person.

I do have one more question. I have to ask you this.

You have agreed to testify before this committee, and we are most grateful for it. Will you testify before other committees of the Congress?

Mr. RUSH. I have not yet made a final decision on that, Mr. Vice Chairman.

Senator PROXMIRE. How about the Senate Banking Committee? The reason I ask that is because Mr. Greenspan is coming before our committee to be Chairman of the Council of Economic Advisers. And from your job description you are to be Mr. Greenspan's boss. I do not see how the Senate can exercise the advice and consent powers intelligently when the man with the real power is not subject to Senate confirmation. Would you be willing to appear with Mr. Greenspan to clarify your relationship with him for the public record?

Mr. RUSH. Yes, I would.

Senator PROXMIRE. Thank you very much.

The witness tomorrow will be Chairman of the Council of Economic Advisers, Herbert Stein, at 10 o'clock in this room.

And we have a change in schedule previously announced. Federal Reserve Chairman Burns will testify Tuesday, August 6, a week from tomorrow, instead of Wednesday, July 31. No hearing Wednesday. And Thursday Walter Heller will be heard.

Thank you again, Mr. Rush, you have been most helpful.

Mr. RUSH. Thank you very much, Mr. Vice Chairman.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, July 30, 1974.]

EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

TUESDAY, JULY 30, 1974

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

The committee met, pursuant to recess, at 10:10 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire and Percy; and Representative Brown.

Also present: John R. Stark, executive director; John R. Karlik and Courtenay M. Slater, senior economists; Richard F. Kaufman, general counsel; William A Cox, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. Our witnesses this morning are Mr. Herbert Stein, chairman of the Council of Economic Advisers, and Mr. William Fellner and Mr. Gary Seevers, members of the Council. Mr. Stein, this morning we meet in the midst of what is probably the worst inflation in our history. We have had other serious inflations in war time, but they all seem to have a termination at the end of the war. And in fact, in many cases in the past, as you know, in our economic history prices have receded to where they were before the war.

This is peacetime inflation and there seems to be no end of it in sight. The latest figures we don't have completed, but everybody seems to expect that the Wholesale Price Index will show the largest increase in almost a year, perhaps about 3½ percent. This comes on top of a whole series of increases.

What has been so puzzling and perplexing and frustrating is that the tools to fight the inflation are so limited.

Wage-price controls, whatever the case for or against them, are obviously politically impossible. There has been virtually no support in the Congress or among the business and labor people who would have to actually work with them so that is out of the question.

Unemployment is high and expected to go higher, and that comes at the same time as a drastic slowdown in production.

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Interest rates are sky high and working a tragic burden on housing and imposing a serious problem on State and local borrowers. Small business seems to rule out any significant tightening of credit.

Now other solutions may be too long term. Solutions like antitrust and productivity improvements seem to be too long term.

The result is that nothing seems to be a realistic or practical solution. There seems to be a conclusion, as I get it—and this may be unfair to the administration—but a feeling there is no solution. The proposals that were suggested to us yesterday I regard as a nothing program; the proposals by Mr. Rush.

I disagree with the nothing type program or the very mild program which he suggests because I think that while dramatic action is difficult, we could do much more than is proposed.

Even without wage-price controls for example I think some real old fashioned Teddy Roosevelt type jawboning and garnishing with antitrust followthrough and embellished with the Government using its regulatory power and its procurement and stockpile power to get results, can help.

We all recall the results the Kennedy administration got with respect to steel back in 1962. And I think this is especially appropriate when you recognize the immense increase in profits.

The Federal Government still does have on the books the power to roll back or at least to control and prevent increases in energy prices. And in view of the fantastic profits the oil companies are reporting now and reported last quarter and the previous quarter, that seems to be another area where action could be taken, but there is no indication from the administration that action is likely to be taken.

I think that a sharp—sharper anyway than the administration proposes but what I would regard as a moderate reduction in this year's increase in spending would be appropriate. The President asked for a $35 billion increase from the $270 billion figure last year. That was the biggest increase in peacetime history. That was a 13-percent increase.

I think we can cut it back to $25 billion as Mr. Burns and others have suggested. The Senate voted by a 74 to 12 vote to provide it.

I would hope that both the Treasury and the Federal Reserve would consider at least indicating to the lending institutions where they think lending would be less productive and I would hope they would take more vigorous leadership in this area although many would regard that as an influence on the free market. But I think under the present circumstances with the great need in housing, with the very high interest rates, with the inflation we have, that at least that kind of moderate action could be used.

Well, these are my opinions based on the hearings that we have had, and I am anxious to hear your statement. It is a long statement and I would appreciate it if you would summarize it in 15 minutes or so. The entire statement will be printed in full in the record.

This may be your last appearance before this committee. And although many people have been critical of you and I have been critical of you sometimes in the past—I disagreed with you then and disagree with you now on some issues—I think we all have to recognize that you are an extraordinarily able and intelligent and articulate man. You served the administration well. It is your wit and your sense of humor and your willingness to take the slings and arrows of outrageous criticism with a smile and with a pleasant rejoinder that has been one of the things that has made a very difficult situation a great deal easier.

I think that your performance on television, for example, has been often unfairly criticized and your statements sometimes taken out of context. After all, it is not politically wise and it takes some courage to tell off the public and say they made a mistake. When you do that, you get it from all of us politicians and the media too, but we recognize that you are an easy target when you make that kind of a statement.

So I think you have contributed very considerably to our understanding and I am sure that you will now.

Now one other point. As you are winding up your service as Chairman of the Council of Economic Advisers, you are in an unusual position it seems to me to give us perspective and advice on what you feel both the Congress should do and perhaps you might have some reflections on how the Council should operate as you look back in perspective having served, I understand, 5½ year on the Council and about 3½ years as chairman. I think that is one of the longest terms of service of anyone who served on the Council of Economic Advisers. Go right ahead.

STATEMENT OF HON. HERBERT STEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY WILLIAM J. FELLNER AND GARY L. SEEVERS, MEMBERS

Mr. STEIN. Thank you very much. I certainly welcome those kind words, which I may say are rather rare these days, but I especially appreciate them coming from you because I have come to recognize and value your judgment in these matters even though we have disagreed, as you have indicated, on many points. I believe unless you call me up again before August 31, that this will be my last appearance in the capacity of a member of the administration, but I will become a professor. And after I become a professor, after I have been laundered in that way, perhaps you will call me back to testify again.

Senator PROXMIRE. We certainly will, but I hope you can speak even now.

Mr. STEIN. Well I think I will and I think I always have. Perhaps that has been part of my problem.

Senator PROXMIRE. Fine.

Mr. STEIN. We have submitted a long statement, which we did not at all intend to read. We would like what we call the appendix to be included in the record and we would discuss any part of that you want to discuss.

Senator PROXMIRE. Fine, that will be placed in the record at the end of your oral statement.

Mr. STEIN. I have a short statement which I will read on behalf of the three of us. Before I do that I would like to insert in the record the text of the speech that the President gave on July 25, because I think that has not yet been done and I think that would be quite relevant.

Senator PROXMIRE. Yes, that is fine. We will be happy to have that printed in full in the record. That will be incorporated in the record at this point.

[The text of the speech by President Nixon, given July 25, 1974, follows:]

REMARKS OF PRESIDENT NIXON AT A CONFERENCE ON THE ECONOMY, SPONSORED BY THE CALIFORNIA CHAMBER OF COMMERCE, CALIFORNIA MANUFACTURERS ASSOCIATION, LOS ANGELES AREA CHAMBER OF COMMERCE, AND MERCHANTS AND MANUFACTURERS ASSOCIATION, JULY 25, 1974, LOS ANGELES ROOM, THE CENTURY PLAZA HOTEL, LOS ANGELES, CALIF.

Mr. Smith, all of the very distinguished guests on the podium and in this audience, and all of the millions listening on television and on radio:

I want to discuss today the major problem confronting America today—inflation.

And I want to discuss where we are in the fight against inflation, how we got here, and what we are doing about it.

Let me begin by touching briefly on the nature and causes of the inflation we have been experiencing.

Basically, we and the other industrialized nations have had a generation of inflation because governments all over the world, for a long period of time, have permitted and encouraged the demand for goods and services to outrun the capacity to meet that demand with rising production.

Governments have repeatedly increased their own spending more than taxation. They have added to demand without making a balancing cut in private spending. They have created new money to finance more borrowing and investment than people were willing to finance out of their savings. Now, all this has added to the upward pressure on prices.

The great worldwide surge of inflation in the past year and a half was caused by three exceptional circumstances coming at once.

One was a decline in the world grain production as a result of bad weather in many areas of the world. Another was the oil embargo, together with the action of the oil exporting countries in suddenly quadrupling oil prices. And the third was a simultaneous economic boom in the industrialized nations, which increased demand for goods far beyond the capacity to produce them in those nations.

Now fortunately, although other inflationary pressures continue, food production now has increased. The oil embargo has ended. World oil prices have leveled off. The worldwide economic boom has slackened.

And so, these particular inflationary forces are no longer propelling the inflationary spiral upward to the same extent that they were. We must recognize, however, that the higher price levels that have been reached by oil and other raw materials will continue to exert strong upward pressures for a time as they work their way through the economy.

We are also now feeling the effect of last year's surge of prices in the form of an understandably strong drive for large wage increases, as workers try to catch up with earlier cost of living increases.

Confronted with an unacceptable level of inflation on the one hand, and with a temporary slackening of economic activity on the other, many voices have lately been raised in America demanding some swift, spectacular action. Some ask for reimposing wage and price controls. Others recommend that we wring out the economy with higher taxes or sharply restrictive monetary policies, even at the cost of a severe recession. And then, on the other hand, there are those who urge that we should lower taxes in order to pump up the economy more rapidly. And still others suggest that we should simply give up—that we should accept a rampant inflation as a mysterious and incurable disease and concentrate on learning to live with it.

Well, we are not going to do any of these things. Let me tell you why not, and let me tell you what we will do instead.

If experience teaches anything, it is that economic policies aimed exclusively at short-term relief too often bring long-term grief.

We must learn to think less in terms of programs and more in terms of policies: policies of respect for the basic laws and forces of the market place and of recognition that in those policies lie the keys to our economic future.

And so, let me tell you first what we are not going to do.

We are not going to resort to the discredited patent medicine of wage and price controls. To return to controls now for temporary relief would only create new distortions and thus intensify our long-term difficulties and lead in the end to even more inflation when the controls came off.

We are not going to respond to the short-term slack in the economy by priming the pumps of inflation with new deficit spending or with a new easing of credit or with tax cuts that would only make inflation worse. These actions would be like pouring gasoline on a raging fire.

And neither will we administer the shock treatment of a sudden drastic "wringing out" of inflation, the cost of which in terms of increased unemployment for millions of Americans would be unacceptable.

Now, let me tell you what we are going to do.

Our aim is to control inflation while continuing to produce more, so that people can live better. The key to this lies in keeping our eye squarely on the long-term—and keeping it there even as we actively manage our short-term difficulties. It lies in choosing a sensible, realistic course and sticking to it, whatever the pressures, and that is exactly what we shall do.

We will continue to monitor every sector of this economy. And I can assure you that we will take what actions are necessary to prevent undue hardship in any sector of the economy. But we will not react either to general or to specific needs with gimmicks or emotionalism, and we will continue steadily on our basic anti-inflationary course.

A policy to check inflation is fundamentally a policy to curb the growth of demand relative to the growth of supply. In the short-run, attention must focus on holding down the increase in demand, because with few exceptions, increasing supply takes a considerable amount of time.

There are exceptions, however, where changes in Government policy can result in rapid expansions of supply. Examples on which we have already acted include the turning back into production of tens of millions of acres of farmland which had previously been kept idle, and the sale of excess Government stockpiles of certain raw materials.

In the longer run, we can focus more on increasing the growth of output—on producing more rather than on demanding less. So our strategy must have two elements—mainly restraining demand in the short-run and expanding supply in the long-run.

Let's turn now to the Federal Government. The most obvious thing the Federal Government can do to restrain demand is to hold down its own spending. For the current fiscal year, expenditures under the budget I submitted in February would be $305 billion. A variety of forces, the most important being pending Congressional legislation in excess of the budget, threaten to raise this to $312 billion; over $7 billion over the budget I submitted in January. Undoubtedly, more spending proposals will be pressed in Congress in the months ahead.

I will not accept this inflation of the Federal budget. On the contrary, I am determined to cut below the $305 billion I submitted in January toward a goal of $300 billion. I intend to veto Congressional actions that would raise that spending above the budget. And beyond this, I have directed the heads of all Federal departments and agencies—without exception—to trim already-programmed Federal spending toward the goal of $300 billion.

I have also ordered a reduction of 40,000 in the number of Federal employees provided for in the budget for the current year. This alone will save $300 million.

For the 1976 fiscal year—in which we are now preparing the budget, a year which begins in just 11 months—I shall submit a budget that will not only be in balance, but that will actually reduce the rate of growth of Federal spending so that the increase from 1975 to 1976 will be less than the increase from 1974 to 1975 rather than more. And when necessary, in proposing this budget, I shall propose repeal of existing legislation that makes spending mandatory.

Now, two weeks ago, I signed the Congressional Budget and Impoundment Control Act of 1974. For the first time in our Nation's history, this law provides a mechanism for the Congress to consider the whole budget comprehensively, not just its parts. It will be essential that this new law be used effectively with the clear, continuing objective of reducing or eliminating expenditures that would help some of the people, but cause higher prices for all of the people.

We have to understand one fact. The President alone cannot cut the cost of Government. This new law provides a means by which the Congress and the President can work together to accomplish that goal.

And I am confident that a majority of the Members of the Congress will support the efforts of the President to balance the Federal budget so that millions of Americans will have a chance to balance their family budgets.

The other principal weapon in the Government's arsenal to control inflation is monetary policy—that is, the control over the expansion of money and credit.

It is the function of the Federal Reserve system to maintain an adequate supply of money and credit but to prevent that supply from rising too fast. The Federal Reserve is doing so. Holding down money and credit in the face of a rapid inflation causes high interest rates, which nobody likes. But allowing more rapid monetary expansion would soon cause even more rapid inflation and ever higher interest rates. And therefore, the course of the Federal Reserve, the course it is on, is the necessary route to less inflation and lower interest rates.

Like any other part of the anti-inflation program, monetary restraint can be overdone. It has not been overdone up to this time: and it will not be overdone. We shall provide the expansion of money and credit necessary to support moderate growth of the economy at reasonable prices. Chairman Burns, of the Federal Reserve, has assured me of the intention of the Federal Reserve to avoid extremes of restriction in the effort to conduct an effective anti-inflationary monetary policy—an effort which every American should endorse. There will not be a credit crunch in which the money for essential economic activity becomes available.

And so, as far as the Federal Government is concerned, we will cut the growth of Federal spending. We will hold down the growth of money and credit to check private spending. And I call on State and local governments, and on businesses and consumers, to hold down their own spending and increase their own savings as their contribution in the fight against higher prices.

I recognize that some Americans cannot cut their spending without real hardship. And I recognize that some expenditures by business cannot be cut without cutting production now or in the future and thereby increasing unemployment. But most families could reduce or defer some expenditures—building their savings instead—without hardship. And every business has some fat in it, just as every Federal agency has. And State and local governments, whose spending has been rising rapidly, should follow the lead of the Federal Government in cutting unnecessary spending.

Now, there are cynics who will say that such an appeal to the public spirit of the American people is futile. Well, I don't believe that. We saw how the American people saved during World War II. And just last winter, we saw how the American people conserved gasoline and fuel oil and avoided, as a result, gas rationing and all the consequences that would have flowed. In my recent meetings to discuss the economy and in my mail, I have had abundant evidence of the willingness of the American people not only to cooperate but to join actively in the battle against inflation.

Less spending means less pressure on prices today. More saving means more investment in new housing and new production, and therefore, lower prices tomorrow. And the consumer—and that is everybody—wins both ways.

I referred earlier to the significance of a $12 billion difference in the Federal budget. A cut of only 1½ percent in personal consumption expenditures—that would mean like putting away 15 cents for every $10 spent—would make a similar difference in the fight against inflation. How rapidly we succeed in cutting inflation will also depend on business and labor. If they continue pushing prices and wages rapidly forward, this will continue the inflationary pressures. But sales will suffer, because consumers will resist paying higher prices and employment will also suffer, and no one in the end will be better off.

And therefore, in their own interest as well as in the Nation's, it is essential that business and labor act responsibly in their price and wage demands. As I have said, we shall not return to price and wage controls. But I intend to use every influence of the Presidency and of the Federal Government to bring about helpful voluntary restraint on the part of both business and labor in this critical area.

In the short run, as I have said, we must focus on measures that restrain demand. But to achieve prosperity without inflation in the long run, we must focus above all on producing more so that we can have more goods and services without higher prices.

To assure a vigorous growth of supplies in the longer run, a number of critical measures are necessary.

A good example is agriculture, where today less than five percent of our population feed all of America, and help feed much of the rest of the world as well. We must keep our agricultural programs focused on a policy of abundance as they now are, rather than on a policy of scarcity.

We have seen vividly the importance of energy supplies and energy prices in the U.S. economy over these past few months. We must now take all necessary steps to assure ourselves of reliable supplies of energy at the lowest possible cost. That is the essence of Project Independence on which we are now moving steadily forward. Let us take whatever steps are necessary to make sure that the United States will never again be hostage to a cut-off of vital energy supplies by any foreign country. And here is another area where the President alone cannot do the job. We need the cooperation of the Congress on many pieces of legislation in this area which await action.

We need to assure adequate long-term supplies of capital for investment, another area we have discussed at great length in recent weeks. In May, I directed the Chairman of the Council of Economic Advisers to undertake a special study of long-range capital needs to provide for the continued growth of our economy and how to ensure that these needs may be met.

Too often today the creative energies of our economic system are stifled by burdensome over-regulation based on policies designed for an earlier era. For example, Government regulations often require trucks to run empty. This wastes fuel and it raises the cost to the consumer of everything these trucks carry. That is just one example. Many others could be cited. And consequently, I have directed a sweeping review of these policies with the objective of recommending those changes needed to bring the regulatory agencies and regulatory policies in line with the needs of a new era when increasing productivity must be a primary means of achieving our primary economic goals.

And where regulatory agencies, because of obsolete rules, have the effect of restricting production, rather than encouraging, those rules need to be changed and they will be changed.

Some of the most important regulations from this standpoint are not Federal, but State or local, such as obsolete building codes. Therefore, this review will encompass the reforms needed at all levels. At the same time I again urge the Congress to enact the regulatory reforms that I have already proposed—with respect to transportation and financial institutions, for example—in order to make our economic system more productive and less inflationary.

And now we come to a very sensitive political point. It is time for us to reevaluate the trade-off between increasing supplies, increasing production and certain other objectives that are worthwhile, such as improving the environment and increasing safety. Those goals are important, but we too often recently have had a tendency to push particular social goals so far and so fast that other important economic goals are unduly sacrificed. and consequently these policies must be reevaluated and adjusted to the new needs.

Congress should enact the trade reform bill so that negotiations to reduce trade barriers can begin. This sometimes sound like an esoteric subject of interest only to those who are in international trade, but competition from abroad can be a powerful force toward increasing productivity in the United States, creating more jobs, making more supplies available for American consumers and in holding down prices.

Finally, and most important, we must restore the idea in America that the way to have more is to produce more. This is true of a nation, it is true of individuals. Too many countries are in extreme difficulty because their people have come to believe that the way to get more is to have the Government spend more, even though no more is produced. That has often been true in this country.

It is often said that we have worldwide inflation because people demand more. That is just a half-truth. We have worldwide inflation because people's demand for more is not matched by a willingness and ability on their part to produce more. The demand too often is translated into a supply of votes, not a supply of work, saving, initiative and innovation.

In America, and may it always be this way, the power of Government is the power of the people. And, therefore, the most important responsibility of each American in fighting inflation is your responsibility, those of you in this room, and the millions listening on television and radio. I can assure you that your Government will take firm measures, measures that will be unpopular with many special interest groups. The voice of the people in support of sound anti-inflation policies needs to be heard in Washington above the voices of the special interests.

In fact, we need in this country the one lobby we don't have—an anti-inflation lobby. This should not be a lobby with plush Washington offices and high paid officers. And I am not reflecting on any of the people who may be lobbiests here. This lobby should have an office in every home in America and every citizen should be an officer in it. When every Government official—whether in the Executive branch, in the Congress or in State and local governments—knows that this anti-inflation lobby will reward anti-inflationary action and punish inflationary action, the fight against inflation will be won.

We have looked, as we should, at many of the troubles in the American economy today, but we must also recognize that despite its troubles the American economy today is the envy of the rest of the world. One needs only to travel, as I have in recent months and over the years, to other nations, particularly industrial nations, to realize the truth of that statement.

Painful as our own inflation is, it is less than that of France, of Italy, of Great Britain, of Japan, and less than that of most of the industrial nations of the world.

In fact, time and again I have found in recent months the leaders of other countries marveling at the great economic strength of America and wishing that they could exchange their economic difficulties for ours.

And consequently, as we look at the troubles in our economy today, we must not overlook its strengths. We have the strongest economy in the world by far, and we can win any economic battle that we determine to win. We are out to win the battle against inflation and with our strong economy we have the resources to do it.

As we look at the strengths of that economy, we have more jobs in America today than ever before and those jobs pay higher wages, real wages, than in any other country in the world, even in the area of food costs, which we all know is one that really strikes home to whoever keeps that family budget. A smaller percentage of the wage earner's income goes to food in the United States than in any country in the world.

Young Americans today are finding work rather than facing the draft, and we can be thankful for that. And our unemployment, which is holding lower than we had earlier predicted, if it is higher than we want—and it is—let us be thankful that those who may be unemployed are not facing the draft and not serving in any war overseas.

In fact, we can be thankful that our problems today are the problems of peace rather than the problems of war.

We will win the fight against inflation, but we are going to win it not by a single set of dramatic actions, but by the cumulative effect of actions that in themselves are often undramatic, actions that may not make headlines in the morning newspapers, but that will be the right actions to take.

In economic policy, impatience is the great enemy of sound policy. If you look at the history of inflation in America, more than anything else it can be laid at the doorstep of impatience: impatience to spend money we have not yet earned, or to spend taxes we have not yet collected; impatience to satisfy all of our social wants at once, without regard to the fact that we cannot afford everything at once; impatience with the short-term dislocations that often are part of long-term adjustments needed to keep the economy growing in a healthy rather than an unhealthy way.

The key to fighting inflation, therefore, is steadiness. The steadiness that accepts the need for hard decisions, for occasional unpleasant statistics and even a measure of sacrifice in the short run, in order to ensure stable growth without inflation for the long run; the steadiness that stands firm against the clamor to take dramatic action just to create an appearance of action, and the kind of steadiness that reflects demagogery, that rejects gimmickry and that gives the enormous creative forces of the marketplace in America a chance to work. That is our strength, the free marketplace in America, and we must keep it free.

And so I say to you that we are on the right road toward our goal, a goal of full prosperity without war and without inflation. We are going to stay on that road.

We will be steadfast in holding down Federal spending, in slowing the growth of the Federal budget.

We will have moderate but firm restraint on the growth of the money supplies.

We will work creatively with other nations to deal with inflation in its worldwide dimensions.

We will take new measures to encourage productivity, and this is perhaps the most important long-term objective we can set for ourselves—to encourage productivity and to increase supplies of scarce resources. And in particular, we are going to press vigorously forward in increasing supplies of energy and food—the biggest components of the recent inflationary surge.

We shall stand firm against efforts to turn us aside from the steadiness of course that is necessary.

We intend to devote the full energies of the Federal Government to the fight against inflation—and I ask for your support, for the full support of the American people in this great cause.

In 1976, America will celebrate its 200th anniversary as a Nation.

Let our goal for that anniversary be an America at peace with every nation in the world, a peace that we helped to bring about, and here at home, let our goal be an economy of prosperity without war and without inflation.

That is a great goal. It will require the united efforts, the dedication of Government, of business, of labor, and of individual Americans all over this country.

What you do, each and every one of you, will matter.

As you play your part in this great crusade, you can be confident that your Federal Government will play its part. And together, we can achieve the goal that all of us want: the goal of full prosperity without war and without inflation, for ourselves, for our children, and for America's future.

Mr. STEIN. As I said, we have submitted a long statement which covers many aspects of the economy, production, employment, prices, housing, balance of payments, incomes, food, and material supplies. These are all important subjects and we will be happy to answer questions about them. However, we would like to use the short time allotted for our oral presentation to concentrate on the question of inflation.

The history of inflation is the history of frustrations, and I noticed you used the word "frustrating" in your opening statement. I think this does characterize our present situation. Again and again the inflation has seemed to be near its end. The reasons for each surge of inflation were regarded as temporary and special. The inflation seemed to be subsiding when the economy softened in 1967. When Congress enacted the temporary tax increase and expenditure ceiling in 1968 there was a feeling that decisive action had been taken, and there was concern about "overkill."

The last economic report written by the previous administration, January 1969, foresaw a decline of the inflation rate by midyear, and the need for expansionary policy thereafter. Many economists thought a decline of food prices in 1969 would help hold down the inflation rate that year. None of that happened in 1969, but a continued policy of fiscal and monetary restraint began to yield signs of smaller price increases in 1970.

However, progress came more slowly than had been expected. This was the time when many people were saying that we had entered a new era of inflation in which the classical remedies would not work. Responding to general impatience and a widespread demand for controls, the President imposed the price and wage freeze of August 15, 1971, which was followed by the more flexible system of phase II. This program was to wring the inflationary expectations out of the general psychology and also to bring about a better balance within the wage structure, so that there wouldn't be a strong claim for one industry after another to catch up.

By the end of 1972 this policy seemed to have gone a long way toward achieving its goal, while the well-known difficulties with controls were becoming larger in fact and even more worrisome in prospect. We believed that the rate of inflation which had declined to about 3 percent at the end of 1972 would remain around that level during 1973. We did not count on controls to contribute much to that result, although controls were to be continued in the modified form of phase III. We counted mainly on several other factors to hold the inflation rate down.

With the unemployment rate at 5 percent there seemed to be room for a good deal of economic expansion before shortages were encountered. Fiscal policy had turned in a restrictive direction at the middle of calendar 1972. Agricultural policy had been changed to bring about maximum food production. In view of the moderate rise of consumer prices in the previous year, the outlook for reasonable wage behavior seemed good.

Needless to say, many of these expectations were disappointed. Larger United States and world food supplies did not begin to push down food prices until the spring of 1974. During most of 1973 food prices were soaring, as booming world incomes pressed on the still limited supply of food. We turned out to be closer to the ceiling of capacity in many parts of the economy than we thought. This situation was intensified by the worldwide boom, which tightened the squeeze on supplies and prices of basic materials. The second devaluation of the dollar, which tended to raise U.S. prices, had not been expected. And in the last quarter of the year we were hit by the sharp increase of oil prices.

Again, at the beginning of 1974 we looked forward to a slowdown of the inflation rate during the year. The increase of food supplies would finally result in a leveling out of food prices. The enormous increase of oil prices would not be repeated, although its repercussions would be felt during much of the year. The abatement of price increases in these two critical sectors would leave us with a much lower overall rate of inflation. This is still our basic view. But it must be admitted that prices outside the food and fuel areas spurted more than many, including us, expected and our estimate of the inflation rate at the end of 1974 is higher than it once was, although we continue to believe it will be significantly lower than in the first half of the year.

What are we to make of these repeated frustrations, of the fact that the inflation rate has moved higher and higher despite the expectations that it would subside? The view is gaining currency that inflation is an inexplicable and inexorable disease which democratic societies cannot control. We do not believe that. The explanation is complex and the solution difficult, but neither is impossible.

For years economists have been saying that once inflation gets started there is a strong tendency for it to persist or accelerate. We have not really understood how strong this tendency was. This has been reflected in forecasts which underestimated the future inflation rate. It has been reflected in policies which were too weak in dealing with inflation or were abandoned too soon.

This is not to say that inflation once started will accelerate endlessly or even continue endlessly, without further propulsion, and cannot be stopped. It is not to say that a complete explanation of present and future inflation is the fact that we had inflation in the past. Inflations have their initial causes, in policies or events, they are sustained by policies and events, and they can be brought to an end by appropriate policies or by fortuitous events. But the failure to foresee the durability of inflations once started probably makes us more likely to embark on inflationary policies in the first place. Because the process once started is so strong the policies needed to stop it are more forceful and painful than commonly recognized. And in an inflationary world random events, like droughts and embargoes, which might be inflationary or deflationary, turn out to be predominantly inflationary, because the economy responds to them in an inflationary way.

An important part of the mechanism by which the inflationary process is continued or accelerated is expectations. Experience with a rising rate of inflation generates the expectation that the rate will be not only higher but even rising in the future. That becomes par for the course and the behavior of businesses and labor in setting prices and wages conforms to it. If policy or external events slow down the growth of demand, price and wage increases abate little if at all, as everyone is looking across the valley to the next surge of inflation. Because price and wage increases persist at a high rate employment suffers, and governments are driven or tempted to pump up demand, validating the expectation of continued or ever accelerating inflation.

The lags on which we once counted to resist the surge of inflation disappear or weaken. In the textbook description of inflation, government revenues outrun expenditures, yielding a surplus and prices outrun wages yielding an anti-inflationary increase of profits and saving. But in the real inflationary world government expenditures keep up with revenues, and wages keep up with the prices of the things labor produces. Moreover, inflation with one country is not restrained by its external economic relations, for several reasons. If all countries are inflating at the same rate, inflation will not show in any country's external accounts. And even a country that inflates more than others may not be inhibited, because it accepts the resulting deficit, or depreciates its currency or allows its currency to float downward.

Random events like droughts, which in other circumstances might raise particular prices but not the general price level, turn out in the inflationary world to be inflationary. A rise of food prices resulting from a drought is not offset in the inflationary world by a decline of other prices. Not only the level but even the rate of increase of other prices is sticky. Moreover, the spectacular rise of a particularly important category of prices, like food prices, only intensifies the general expectation of inflation and causes other prices to rise more, not less.

Restrained growth of the money supply might prevent surges of inflation from occurring or persisting. But there is some tendency for monetary growth to expand when there is inflationary pressure, especially if the monetary authority tries in some degree to moderate rises of interest rates. And there is a good deal of looseness, especially in the short run, between the rate of monetary expansion and the rate of inflation, so that inflation can accelerate for a while even if monetary expansion does not. The monetary authorities then confront the problem of slowing down an existing high rate of inflation, which is likely to entail more unemployment than would have been involved in avoiding the acceleration, and also higher interest rates and more injury to housing and other sensitive sectors.

While this general scenario applies to many countries and times, its specific sequences have varied. Our own current inflation began almost 10 years ago when the costs of the Vietnam war were piled on the costs of the Great Society, without any tax increases until 1968. The inflationary boom thus generated was financed by an increased expansion of the money supply. By the time policy turned in an anti-inflationary direction, in late 1968 and early 1969, we had already experienced an unusually long and strong inflation. The restrictive fiscal and monetary policy of 1969 and 1970 was beginning to reduce the inflation rate, but the country, including the administration, was not prepared for how long it would take.

We were assailed for having the "worst of both worlds," continued inflation and rising unemployment. Complaints on this score were intensified by the common belief that there was a better way—a way by which we could both stop the inflation and reduce the unemployment. That way price and wage controls, then often euphemistically described as "incomes policy." Finally, and reluctantly, in August 1971, the administration switched course. It imposed controls and turned to more expansionist policies. Taxes were reduced and expenditures increased. The dollar was allowed to decline in value, which increased net exports and contributed to domestic expansion. The rate of monetary growth increased.

Around the middle of 1972 the administration decided to turn away from these expansionist policies, by clamping down on the rise of Federal spending. However, looked at with hindsight the prior expansionist push had been too great and the reversal too slow. As a result we entered 1973 with demand rising too rapidly, relative to productive capacity. The food shortage, the worldwide commodity inflation, the oil price increase, and the further depreciation of the dollar all impacted on this inflationary environment, and the result was a violent surge of the price indexes. Many of the causes of this surge have now passed, but we are still feeling its effects, in the movement of earlier cost increases through successive stages of production and distribution and in the rise of wages to catch up with earlier cost-of-living increases. We still have shortages in many sectors of the economy. We still have inflationary expectations. We still live in an inflationary world.

The basic lesson of our decade of inflation is that a policy of firm restraint on the expansion of demand must be continued steadily for a long period. We must guard against underestimating the force of the inflation and the strength of the policies needed to deal with it, even at the risk of possibly leaning too far in the other direction. The instruments for restraining demand are well known—chiefly limiting the increase of the money supply and the increase of Government spending. They must be our main reliance.

This prescription is sometimes dismissed contemptuously as "the same old medicine," as if it had been commonly used and found inadequate. However, what stands out from our experience is that our troubles are due to failure to follow this prescription. We surely did not follow it from 1965 to 1968 and we turned away from it too soon in 1971. The evidence is not that the prescription is ineffective, but that it will work if applied firmly and continuously.

How long the restraint would have to be applied to achieve any specified, durable reduction of the inflation rate, no one can tell. Much will depend on how the public estimates the determination of Government to stay on the restrictive course. It would be irresponsible, and probably self-defeating, to tell the public that victory against inflation will come quickly or easily. But every Government official has said that checking inflation is the number one economic objective; polls show that the public agrees. If this means anything it means willingness to bear some cost to achieve the objective.

We should try if we can to avoid excessive concentration of the burdens of checking inflation on particular individuals. That is why, for example, it would be desirable to enact the improvements of the unemployment compensation system proposed by the administration. But perfect fairness is no more likely to be found in the war against inflation than in other human endeavors, and insistence on it would guarantee failure.

Restraint of demand is the indispensable condition for restraining inflation. It is not the only thing that can be usefully done. Measures to increase the competitiveness of the economic system will tend to make prices and wages more responsive to a deceleration of demand and reduce the cost that must be paid in employment and output when anti-inflationary action is taken. Increasing competition will also tend to make the economy more efficient and so enable us to meet the demands on the economy with a real supply of goods and services, rather than by an illusory supply of inflated incomes. Other ways to increase production and productivity, which we have dealt with repeatedly in our economic reports, deserve serious attention. If there were more time these could be elaborated. However, these other possibilities should not distract us from the central lesson, which is the need for continuing, firm restraint of demand.

Thank you.

Senator PROXMIRE. Thank you very much.

[The appendix to the statement of Mr. Stein follows:]

APPENDIX TO STATEMENT OF HON. HERBERT STEIN

The Economy at Midyear

The American economy has been through a difficult half year as a result of the energy crisis and the continuing problem of inflation. The oil embargo had a severe economic impact and although we continue to feel its effects the most difficult part of that problem is now a thing of the past. The inflation problem, which was heightened by the embargo and subsequent price increases, is a much more troublesome and enduring one. Any serious effort against inflation involves costs that still lie ahead of us and will be felt for a long time.

At the time of our Annual Report at the end of last January the problem uppermost in our minds was the energy crisis. We knew that this would involve cuts in production, employment and living standards. While we viewed the outcome with great uncertainty we did not share some of the dire predictions of things to come. We expected total output to fall in the first quarter of 1974 and then to stop falling in the second. Output did decline in the first quarter—more than we expected—but the decline now seems to have come to a halt. We expected unemployment to rise more or less continuously in the first half of 1974. Unemployment did rise sharply from November to January but since then it has stabilized—at lower levels than we had projected and despite the sharper-than-expected cut in domestic output. We foresaw a high rate of inflation in the first quarter and a lessening in the rate in the second quarter. Although this is the pattern that has unfolded the rates of price increase in both quarters of 1974 have been greater than we anticipated.

Prior to the time of the oil embargo overall demand was strong, production and capacity utilization were high and unemployment was low. Shortages of many basic materials were common and were holding down production in several industries. At the same time it was clear that demand in some sectors, notably housing and automobiles, had fallen from very high rates that prevailed earlier in 1973 and were continuing downward. Under these circumstances we foresaw a slower rate of growth in demand and output in 1974 than in 1973 and a small rise in unemployment. We viewed a slowdown of this kind to be desirable because of the strong inflationary pressures that existed in 1973 and were likely to persist into 1974.

The energy crisis transformed a slowdown of the rise in output into a very sharp decrease as consumers refrained from buying large cars and reduced their real outlays on energy related products and services. In the autumn of 1973 the typical expectation for calendar 1974 was a production cut for autos of about 8–10 percent from calendar 1973. Production fell much more sharply; from the fourth quarter of 1973 to the first quarter of 1974 alone output of automobiles fell by 30 percent. Consumer real spending on gasoline, fuel oil, electricity and gas, which had typically grown by 1 to 1½ percent per quarter, fell by 10 percent as a result of curtailed supplies, high prices, voluntary conservation efforts, and an unusually warm winter. Indeed, that part of the overall output cut associated with energy-affected items appears to account for all of the first quarter decrease, if not more.

On July 18 the Commerce Department released its preliminary estimate of second quarter GNP, which in real terms showed a decline of 1.2 percent at an annual rate. Several points should be made about these figures. First of all, if we confine attention to domestic output only—which affects employment and unemployment—we find that the second quarter was essentially the same as the first, (and the first quarter drop was a little larger than the drop in total GNP). By way of explanation we may note that the GNP includes interest and dividends received by U.S. corporations and residents from abroad net of interest and dividends sent abroad. These net receipts were reduced in the second quarter because oil-producing countries increased their ownership of foreign subsidiaries of U.S. corporations.

[In billions of 1958 dollars]

	3d quarter, 1973	4th quarter, 1973	1st quarter, 1974	2d quarter, 1974
Real GNP	840.8	845.7	830.5	828.0
Rest of world	5.1	5.0	7.0	4.2
Domestic GNP	835.7	840.7	823.5	823.8

Second, the second quarter GNP estimates are based on incomplete data. In accordance with its usual procedures it was necessary for the Commerce Department to make its own estimate of inventories, net exports and consumer prices in June. Final figures could show a somewhat higher or a somewhat lower figure. The key point is that we should not attach much significance to a small change in either direction since any statistical estimate is subject to a margin of error.

Ever since the second quarter GNP statistics were released there has been a good deal of discussion about whether we are in a recession because real GNP fell in two consecutive quarters. The National Bureau of Economic Research (NBER), commonly regarded as the arbiter of recessions, does not use the existence of two consecutive quarters of decline as its criterion of a recession. The NBER looks at a wide variety of economic statistics and cannot reach a judgment until some time has passed, so that the changes can be viewed in perspective.

We are encouraged by the behavior of industrial production and unemployment so far. Industrial production is a comparatively volatile component of overall production and the sector most affected by cyclical influences. Industrial production declined 2½ percent from last November to February and since then has risen by 1 percent, paced by a recovery in motor vehicle production. For the second quarter as a whole industrial production was 1.3 percent higher (at an annual rate) than the first quarter. As noted earlier, unemployment has been essentially unchanged since January.

Table 1 compares the behavior of industrial production and the unemployment rate in past periods of declining real GNP. Whenever in the past we have experienced two successive declines in real GNP we have also experienced declines in industrial production. The rise of industrial production in the second quarter of 1974 stands in sharp contrast to earlier experience. The contrast with respect to the unemployment rate is even more striking and more significant.

Prospects—Second half 1974

We believe that overall production will recover in the second half of 1974 but the rise will be slower than we had thought earlier. This in turn will entail a rise of unemployment in this period; however, the unemployment rate is now lower than we had expected it would be at this time, and we do not think the rate will exceed 6 percent this year, aside from the occasional erratic behavior to which the estimates are subject. We continue to expect a less rapid rate of inflation by the end of 1974 than we saw in the first half.

TABLE 1.—CHANGES IN INDUSTRIAL PRODUCTION AND THE RATE OF UNEMPLOYMENT DURING THE 1ST TWO QUARTERS OF DECLINING REAL GNP

	Percent change, seasonally adjusted annual rate				Point change in unemployment rate	
	Real GNP		Industrial production			
Initial quarter of real GNP decline	Initial quarter	2d quarter	Initial quarter	2d quarter	Initial quarter	2d quarter
1974 I	−7.0	−[1] 1.2	−6.5	[1] 1.3	0.5	0.0
1969 IV	−2.3	−2.1	−3.5	−9.4	0	.6
1960 II	−.4	−1.9	−8.0	−6.4	0	.4
1957 IV	−6.0	−9.2	−15.7	−20.9	.7	1.4
1953 III	−2.6	−4.7	−0	−17.4	.1	1.0
1949 I	−5.0	−2.4	−12.1	−12.5	.8	1.3

[1] Preliminary.

The slower rise in production will reflect continuing unfavorable financial conditions in mortgage markets, which will hold down the recovery of housing. In addition, there is some question as to whether businessmen will step up their investment in inventories. Revisions in the estimates of inventory accumulation suggest that stocks are higher in relation to overall output or sales than we had been led to believe on the basis of the statistics available earlier. Even so, we are not now inclined to compensate for these shortfalls from our earlier expectations because of the continued rapid increase in prices. Demand continues to be excessive in some sectors. In industries like primary metals, industrial chemicals, and machinery and equipment, output will continue to feel the effects of supply shortages.

Demand for capital goods continues to be very strong even though in real terms nonresidential investment outlays have changed little since the fourth quarter. In the first quarter there was a dip in business purchases of cars and trucks associated with last winter's energy crisis while supply limitations seem to have held back shipments of machinery and equipment this spring. There are many signs of strong demand for capital goods at the present time. The ratio of output to capacity in major materials industries in the second quarter of 1974, although 3 percentage points below its peak one year earlier, was still very high gauged by the experience of post-World War II years. At the end of March the proportion of manufacturing firms indicating a need for more capacity remained at its peak reached at the end of 1973; chemicals and primary metals, where shortages have been common, the proportions showed a rise as compared to December. Backlogs of nondefense capital goods industries at the end of June were 35 percent greater than a year earlier and the ratio of backlogs to shipments in these industries at the end of June was close to the peaks reached in the late 1960's. In the face of declines in automobiles and residential construction, two important users of steel, the continued high rate of operations in the steel industry attests to the strength of demand for capial goods at the present time.

The Commerce Department survey of business investment plans published in early June pointed to a current dollar rise of 11 percent (annual rate) from the first to the second half of the year. Given the outlook for capital goods costs, this implies a moderate rise in real terms.

The energy crisis seems to have had a differential impact on investment programs of energy industries. As compared to the survey published in March the Commerce Department's June survey pointed to stronger plans by petroleum firms but reductions in planned increases in motor vehicles and electric utilities. The electric utilities have been cutting back investment plans not only because they are re-evaluating the long-run growth of their markets but also because of liquidity problems and high interest costs. However, because of the large volume of work underway, these cutbacks will probably have a greater effect in 1975 than in 1974 and will mean smaller rises rather than outright declines.

The inventory situation looks different from the way it did just a few weeks ago because of major divisions in the underlying statistics. Investment in inventories in the 1971–73 period now appears higher on the basis of new data from the Commerce Department. For example, one measure used to guage the level of inventories is the ratio of real nonfarm stocks to total real GNP. At the end of March this ratio, based on figures then available, stood at .227. This was somewhat higher than a year earlier but close to the 1947–73 average of .225. Revised estimates by Commerce now put this ratio at .235 for the end of March and .238 for the end of June, both of which would make total nonfarm stocks appear comparatively high. It may be that because of continuing shortages and prospective price increases businessmen desire to hold larger than normal stocks. However, there is some evidence that stocks are greater than desired—among department stores, for example, and among foreign car dealers. Given the new view of inventories in a setting of high interest rates we are not likely to see much change in the rate of inventory accumulation for the rest of the year.

Real consumption outlays fell sharply in the fourth quarter of 1973 and first quarter of 1974 but recovered slightly in the second. The decline last fall and winter and the pickup this spring centered in products and services affected by the energy crisis. In aggregate all other consumption in real terms has been essentially unchanged since the third quarter of 1973. Since that time a drop in the saving rate has helped to sustain consumption in the face of declining real incomes but the large revisions in the savings figure suggest caution in attaching too much significance to changes in the saving rate.

We anticipate a slow rise in real consumption over the balance of 1974. The number of new automobiles sold in the second half of 1974 should rise over the first half rate. Domestic sales had been running at an annual rate of 10 million units in the first 3 quarters of 1973 but they fell to a rate of 8 million in the fourth quarter and 7⅔ million in the first quarter. The drop in the fall and winter was concentrated in large cars, but with the improvement in gasoline supplies in March large car sales began to revive. The second quarter total rose to a rate just over 8 million. In the meantime the automobile industry has taken steps to increase its capacity for producing small cars. Prospects for a further sales pickup this summer appear good partly because real incomes should be improving and partly because there may be some consumer purchasing in anticipation of price increases scheduled to go into effect in the new model year. Price increases already announced should curtail demand late this year but the greater availability of smaller vehicles with improved gas mileage performance should act as a stimulus.

Reduced supplies, rising prices and voluntary conservation efforts put a halt to the strong growth in consumer real outlays for energy—gasoline, fuel oil, electricity and gas—in late 1973 and early 1974. In real terms, first quarter 1974 outlays for these items were 11 percent below their third quarter 1973 rate. On the basis of very preliminary and incomplete figures it appears that consumer outlays for gasoline and oil have recovered part of their earlier drop but this is not so for fuel oil and electricity and gas. A return in the direction of the long-term trend existing prior to the energy crisis seems to be a reasonable prospect but given the price increases that have occurred the speed of the return is likely to be slow. Considered as a whole all other real consumption—consumption excluding autos and parts and energy—will probably show a somewhat sluggish improvement over the balance of 1974 and into 1975. This increase will stem from rising real incomes but it will be dampened by continuing adjustments by consumers to high energy prices.

TABLE 2.—REAL DISPOSABLE INCOME AND ITS COMPONENTS

[Billions of 1958 dollars]

	1973		1974		Change 1973 III to 1974 II
	III	IV	I	II	
Real disposable income	621.8	622.9	610.3	604.3	−17.5
Real saving	49.9	59.2	54.2	45.9	−4.0
Real personal outlays	571.9	563.7	556.1	558.4	−13.5
Interest and transfers	16.5	17.4	16.4	16.1	−.4
Personal consumption expenditures	555.4	546.3	539.7	542.3	−13.1
Autos and energy	95.3	87.0	79.6	81.7	−13.6
Autos and parts	51.7	44.9	41.8	42.9	−8.8
Energy	43.6	42.1	37.8	38.8	−4.8
Other	460.1	459.3	460.1	460.6	+.5

TABLE 3.—DISPOSITION OF REAL DISPOSABLE INCOME

[Percent]

	1973		1974	
	III	IV	I	II
Real disposable income	100.0	100.0	100.0	100.0
Real saving	8.0	9.5	8.9	7.6
Real personal outlays	92.0	90.5	91.1	92.4
Interest and transfers	2.7	2.8	2.7	2.7
Personal consumption expenditures	89.3	87.7	88.4	89.7
Autos and energy	15.3	14.1	13.0	13.5
Autos and parts	8.3	7.2	6.8	7.1
Energy	7.0	6.8	6.2	6.4
Other	74.0	73.7	75.4	76.2

EMPLOYMENT

During the first two quarters of 1974 the seasonally adjusted unemployment rate was approximately level at 5.2 percent, which can be compared with the 4.7 percent average rate in the second half of 1973. This pattern of an increase in unemployment from the second half of 1973 to the first half of 1974, and a constant level in 1974 is observed within demographic groups.

The seasonally adjusted unemployment rate for married men increased 0.3 percentage point from 2.1 percent in 1973–III–IV to 2.4 percent in 1974–II, while for all adult men it increased 0.5 percentage point to 3.5 percent. During the same period the seasonally adjusted unemployment rates for adult women increased 0.3 percentage point to 5.1 percent, and for teenagers of both sexes the increase was by 0.9 percentage point to 15.2 percent. The unemployment rate rose 0.5 percentage point to 4.7 percent for whites and 0.4 percentage point to 9.2 percent for Negroes and other races. The seasonally adjusted state insured unemployment rate increased 0.6 percentage point to 3.3 percent during the same period.

The seasonally adjusted unemployment rate among male Vietnam-era veterans (those who served after August 4, 1964) age 20 to 34 was 5.0 percent in the second quarter, approximately the same as the national rate. This can be compared with an unemployment rate of 5.6 percent for male nonveterans in the same age bracket. Except for the youngest of veterans (age 20 to 24), who are primarily recent dischargees and hence recent entrants to the civilian labor force, male Vietnam-era veterans appear to have a lower unemployment rate than male nonveterans of the same age. Higher unemployment rates are a

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characteristic of both men and women who are recent entrants or reentrants to the civilian labor force.

TABLE 4.—LABOR FORCE DATA 1973–74

[Seasonally adjusted quarterly data]

	Civilian unemployment rate (percent)	Labor force participation rate[1] (percent)	Civilian labor force (in thousands)	Civilian employment (in thousands)	Civilian unemployment (in thousands)	Employment rate[2] (percent)
1972	5.6	61.0	86,542	81,702	4,840	57.7
1973	4.9	61.4	88,714	84,409	4,304	58.5
1973IV	4.7	61.8	89,896	85,656	4,240	58.9
1974I	5.2	61.9	90,532	85,826	4,706	58.8
1974II	5.1	61.7	90,637	85,970	4,667	58.6

[1] Total labor force as percent of noninstitutional population 16 yr. of age and over.
[2] Total employment as a percent of noninstitutional population 16 yr. of age and older.

The changes in the unemployment rate by demographic group indicate that the increase in unemployment was relatively greater among persons who had been employed as skilled and semi-skilled workers in the manufacturing sector.

The seasonally adjusted average monthly number of unemployed persons was fairly constant at 4.7 million during 1974I–II. Civilian employment increased seasonally adjusted by 144,000 from 1974I to 1974II to 86.0 million, an annual rate of 0.7 percent. This small increase is in sharp contrast with the 3.1 percent rate of increase in employment from 1973I to 1974I, an increase of 2.6 million persons. The slow growth in the labor force (employment plus unemployment) led to a decline in the labor force participation rate from 61.9 percent in 1974I to 61.7 percent in 1974II. Except for the two previous quarters, 1973IV and 1974I, the most recent quarter's labor force participation rate was at a record peacetime level.

The labor force participation rate has been on a general increase in the post-World War II period from 58.9 percent in 1947 to 61.4 percent in 1973. The average annual *secular* rate of increase is 0.03 percentage point. The secular increase is largely due to the fact that the increase in the labor force participation of married women was outweighing the effect of earlier labor force withdrawal of older workers. The participation rate also has a cyclical component, increasing in a business expansion (as married women and teenagers are attracted into the labor force and early retirements decrease), and decreasing in a cyclical contraction.

From 1972–IV to 1973–IV the labor force participation rate increased by 0.7 percentage point. The large increase was, in part, a consequence of the joint effects of a secular increase in participation and the cyclical improvement in labor market opportunities. However, the labor force participation rate of 61.8 percent in 1973–IV was greater than would have been predicted on the basis of historical experience, which would have been 61.1 percent.

The unusually high participation rate continued in 1974–I with an increase to 61.9 percent, which was also greater than the predicted value (61.0 percent). The employment rate (percent of the noninstitutional population 16 years of age and older that is employed) declined somewhat from 1973IV to 1974I. As a result, the unemployment rate increased. The increase in the unemployment rate in 1974I was, therefore, a consequence of an expansion of the labor force which was already above the trend at a time when employment opportunities were on a decline.

In the second quarter of 1974 the labor force participation rate declined to 61.7 percent, a level 0.3 percentage point closer to the predicted value (61.1 percent). The unemployment rate was essentially unchanged as the decline in the participation rate was combined with a continued decline in the employment rate. Thus, in spite of the weakening of employment opportunities in 1974II, the slow growth of the labor force as the participation rate declined toward its long-term predicted level was responsible for a fairly constant level and rate of unemployment in 1974I–II.

The pattern of change in labor force participation during the first two quarters of 1974 differed across demographic groups. Whereas the number of adult women in the civilian labor force increased at a seasonally adjusted annual rate of 5.4 percent, the number of adult males decreased at an annual rate of 0.6 percent, and teenagers decreased at an annual rate of 10.0 percent. Thus, whereas teenagers found the labor force to be less attractive, women continued to increase their attachment to market employment.

Data on nonagricultural payroll employment indicate a continued growth in the number of jobs, although at a decelerating rate. From 1973I to 1974I, the number of nonfarm payroll jobs increased by 2.1 million to 76.7 million, an increase of 2.8 percent. From 1974I to 1974II, however, 354,000 additional jobs were created (seasonally adjusted) for a total of 77.1 million, an annual rate of increase of 1.9 percent.

The slower growth in jobs in 1974 was not experienced uniformly across sectors. Durable manufacturing jobs increased in 1974II by 1.4 percent on a seasonally adjusted annual basis. This was partly due to the recovery in the transportation equipment sector where 50,000 jobs were added in the second quarter of the year (an annual rate of increase of 12.2 percent) for a total employment of 1,763,000. This increase reversed a three quarter decline, but employment was still lower than in any quarter (other than 1974I) since 1972IIII. Although transportation equipment comprises approximately 15 percent of all durable manufacturing jobs, increased production in this sector has positive spillover effects on other durable manufacturing sectors that produce inputs for the production of automobiles, trucks, etc.

Employment decreased on a seasonally adjusted annual basis from the first to the second quarter of the year in nondurable manufacturing (1.7 percent) and in contract construction (6.5 percent). On the other hand, the number of private service producing jobs and government jobs increased at seasonally adjusted annual rates of 2.5 percent and 4.7 percent, respectively, during the same period. Thus, although employment in the goods producing sector was sluggist during the first half of the year there were clear signs of a recovery in the transportation equipment sector. Employment increases were strong in the service producing sector, especially in government.

HOUSING

During the first half of 1974, private housing starts were 31 percent below those registered in the same period of 1973. Mobile home shipments also declined substantially as shown in Table 5.

In the first quarter of this year, an unusually large inventory of unsold homes restrained starts, while supply bottlenecks caused delays in construction planning and completion. At the end of the quarter interest rates began a sustained new rise which weakened the competitive position of thrift institutions. As a result, seasonally adjusted net savings flows to the thrift institutions, including interest credited to their depositors, fell by one-half from over $7 billion in the first quarter to less than $4 billion in the second quarter of 1974. Without the interest credited, there was a slight outflow.

Thus, mortgage loans became increasingly hard to get and more expensive. For instance, the effective conventional mortgage interest rates rose from less than 8 percent in June 1973 to almost 9 percent in June of this year. Over the same period, the FHA–VA ceiling rate went from 7 percent to 8¾ percent. It has since been raised to 9 percent, effective July 8. Mortgage interest rates required in the secondary market rose to even higher levels. For instance, in FNMA's bi-weekly auction of 4-month commitments to purchase FHA–VA and conventional home mortgages, an average yield of 9.90 percent was registered on offers accepted in mid-July.

TABLE 5.—SEASONALLY ADJUSTED PRIVATE HOUSING STARTS AND MOBILE HOME SHIPMENTS, AT ANNUAL RATES

	Private housing starts			Mobile home shipments		
	1973	1974	Change (percent)	1973	1974	Change (percent)
January	2,472,000	1,464,000	−41	632,000	469,000	−28
February	2,423,000	1,922,000	−21	626,000	449,000	−26
March	2,283,000	1,499,000	−34	703,000	475,000	−32
April	2,153,000	1,630,000	−24	639,000	435,000	−32
May	2,330,000	1,476,000	−37	628,000	451,000	−28
June	2,152,000	1,595,000	−26	600,000		
1st half	2,302,000	1,598,000	−31	[1] 646,000	[1] 456,000	[1] −29

[1] 1st 5 mo. of year.

As a result of these factors, the outlook is for housing starts to decline in the third quarter from the 1.6 million level maintained in the first half of the year. However, the decline will be cushioned by the $10.3 billion program of mortgage credit assistance announced by the President on May 10 of this year. Already almost $4 billion of mortgage credit and subsidized advances has been committed under this program.

One component of the President's program enabled the Federal Home Loan Mortgage Corporation to offer commitments to purchase up to $3 billion of mortgages at 8¾ percent interest in the coming months. Within two months from the announcement date, the entire $3 billion had been committed. Of the $4 billion of advances subsidized internally by the Federal Home Loan Bank Board almost $1 billion has already been paid out in cash or committed at interest rates of around 8 percent. However, since the FHLB system's borrowing costs have risen to 9½ percent in July, subsidized advances will have to be offered at around 9 percent in August.

The commitment authority granted under the GNMA Tandem program in January, which involved more than 200,000 units at 7¾ percent interest, may be exhausted by the end of the current quarter. Commitment activity is currently running at the rate of 20,000 to 30,000 units per month. An additional 100,000 units at 8 percent interest authorized under the Tandem program on May 10 remain available for commitment, probably in the fourth quarter. The increase in value limits provided in the proposed Housing and Community Development Act of 1974 would widen participation in the program.

Together with the decline in the rate of inflation and the reduction in short-term interest rates expected later this year, the President's program will support housing starts in the coming quarters.

In the long run, the improvement of secondary mortgage market facilities and the adoption of variable mortgage interest rates should provide greater stability for the housing sector. The initiation of an automated mortgage market information network (AMMINET), cosponsored by the Federal Home Loan Mortgage Corporation, in June of this year will increase the liquidity of mortgages. Over 200 mortgage trading institutions will be phased into the system by the beginning of August with the network, over which traders can communicate offers to buy and sell mortgage investments, becoming completely operational by August 1. Other recent innovations include the adoption of an experimental program for insuring mortgages with varying financing instruments, including a variable interest rate, contained in the proposed Housing and Community Development Act of 1974. In addition, passage of the Financial Institutions Act would make mortgages more attractive to investors and broaden the lending powers of the thrift institutions.

There are fundamental factors at work which should boost the rate of housing starts in 1975 if monetary conditions permit an increase in the supply of mortgage credit. Net household formations are expected to amount to about 1.5 million per annum in coming years. Adding 0.1 million to provide for the normal growth in the stock of vacant units and 0.7 to provide for normal replacement demand yields a normal growth of about 2.3 million dwelling units per year. Reducing this figure by about 0.3 million additional mobile homes, net of discards, which correspond to at least 0.5 million shipments per annum, leaves 2 million private housing starts which will be required on the average per year to meet normal additions to the stock demand for housing. Since actual starts will be lower in 1974, resulting in low rates of housing completion in 1974 and in the early part of 1975, there will be increasing pressure from the side of demand to raise starts to—or temporarily somewhat above—the 2 million level.

PRICES AND WAGES

Inflation continued at a rapid rate in the second quarter of 1974, but not as rapid a rate as in the first quarter. The slowdown was most noticeable in the GNP deflator which increased at an annual rate of 8.8 percent in the second quarter as compared with 12.3 percent in the first quarter. The improvement on a quarterly basis was much smaller for the Consumer Price Index—from a rate of 12.2 percent in the first quarter to 11.4 percent in the second, though the rate of increase measured from March to June slowed to 10.9 percent from 14.2 percent in the preceding three months.

In the first quarter of 1974, higher prices for food and fuel accounted for two-thirds of the 12.2 percent rise in the CPI. In the second quarter, the composition of inflation changed. Price increases for food (discussed further in the next section) and directly purchased fuel slowed and accounted for only one-third of the CPI increase during that quarter. (See Table 6.) All other items accounted for two-thirds of the rise. The increase in the contribution of prices of all other items to the second quarter increase in the CPI reflects several forces: (1) the pass through of earlier increases in prices of fuels and other industrial raw materials; (2) the termination of controls on April 30 (the increase in the CPI was 0.6 percent in April but stepped up to about 1.0 in May and June) and (3) the increase in May in minimum wages from $1.60 to $2.00 per hour for most workers covered by the legislation which appeared to be reflected in the prices of many consumer services. In addition there was a special factor—used car prices rose at an 89.3 percent annual rate in the second quarter and accounted for about one-sixth of the rise in all items other than food and fuel. The increase in used car prices does not affect consumers in the same way as most other price increases since consumers are both sellers and buyers of used cars.

TABLE 6.—CONSUMER PRICE INDEX AND MAJOR COMPONENTS CHANGES AND CONTRIBUTION TO CHANGE—1974-II

	Relative importance December 1973 (percent)	Percent change (SAAR)	Contribution to change (percent)
All items	100.000	11.4	[1] 100.0
Food	24.810	5.5	12.2
Directly purchased fuels	6.424	35.7	18.6
All other	68.766	11.0	66.3
Used cars	1.849	89.3	11.7

[1] Contributions to change do not add to 100 percent because relative importances change monthly but are published only once a year by BLS.

Declining farm prices held the increase in the Wholesale Price Index to 14.6 percent rate in the second quarter as compared with 24.4 percent in the first. The pass through of cost increases and the termination of controls were factors in the continued high rate of increase in industrial commodity prices. Toward the end of the quarter one impetus to cost increases—soaring raw commodity prices—showed signs of petering out.

But, wage rates, the other major source of cost increases, advanced markedly in the second quarter. Private nonfarm hourly wage rates—adjusted for overtime in manufacturing and interindustry shifts—rose at an annual rate of 9.6 percent in the second quarter of 1974, with all of the acceleration from the first quarter rate of 6 percent occurring in May and June. Year-over-year changes in this measure had fluctuated between 5.5 and 7.0 percent in almost every quarter since the beginning of 1968. But during the same period quarterly changes fluctuated more, reaching almost 8.5 percent in some three-month periods. The sharp rise in the second quarter may also be somewhat of an aberration brought about by the confluence of the termination of controls and the increase in the minimum wage. But this increase, together with the effect of output per manhour combined to bring about a rise in unit labor costs (all private employees) at a 12 percent rate in the second quarter.

Although price and wage advances in the second quarter of 1974 proceeded at a somewhat faster rate than we anticipated, our earlier forecast that the rate of increase in the CPI would be in the neighborhood of 7 percent in the fourth quarter still looks reasonable. (See statement in appendix supplement detailing the basis for this projection.) But price forecasting continues to be fraught with uncertainty. Three key assumptions surrounded by uncertainty in our forecast are: (1) that the second quarter rise in wages was to some extent influenced by transitory factors, (2) that retail food prices will not fully reflect the recent rise in farm prices just as they did not fully reflect the decline in farm prices during the spring and (3) that farm prices will end up in 1974 about 5 percent higher than a year earlier.

FOOD AND AGRICULTURE

There has been a sharp reduction in the rate of increase of retail food prices in recent months. The annual rate of increase fell to 3.1 percent in the three month span ending in June compared with 20.1 percent in 1973, and 19.4 percent in the three months ending in March 1974. Grocery prices rose only 1.0 percent at an annual rate in the three months ending in June.

The increases for the first six months of 1974 as a whole were very close to our expectations although they were larger early in the year and smaller later.

This improvement in retail food prices resulted from reduced prices at the farm level, especially livestock, poultry, and egg prices. Indeed, in June the price of the farm-value component in the Department of Agriculture's food "market basket" was lower than a year earlier. In contrast, the market basket statistics have reported a substantial widening of the difference between farm and retail prices. A number of factors account for this widening. Margins were being held down by price controls a year ago, and so some of the expansion has been simply a recovery to more normal levels. Costs in the food chain have risen considerably faster than productivity over this period, especially for transportation, packaging, and labor. Finally, changes in margins in the past typically have been inversely related to changes in farm prices. Since farm prices declined substantially from February through June, processor and retail margins could be expected to widen.

Indeed, the wide margins in the second quarter can serve as a buffer, at least temporarily, to the rise in farm prices which began in mid-June and which is not expected to be reversed before this fall.

Second half outlook

Earlier this year we had anticipated a further deceleration in food price increases during the second half because food supplies were expected to expand faster than demand. Indeed, it was our view that food prices would increase less rapidly than other consumer prices and lower the overall average. There were considerable uncertainties in this picture. In particular, it depended on an expansion of red meat supplies; and it depended on "average" weather that along with expanded acreage would lead to record domestic grain crops and to increased crop production abroad. This combination of events would lower grain and soybean exports from the United States and allow for some rebuilding of the historically low carryover stocks of grain from the 1973/74 crop year.

Estimated red meat production in the first six months increased about 6 percent compared with a year earlier. The outlook is that beef and pork production will continue to exceed the abnormally low levels of last summer for several months but fall below the slaughter rates of the last three months. The grain situation has developed less favorably. After getting off to a good start, planting and growing conditions have reduced earlier estimates of both plantings and yields of major crops. Despite this slippage, wheat production is estimated to increase 12 percent over the previous record (1973); rice production will increase by at least 20 percent; and feed grain production, while still somewhat uncertain, should reach a new record. Although record food and feed grain harvests are still highly probable for this year, any easing of the tight supply-demand balances will be marginal because of the low level of stocks left over from the 1973 crop year. The price outlook, of course, will depend on export demand relative to a year earlier. The current expectation is that grain and soybean exports will be somewhat lower, thereby not adding any significant net increase in demand.

The revised crop outlook since mid-June has caused sharp increases in crop prices, especially of corn and soybeans. There has also been a sharp recovery in prices of livestock and poultry from unexpectedly low June levels. At this stage, the outlook for livestock prices is consistent with our forecasts at the beginning of the year, but current and prospective crop prices are higher. Because of the lag between changes in feed supplies and their impact on livestock supplies, the outlook for retail food prices in the second half of this year has not changed materially. We still expect a deceleration in the second half compared with the first half and increases somewhat less than overall consumer prices. The recent sharp recovery of livestock prices will translate into some step-up from the second quarter in late summer and early fall; the outlook for late 1974 and early 1975 will be contingent on the final crop output and how the recent squeezes on feeding margins affects the planning of livestock and poultry producers.

Redirection of food policy

Beginning in late 1972, it became apparent that the demand for food commodities was outstripping supplies, a condition which continued until the spring of 1974. In response the Administration took numerous steps through trade measures, stockpile releases and annual farm programs to expand supplies. Previous Council reports have detailed these steps. The policy of all-out production has been an important factor in increasing farm production of food commodities. In 1973 estimated food production increased 2.1 percent.

Another 4 percent increase is forecast for 1974. The dependence of production on Government policy is most direct for the major commodity programs. Under these programs, about 60 million acres—over 15 percent of the nation's cropland—was withheld from production from the late 1950's through 1972, with a brief relaxation in 1971 following the previous year's corn blight. In exchange for removing land from production, farmers received direct Government payments. From 1972 to 1974, the 60 million acres were released to production. About 33 million acres have been planted to crops this year and it is estimated that another 7 million would have been planted had the weather cooperated. This has made a significant contribution to the Administration's policy of expanding food production. Crop production in 1973 and 1974 should be about 7 percent above the average of the previous two years.

The policy of all-out production has been implemented mainly by removing Government interference with food production, marketing, and imports. It has been implemented concurrently with a shift toward free markets for agriculture. It is for this reason that the Administration's all-out production policy would be inconsistent with raising market price support levels, for example ,and the policy to expand food supplies would be inconsistent with controlling the free flow of exports. To a greater extent than at any time since the 1930's, agricultural production is determined by price incentives resulting from market forces.

Longer-term food policy

The conditions that have permitted the shift to a new agricultural policy have now lasted nearly two years. There are several reasons that point toward a continuation of an agricultural economy producing at full capacity for the next two or three years, at least.

1. Grain stocks are low and are unlikely to be replenished to satisfactory levels this crop year.
2. Export demand, especially from the centrally-planned economies, appears to be on a considerably higher plateau than just a few years ago.
3. Land availability in the short run is more limited than was indicated by estimates that Government programs were holding 60 million acres out of production. In the last two years only 33 million acres have returned to production even with much higher crop prices.
4. The period of chronic excess labor in the farm sector may have passed. If so, the farm sector will have to pay higher returns to hold and attract adequate labor and management.
5. The cost of purchased inputs (particularly fertilizer, fuels, and chemicals) has risen dramatically, even relative to farm prices.
6. The flow of new technology into agriculture, which has been an important source of productivity improvement in the past, may be ebbing temporarily.

What are the implications of these propositions? It is not that the country will run out of food or that there will be food shortages. Rather, it would mean that for a period farm prices would remain relatively high and, perhaps more important, there would be considerable price instability for farm commodities. Small shifts in production or demand would cause large price swings because of the absence of the excess productive capacity and reserves of the past. It would also mean that resources and investment would be attracted to agriculture in response to higher prices.

MATERIALS SHORTAGES IN 1973–74

One outstanding feature of the accelerating inflation of the past year-and-a-half has been the surge in prices of primary products, both agricultural and mineral. Prices of nonferrous metals and other industrial commodities exceeded all past peaks, including those of the Korean war period. These record increases reflected growth in world demand resulting from the nearly simultaneous cyclical expansion in the economies of the major non-Communist developed nations to near full-employment levels in 1973 and early 1974. The surge in materials demand pressed on the available domestic supply of many materials and resulted in some temporary shortages.

It should be emphasized that "shortage" as used here indicates that prices have not been allowed—for several possible reasons—to rise to levels which would equate demand and supply thus allowing the market to be cleared. In the United States, until recently, price controls were a major factor in suppressing this normal price reaction. Other factors were contractual or other continuing relationships between some sellers and buyers which restrained price increases.

With respect to supply constraints it is important to note that these shortages did not reflect inadequate reserves below ground but rather bottlenecks in the extractive, transportation and processing operations which prepare and deliver materials for industrial consumers. The effect of price controls was to make uncontrolled export sales more attractive than domestic sales at controlled prices and to make some products more profitable than others, thus resulting in "shortages" of the less profitable items. Significantly, the staged decontrol of commodities beginning in the second half of 1973 usually had the effect of alleviating the shortage of a given commodity.

The materials supply situation also was improved in early 1974 as overall materials production continued to exceed the comparable period of 1973 although falling slightly below the late months of last year:

TABLE 7.—INDEX OF PRODUCTION OF DURABLE MATERIALS, NOT ELSEWHERE CLASSIFIED [1]

[Seasonally adjusted]

Month	1973	1974
January	130.6	140.0
February	134.2	137.6
March	134.9	137.5
April	134.7	137.1
May	135.3	137.2
June	134.9	137.7
July	137.6	
August	138.0	
September	138.7	
October	139.0	
November	138.7	
December	141.6	

[1] Includes basic metal materials such as ores, primary metals, castings and mill products; and miscellaneous materials including wood, rubber, plastics, cement, glass and stone.

Source: Board of Governors of the Federal Reserve System.

The great variety of material supply-demand situations reflects particular factors in the mix of final demand as well as specific factors impinging on supply. However, aggregated capacity utilization data show that recent durable materials output has been closer to capacity than at any time in the past quarter-century except for the peak during the Korean hostilities:

TABLE 8.—*Capacity utilization in major materials (durable goods) industries* [1]

[Output as percent of capacity]

1951 (highest in 1948–74 period)	93.2
1965	88.8
1966	88.4
1967	81.7
1968	83.6
1969	87.6
1970	83.6
1971	78.8
1972	84.7
1973 (seasonally adjusted):	
I	90.0
II	91.6
III	92.1
IV	91.7
1974: I	90.3

[1] Includes metals, cement, and plywood.

Source: Board of Governors of Federal Reserve System.

Steel industry

One important example of the pressures on domestic production capabilities has been the steel industry. "Capacity" is a somewhat indefinite concept in that industry, since for particular steel producers the constraint on final output may be at any one of the several stages of processing, ranging from raw materials supply (including coal for coke production) to the final rolling mill stage which produces a steel sheet or beam. The conventional measure of capacity has been at the raw steel (formed into ingots or continuously cast) stage. In 1973 and thus far in 1974 there is little doubt that most steel companies have been producing at close to practical capacity which has been limited variously by fuel availability or by equipment capabilities, including the need to repair and renovate worn-out units. Coking coal supplies and blast-furnace shut-downs are reported to be major problems.

The significant fact is that the industry has maintained its volume of shipments at record levels during the period of peak demand in spite of difficult materials supply conditions. However, a shift in international trade in steel mill products has resulted in reduced net imports of steel thus far in 1974, offsetting slightly higher shipments by domestic producers.

At midyear, according to trade sources, domestic steel demand remained strong with producers allocating their output among customers several months in advance. There was some evidence that increased imports might augment supplies in the second half.

TABLE 9.—STEEL MILL PRODUCTS SHIPMENTS AND APPARENT CONSUMPTION, QUARTERLY 1973-74

[Millions of net tons]

	Industry shipments	Imports	Exports	Apparent consumption
1970 (average)	22.7	3.3	1.8	24.2
1971 (average)	21.8	4.6	.7	25.7
1972 (average)	23.0	4.4	.7	26.7
1973:				
I	27.6	3.9	.8	30.7
II	28.9	3.9	1.0	31.8
III	26.9	3.8	.9	29.8
IV	28.0	3.6	1.2	30.4
1974:				
I	28.8	2.5	1.4	29.9
II (estimate)	29.5	3.2	1.7	31.0

Source: American Iron and Steel Institute; 2d quarter 1974 estimated by CEA from partial data.

Stockpile releases to expand supplies of materials

Under authority of legislation mainly passed shortly after World War II and during the Korean hostilities, the Government acquired during that period massive inventories of strategic and critical materials. This stockpile was intended, in the words of the legislation, to prevent "a costly and dangerous dependence on foreign sources of supply in a period of national emergency". By early 1973 the stockpile was valued at $6.7 billion with 95 percent of the materials having been acquired before 1959.

For several years the Administration had been conducting, under the leadership of the National Security Council, an intensive review of the strategic and economic basis for estimates of materials requirements in a future national emergency. This review, which was concluded in early 1973, indicated that because of increased size and flexibility of the economy and because of technological progress, the possibilities for material substitution were much greater than formerly believed and the need for stockpile inventories correspondingly less. New guidelines for stockpile requirements or "objectives" were accordingly drawn up which drastically reduced those objectives to an estimated combined total of approximately $700 million of materials. This resulted in materials valued at $6 billion becoming excess to the new strategic objectives.

The President, therefore, on April 6, 1973 asked Congress for authority to sell $4.1 billion of these materials; existing legislation already provided authorization for sale of $1.9 billion. He pointed out that world demand for many industrial commodities had outpaced production capacity in the short term, resulting in rapid price increases which would soon be reflected in higher prices of consumer goods and that, therefore, stockpile sales would be particularly timely in expanding supplies. The potential savings on interest and warehousing costs of this large investment obviously were also large.

Stockpile sales in 1973–74

Although Congress has not yet acted on all of the proposed disposition programs for particular commodities, the Administration, with strong support from industrial consumers, moved to accelerate sales under existing authorization and new authorizations granted piecemeal during the past year. Sales from the strategic stockpile totaled $2.2 billion in FY 1974 compared to $.6 billion in the preceding year. In terms of particular commodities, these sales provided very substantial increments to domestic supplies during a period of severe demand pressure on markets.

TABLE 10.—U.S. NATIONAL STOCKPILE; STATUS AND SALES OF SELECTED METALS AND RELATIONSHIP TO CONSUMPTION

[Thousands of net tons except as noted]

Metal	Status June 30, 1974			Authorized for disposal	Sales July 1973–June 1974	Estimated 1973 consumption	Sales as percent of consumption
	Inventory	National security objectives	Excess				
Aluminum	17.3	0	17.3	17.3	952.6	5,650.0	17
Copper	20.5	0	20.5	20.5	231.1	2,401.0	10
Zinc	464.7	202.7	262.0	262.0	332.4	1,449.0	23
Tin	234.2	45.4	188.8	9.5	44.7	72.8	61
Lead	686.2	65.1	621.1	156.2	321.4	1,484.0	22
Platinum metals [1]	1,725.0	518.0	1,207.0	0	0	1,788.0	

[1] Amounts in thousands of troy ounces.

Source: General Services Administration; Department of Interior.

All of these metals showed large price increases in 1973–1974 and particularly after the removal of price controls early this year. The extent to which their prices would have risen further in the absence of stockpile sales is difficult to estimate, particularly under the system of controls. However, at least in the case of aluminum and zinc, capacity limitations would have certainly precluded any significant production increase so that the demand supplied from the stockpile would have otherwise remained unsatisfied with resulting curtailment of consuming industry activity or with increased imports at much higher prices making up the difference. In either eventuality the added impetus to general inflationary forces would have been substantial.

Economic stockpile proposals

Because of the traumatic economic effects of the petroleum embargo and higher energy costs in the past year, serious concern has been expressed about similiar supply problems developing in the case of other imported industrial commodities which are of critical importance economically. This concern has also extended to a questioning of the wisdom of further sales from the stockpile and recommendations for stockpiles established on the basis of protection against economic disruptions rather than on the narrower national security basis.

An interagency group including representatives of OMB, NSC, CIEP, Interior, State and other agencies has been studying this question on a commodity-by-commodity basis together with possible remedial actions. Although the work of this group is not complete, it appears that there are relatively few imported commodities for which the U.S. might experience serious supply problems as a result of embargo or other restrictive action by producer countries. The commodities in Table 11 are those having the highest dependence on imports. Fortunately, this country remains largely self-sufficient in most industrial materials; in aggregate, about 15 percent of our annual consumption of industrial materials are imported and about one-half of our imports of such materials come from Canada, a relatively secure supply source. In the relatively few instances where major supply sources are insecure, there are several possible alternative policies.

These include development, through subsidy or otherwise, of high-cost domestic production; international agreements to assure access to markets; and establishment of economic stockpiles. Each course would be recommended only after careful assessment of alternative strategies including costs and benefits.

It should be noted that, even after the heavy sales of the past year, strategic stockpiles of many industrial materials are large. In the event of a broadening of the stockpile concept to include purely economic contingencies these supplies could form the basis of an economic stockpile (see Table 12).

TABLE 11.—UNITED STATES 1973 NET IMPORTS OF SELECTED COMMODITIES AS SHARE OF DOMESTIC CONSUMPTION; LEADING SUPPLIER COUNTRIES

Commodity	Net imports as percent of 1973 consumption	Leading supplier countries and their percent of total 1973 U.S. imports
Alumina	35	Australia (50), Jamaica (22), Surinam (18).
Bauxite	84	Jamaica (54), Surinam (23).
Chromium	56	USSR (32), South Africa (30), Turkey (18).
Platinum metals group	95	United Kingdom (39)[1], USSR (32), South Africa (12).
Iron ore	28	Canada (50), Venezuela (31).
Nickel	82	Canada (82), Norway (8).
Natural rubber	100	Malaysia (40), Indonesia (39).
Manganese	82	Gabon (35), Brazil (33).
Zinc	52	Canada (60), Mexico (24).
Tin	81	Malaysia (64), Thailand (27).
Cobalt	77	Zaire (45), Belgium-Lux. (29)[2].
Mercury	82	Canada (59), Mexico (17).
Tungsten	55	Canada (61), Peru (9).
Columbium	63	Brazil (62), Canada (16).
Fluorspar	84	Mexico (77), Spain (12).

[1] Refined products; United Kingdom sources are South Africa, Canada and USSR.
[2] Of Zaire origin.

Source: Department of the Interior.

TABLE 12.—U.S. NATIONAL STOCKPILE LEVELS RELATIVE TO DOMESTIC CONSUMPTION OF SELECTED MATERIALS

[Stockpile amounts as of June 30, 1974, expressed in months of consumption at 1973 rates]

	Held as strategic objective	Excess to strategic objective	Total
Aluminum/bauxite	2½	5½	8
Chromium	4	42	46
Cobalt	7	30	37
Columbium	3½	18	21½
Copper	0	0	0
Fluorspar	1	10	11
Lead	¾	9	9¾
Manganese	4	16	20
Natural rubber	0	2½	2½
Nickel	0	0	0
Platinum metals	4	10	14
Tin	9	36	45
Tungsten	3½	96	99½
Vanadium	0	1	1
Zinc	1½	2½	4

Source: Department of Interior; GSA.

CHANGES IN INCOME AND EARNINGS

During 1973 the real income of the population made substantial gains. The results for the first half of 1974 were less satisfactory. In 1973, however, per capita disposable income rose well in excess of the increase in prices and this increase in per capita income was echoed in the rise in the income of families and individual income recipients. One factor behind these income gains was an increase in real earnings of individuals who seem to have earned more per hour as well as to have worked more weeks and hours. Gains were also made at the lower end of the income distribution as the percentage of families and persons with income below the poverty line dropped.

Income

Different rates of increase are of course obtained when different measures of income are used as is illustrated in Table 13. Income figures from the household survey show a somewhat smaller increase than income from the national accounts even when both are put on a before tax, per capita basis. Taxes evidently did not increase as fast as personal income, so per capita personal disposable income increased faster than per capita personal income before taxes.

Different rates of increase are also obtained when different price indexes are used as deflators. The deflator for personal consumption expenditures (PCED) increased more slowly than the Consumer Price Index (CPI) from 1972 to 1973, primarily because the PCED gives a smaller weight to food than the CPI and food prices increased faster than other prices during the period. The weight given to food in the PCED is considered to be more realistic in terms of the current expenditure pattern of the average family than that in the CPI. In real terms (deflated by the PCED), per capita disposable income rose by 6 percent from 1972 to 1973. As a result of the slowdown in growth from the fourth quarter of 1973 through the second quarter of 1974, however, there was a decline in real terms of 3.3 percent in per capita disposable income (deflated by the PCED, which has been rising faster than the CPI recently).

The income of families and individual income recipients also rose from 1972 to 1973. In real terms (deflating by the CPI), the increase for all families was 2.1 percent, for nonfarm families 1.9 percent, and for farm families 6.9 percent. The median income of unrelated individuals rose by 17.4 percent in current dollars and 10.5 percent after adjustment for increases in the CPI. This large increase is probably in part due to increases in social security retirement and disability benefits since a large proportion of unrelated individuals are eligible for these programs.

Changes in family income are influenced by many factors including changes in age-sex composition of family, in composition of income sources of family (earnings vs. other income), in number of earners per family, in weeks and hours worked per earner, in wage rates received. Available data for 1972 and 1973 indicate a slight increase in the proportion of families headed by a female and a slight increase in the proportion of male-headed families without an earner, presumably because of increased retirements. Both factors would in themselves usually lower the overall measured income. Working in the other direction, the proportion of families with 2 or more earners increased slightly and among male family heads who worked both years, the proportion working year-round full-time increased somewhat from 78.4 to 79.5 percent. However, the practical importance of these and other changes in affecting income in 1972 and 1973 has not yet been determined.

While the precise contribution of the various factors to the increase in family income is not clear, one factor that most certainly added to family income was the increase in income of male heads of families—an increase in real terms of 3.2 percent for married men. Increases in social security benefits for the retired, increase in weeks worked by the working population, and increases in real hourly earnings all contributed to the rise in income of married men.

Earnings

A meaningful increase in earnings is one in which a worker of a given skill level experiences a gain in real earnings for a given amount of time worked. Most wage rate data give averages for the whole labor force which are as likely to reflect changes in the skill mix of the labor force as they are to reflect changes in earnings of particular kinds of workers. On the other hand, earnings data with detail about worker characteristics are seldom adjusted for amount of time worked. Because of these discrepancies, different series of earnings with different degrees of disaggregation show different earnings increases. Table 14 illustrates the point. From 1972 to 1973 the Census indicates a substantial increase in annual real median earnings for men who were year-round, full-time workers (3.2 percent). The more comprehensive group of all men (including part-year, part-time workers) shows a somewhat smaller increase, although weeks worked probably increased with the cyclical gain in employment. However, the results are blurred by compositional changes such as the increase in teenage males with lower earnings.

Usual weekly earnings obtained from the May household survey show even larger gains than those implied by the annual data. But the May to May change may have caught a peak and there is also a possibility that a change in the questionnaire made in 1973 biased the results upwards. It is of interest, however, that the increase in usual weekly earnings of all workers (full- and part-time) was 7.7 percent while the increase for full-time workers alone was 10.4 percent. The increase in part-time workers, who may also be less experienced workers, probably can explain the discrepancy.

Earnings data collected from establishments are more widely used because they have been more regularly collected and over a longer period of time. But these data are not meaningful for evaluating changes in the return to workers of a given level of skill since they are derived from payroll data which cannot be adjusted for changes in the mix of workers. In 1973, the influx into the labor market of less experienced workers would have the effect of increasing the weight of low-wage workers and of lowering the average measured wage rate. The payroll data could also show different earnings changes than the household data since wages of supervisory workers and of all farm and government workers are excluded from the payroll series. And multiple job holding by individuals can cause additional divergence between the two series.

Although the information is limited, available data point to a situation of price increases outstripping wage and income increases during the first half of 1974. The decline in real per capita personal income is consistent with the observed decline in real hourly wage rates. Since the labor force has not expanded so rapidly during 1974 as it did in 1973, it is less likely that compositional changes are important in explaining the failure of real wages to rise in 1974.

Male-female differentials

The increase in earnings of women does not appear to be as great as for men in 1973. The very low (2.7 percent) increase in earnings of all women is of course influenced by changes in weeks and hours worked during the year and by less experienced women entering the labor force. Although women who worked year-round, full-time did increase their earningsg by 7.3 percent (a 1 percent gain in real terms) this was not up to the increase of 9.6 percent shown for men.

It is difficult to interpret year-to-year changes in the earnings of women relative to men since there is considerable turnover in the female labor force each year. Even year-round workers could have been out of the labor force in the preceding year, so it is difficult to know whether the skill-experience mix of women is falling or rising relative to men's without specific information on this question, and such information is not available. However, women are concentrated in different occupations and industries than men and it may be that in 1973, earnings in male-dominated activities increased more than in the female-dominated activities. For example, a larger proportion of women than of men are employed in the public sector and in 1973, wages of government workers rose less rapidly than wages of workers in the private sector.

Black-white differentials

Although the per capita income of blacks has been increasing faster than the per capita income of whites, the relative median family income of blacks has been falling during the same period (Table 15). The seeming paradox arises because of the differences between blacks and whites in family structure and of changes in family structure and the distribution of earners among families. The proportion of black families headed by a female is much larger for blacks than for whites (34 percent compared to 10 percent) and the increase in the proportion has been greater among black families. Also, there has been a decline in the number of earners per family in black male-headed families (related to the decline in the proportion of working wives) while earners per family have increased among white male-headed families.

When the income and earnings of individuals are compared, blacks are found to have experienced larger gains than whites; hence, it is not surprising that black per capita income, which is free from changes in family organization, has been rising relative to white income.

Changes in low-income status

The long-term trend towards a decline in the percentage of persons living below the poverty line continued in 1973 (Table 16). Although the slowdown of 1970–71 had interfered with this trend, by 1973 almost all groups had a lower incidence of poverty than in 1969. There was a continuing large drop in the incidence of poverty among the population 65 years old and over and among the farm population, and the difference in poverty status between these groups and the population at large has sharply diminished since 1969.

It is possible that the decline in persons below the poverty line in 1973 is overstated, since the CPI is used to update the "low-income threshhold" which determines low-income status. Although, because of the exaggerated weight given to food, the CPI may overstate the increase in cost of living for the average family when food prices are rising, it may understate the rise in cost of living for poor families who may spend more of their income on food than the CPI weight allows. The poor do have access to food stamp bonuses which can provide a substantial supplement to income and, as discussed in the Economic Report of 1974, this kind of income is not collected by the Census and so cannot be used to calculate low-income status. Although food-stamp bonuses are adjusted for increases in food prices, the adjustments generally take effect with a lag, and as a result, in 1973, the bonus did not keep up with food price increases. However, in 1974, the subsidy has risen faster than food prices. For example, in July, 1974, a family of four with zero net income[1] was eligible for a food-stamp bonus of $150 a month, an increase of 29 percent over the preceding July, while food prices from June 1973 to June 1974 (as measured by the CPI) had increased by 15 percent.

TABLE 13.—PERCENTAGE CHANGES IN VARIOUS MEASURES OF INCOME AND PRICES, 1972 TO 1974-IV

	1972-1973	1972-IV-1973-IV	1973-I-1974-I	1973-II-1974-II	1973-IV-1974-II [1]
National accounts:					
Per capita personal income	10.8	10.8	9.0	8.3	2.8(5.7)
Per capita disposable personal income	11.8	11.3	8.5	7.5	2.5(5.0)
Household Survey (Census):					
Aggregate income of families and individuals on a per capita basis [2]	9.7				
Median family income	8.4				
Nonfarm	8.2				
Farm	13.5				
Male-headed families	9.3				
Female-headed families	8.5				
Median income of unrelated individuals	17.4				
Price indexes:					
Consumer Price Index (CPI)	6.2	8.4	9.9	10.7	5.7(11.8)
Personal Consumption: Expenditures Deflator (PCED)	5.6	7.9	10.2	10.7	6.0(12.3)

[1] Projected as an annual rate in parenthesis.
[2] Calculated as: mean family income times number of families plus mean income of unrelated individuals times number of unrelated individuals divided by total population.

TABLE 14.—PERCENTAGE CHANGES IN VARIOUS MEASURES OF EARNINGS, 1972 TO 1974-IV

	1972-1973	May, 1972-May, 1973	1973-I 1974-I	1973-II-1974-II
Household data:				
Median annual earnings of all workers:				
Male	8.6			
Female	2.7			
Median annual earnings of year-round, full-time workers:				
Male	9.6			
Female	7.3			
Median usual weekly wage and salary earnings:				
All workers 16 yrs. and over		7.7		
All full-time workers:				
16 yr and over		10.4		
Men 25 yr and over		14.0		
Women 25 yr and over		10.0		
Establishment data:				
Average gross hourly earnings of private, nonagricultural workers [1]	6.6	6.4	6.9	7.3
Average gross weekly earnings of private, nonagricultural workers [1]	6.3	6.6	4.7	5.9
CPI	6.2	5.5	9.9	10.7

[1] Includes only production and nonsupervisory workers; not seasonally adjusted.

[1] Net income for calculating eligibility for food stamps is gross income minus specified expenses such as all taxes (including social security taxes), certain work-related expenses (including child care expenses), medical expenses, rent and utilities exceeding a certain percentage of income, and there is a $30 a month earnings disregard.

TABLE 15.—INCOME OF BLACKS AS A PERCENT OF INCOME OF WHITES

	1969	1972	1973
Per capita income [1]	54.0	56.6	56.8
Median family income	61.9	59.4	57.7
Male headed families:			
Married (wife present)	71.6	75.5	73.2
Wife worked	76.8	80.1	78.4
Wife did not work	61.6	63.9	61.0
Female headed family	60.7	61.8	64.4
Median personal income:			
Males	58.2	60.6	60.5
Year-round, full-time workers	66.1	67.5	67.4
Females	84.3	93.4	90.3
Year-round, full-time workers	79.6	85.5	84.8

[1] Calculated as: mean family income times number of families plus mean income of unrelated individuals times number of unrelated individuals divided by total population.

TABLE 16.—CHANGES IN THE LOW-INCOME POPULATION, 1959 TO 1973

	1959 [1]	1969	1971	1972	1973
Persons below the poverty line (thousands)	39,490	24,147	25,559	24,460	22,973
Families below the poverty line (thousands)	8,320	5,008	5,303	5,075	4,828
Percent of persons or families living below the poverty line:					
Persons:					
Total	22.4	12.1	12.5	11.9	11.1
65 yr. and over	(2)	[1] 25.3	21.6	18.6	16.3
White	18.1	9.5	9.9	9.0	8.4
Negro and other races	56.2	31.0	30.9	31.9	29.6
Farm	(2)	20.7	20.9	14.9	13.4
Nonfarm	(2)	11.7	12.1	11.7	11.0
In male-headed families	18.2	7.4	7.5	6.8	6.0
White	14.7	6.0	6.2	5.6	4.9
Negro and other races	51.0	19.8	19.1	18.5	17.7
In female-headed families	49.4	38.2	38.7	38.2	37.5
White	40.2	29.1	30.4	27.4	28.0
Negro and other races	75.6	57.8	55.6	57.7	56.5
Families:					
Total	18.5	9.7	10.0	9.3	8.8
With head who worked	14.6	6.3	6.4	6.0	5.5
Male headed	13.4	4.8	5.0	4.6	4.0
Female headed	33.3	23.5	21.9	21.5	21.1
With head who worked year round, full time	9.4	3.2	3.3	2.9	2.5
Male headed	9.1	2.9	3.0	2.7	2.2
Female headed	16.6	8.5	7.2	7.2	7.2

[1] Not strictly comparable to data for later years.
[2] Not available.

THE U.S. EXTERNAL DEVELOPMENTS IN EARLY 1974

The United States commercial relationships with the outside world in the first part of 1974 were strongly influenced by the world-wide inflation and the impact of the energy crisis: Large, divergent movements in prices of U.S. exports and U.S. imports have had a profound impact on both the value and the volume of U.S. trade; the U.S. financial transactions with the outside world have been influenced by flows of payments for higher-priced oil and other special, related developments; movements in the value of the dollar relative to major world currencies reflected the unsettled international climate, as the foreign exchange markets were adjusting to the aftermath of the energy shock.

The U.S. trade balance, as conventionally measured in terms of the difference between the dollar value of commodities and merchandise sold to and purchased from abroad, showed a sharp decline in the first half of 1974 over the previous year. From a surplus in the last half of 1973 of about $1.6 billion (seasonally adjusted, balance-of-payments basis), it dropped to a deficit of $1.6 billion in the first half of 1974. On the Census Bureau basis, the trade balance changed from a surplus of $2.3 billion in the second half of 1973 to a deficit in the first half of 1974 of $254 million.[2] Price developments in the United States and the world markets in general have been entirely responsible for this reversal.

On the import side, the sharp rise in the price of oil has been the main factor in the rise in the value of imports in this category. The price of imported oil rose from a little over $3 per barrel in 1973 to about $9 during the first quarter, and to over $11 in the second quarter of 1974. As a result, although the quantity of crude oil and petroleum products imported during the first half of this year has actually declined to 1,132 million barrels from 1,175 million barrels during the first half of 1973, the payment for these products rose to $11.1 billion in the first half of 1974, from $3.2 billion in the first half of 1973. The increase in prices of non-fuel imports was far less spectacular but nevertheless significant; the unit value index of these imports rose by about 20 percent by the end of the first half of 1974 over 1973 as a whole. When overall imports are corrected for the price changes, the figures show a rather startling picture: "Real" imports have remained almost level through 1973 and the first half of 1974, although the dollar value of imports has risen almost 60 percent.

TABLE 17.—U.S. IMPORTS IN CONSTANT DOLLARS (BALANCE-OF-PAYMENTS BASIS, SEASONALLY ADJUSTED)[1]

[In millions of 1967 dollars]

	1973				1974	
	I	II	III	IV	I	II[2]
Foods, feeds, and beverages	1,560	1,508	1,389	1,473	1,659	1,455
Industrial supplies	4,921	4,750	4,783	4,724	4,344	4,529
Fuels and lubricants	1,254	1,430	1,510	1,463	1,199	1,415
Capital goods	1,320	1,365	1,474	1,429	1,487	1,563
Consumer goods	2,393	2,230	2,243	2,145	2,004	2,054
Total imports, 1967 dollars[1]	11,984	11,617	11,533	11,407	11,531	11,589
Total imports, current dollars	16,190	17,030	17,541	16,868	22,198	25,732

[1] Categories above do not add up because of exclusion of certain categories.
[2] Estimated.

The difference between the change in dollar values and the change in real terms over this period is partly a reflection of the effects of the devaluation of the dollar relative to major currencies; this, and the general rise of prices abroad, caused sharp rises of prices of foreign goods in terms of U.S. dollars in the U.S. markets, and caused substitution of domestic products for imported products by the U.S. consumers. However, other factors were, of course, also at work here.

The value of U.S. exports was also affected by rising prices. The rise in the prices of agricultural products in 1973 and the first part of 1974 has had a significant impact on the value of U.S. exports in that category. Agricultural exports, in value terms, rose from $9.5 billion in 1972 to $17.9 billion in 1973—a rise of about 70 percent. However, when corrected for price increases, the quantity increase was only about 28 percent. In 1974, the value of exports of agricultural products rose further, reaching an annual rate of over $23 billion in the first half of 1974. The 29 percent rise in the value, however, was represented all by price rises; in volume terms, agricultural exports actually declined during the first half of the year. On the other hand, exports on nonagricultural goods in real terms continued to rise strongly, partly, no doubt, in response to greater competitiveness of U.S. goods in the world markets as a result of the depreciation of the dollar, but also, quite possibly, due to the impact of price controls in the United States which, while in effect, made export sales more attractive to producers than domestic sales.

[2] The Census basis *export* figures are adjusted by adding inland freight to Canada (which, in the first half of 1974 amounted to $265 million), private gift parcels and other such items ($280 million), and by deducting exports transferred under U.S. military agency sales contracts ($836 million). Census basis *import* figures are adjusted by adding imports to Virgin Islands ($808 million), imports of non-monetary gold ($210 million), valuation and timing adjustments ($452 million), and by deducting automotive trade valuation adjustments ($298 million), and imports of U.S. military agencies ($106 million).

TABLE 18.—U.S. EXPORTS IN CONSTANT DOLLARS (BALANCE-OF-PAYMENTS BASIS, SEASONALLY ADJUSTED)

[In millions of 1967 dollars]

	1973				1974	
	I	II	III	IV	I	IIe
Agricultural products	2,637	2,638	2,540	2,596	2,600	2,442
Industrial supplies	3,683	3,886	4,062	4,101	4,205	4,395
Machinery	3,319	3,431	3,828	3,959	3,910	4,392
Consumer goods	842	947	941	935	1,121	1,218
Total exports, (1967 dollars)[1]	12,095	12,648	12,886	13,429	13,697	14,039
Total exports (current dollars)	15,228	16,670	18,143	20,211	22,299	24,023

[1] Categories above do not add up because of exclusion of certain categories.

The sum total of these transactions in "real terms" is a trade balance that exhibits a considerably different pattern than when viewed through inflationary distortions—as may be seen from the following table.

TABLE 19.—U.S. MERCHANDISE TRADE BALANCE (BALANCE-OF-PAYMENTS BASIS)

	1970	1971	1972	1973	[1] 1974
Current dollars	+2.2	−2.7	−7.0	+.6	−3.2
Constant (1967) dollars	+2.2	−1.2	−2.7	+4.2	+9.8

[1] Seasonally adjusted annual rate estimate for the 1st half of the year.

Balances on Current Account data are available only for the first quarter of the year 1974. In analyzing that measure of our balance-of-payments performance, we may note that the decrease in the nominal trade balance was offset in the first quarter of 1974 by increases in income on U.S. investment abroad, primarily reflecting the higher earnings of foreign affiliates of U.S. petroleum companies. Net income in this category rose by $1.5 billion over the IV–Q 1974 to $2.9 billion. As a result of these and other transactions, the U.S. balance on goods and services showed virtually no change between IV–Q 1973 and I–Q 1974. The balance on current account, however, shifted from a surplus of $1.8 billion in IV–Q 1973 to a small deficit as a result of a special grant of the U.S. government to India in the amount of $2.0 billion worth of rupees.

Capital Account developments in the U.S. balance-of-payments accounts during the first quarter of 1974 were strongly influenced by the removal of restrictions on capital outflow from the United States. Following that step that was taken by the Administration at the end of January (which included an elimination of a voluntary ceiling on bank lending to foreigners) bank loans to foreigners rose by $2.6 billion to $5.2 billion in the first quarter. Purchases of foreign securities by U.S. residents that, too, were freed from constraint by the removal of the Interest Equalization Tax (I.E.T.) imposed on such purchases since 1964, rose only slightly but to an all-time high of $647 million. Transactions not previously covered by the I.E.T. accounted for most of the outflow. U.S. direct investment declined sharply in the first quarter of 1974 by $1.2 billion to $220 million, reflecting largely temporary transfers of payments of foreign subsidiaries of U.S. oil companies. The high level of foreign direct investment in the United States recorded in the I–Q 1974 (at $1.1 billion) was subject to similar distortions. At the same time, purchases of U.S. securities amounting to almost $700 million, and the U.S. government capital account that showed a $2.0 billion improvement as the grant to India was used by the Indian government to repay previous loans, contributed to the improvement in the capital account.

The sum of these and other transactions has been a change, from a deficit of $498 million in IV–Q 1973 to a surplus of about $2.0 billion in I–Q 1974 in the country's balance of payments as measured by the Basic Balance. The Official Reserve Transactions Balance, however, moved during this period from a surplus of $2.7 billion to a smaller surplus of $1.0 billion. This surplus reflected continued but substantially diminished intervention in the foreign exchange markets by the official institutions abroad in their effort to moderate the decline of the value of their currencies relative to the U.S. dollar in the early months of 1974. It also reflected a rise in the U.S. international reserve position in that period.

APPENDIX SUPPLEMENT

Inflation Rate in the Fourth Quarter 1974, Forecasting Assumptions and Methods

In our report of May 28 we said, "While forecasting the behavior of prices is notoriously uncertain, we would suggest that the rate in the fourth quarter might be in the neighborhood of 7 percent." Because of the interest generated in this forecast, set forth below is a detailed description of the assumptions and methods underlying the projection. The basic tool employed is an econometric model of price behavior by stage of processing.

The stage-of-process model is one in which raw commodity prices, together with other variables, are related to prices of intermediate materials and components which in turn are related to manufacturers' prices of both consumers' and producers' finished goods (see diagram attached). The prices of finished consumer goods are then used to explain the behavior of appropriate components of the Consumer Price Index. At each stage of processing the model is disaggregated to reflect relationships for food, other nondurable goods, and durables. An equation has been estimated to explain price movements for the component in each endogenous block in the diagram. In most cases the explanatory variables are prices at the earlier stage of processing, in other words the cost of materials, wage rates, and a variable measuring the strength of demand relative to capacity. Some of the variables enter with lags. The length of the lags is based on available information and empirical experimentation. While the estimated equations do not embody any precisely identified theory of price behavior, they come closest to approximating a variable markup model in which wage rates are proxies for standard unit labor costs. Thus, short-run changes in output per manhour affect profits more than prices.

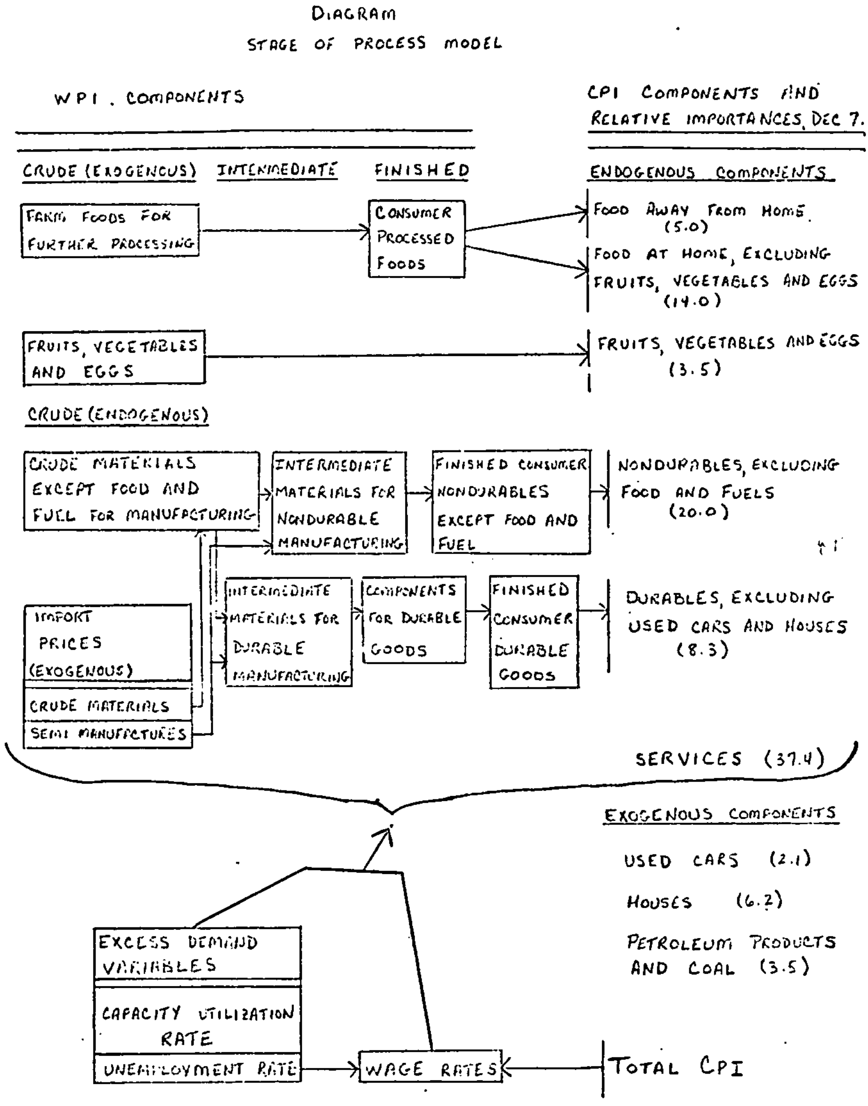
Below are the rates of increase for the CPI and major components generated by the stage-of-process price model in mid-July. These projections, particularly those for commodities, are not much different from those of mid-May because the assumptions for May and June about major WPI industrial index components were not far off the mark.

TABLE 20.—*Percent change (SAAR) 1974–III to 1974–IV*

Consumer Price Index	
All items	6.5
Food	4.0
Commodities less food	6.9
Services	7.8

To obtain these projections, the following assumptions were fed into the model, together with relevant data from the latest Troika forecast:

1. Retail gasoline prices level off at their June level of about 56 cents per gallon; other petroleum product prices also stay at their June level. (Implied is that the average of domestic and international crude oil prices will not change during the rest of 1974.) These price increases affect other fuels and prices charged by fuel users in proportion to the importance of fuel costs in total costs as reflected in input-output table relationships. This causes natural gas and electricity prices to rise throughout 1974, 3.5 percent in the fourth quarter.
2. By the fourth quarter of 1974 the prices of farm foods are about 5 percent above their year-earlier level.
3. Wages (components of BLS adjusted average hourly earnings index) are projected to increase at an annual rate of 10 percent in the second half of the year.
4. Industrial raw commodity prices other than fuels level off in the third quarter and then rise 3 percent in the fourth.
5. Because price developments in steel and therefore in transportation equipment industries are not likely to be fully captured in the model, an independent



estimate was made of prices of new cars (other transportation equipment as well), the most important form in which steel reaches consumers. The estimate takes into account the likelihood that 1974 model car prices will not be discounted as much as usual as the model year draws to a close, and public announcements about prices for 1975 models. The estimate was adjusted downward because that part of the price increase for 1975 models associated with the cost of antipollution equipment is treated by BLS as a quality change. Used car prices were projected to rise more because they are likely to reflect actual new car price changes, without regard to the part associated with antipollution devices.

6. The home purchasing and financing component of the CPI was estimated to rise 2.3 percent in the fourth quarter reflecting continued increases in house prices and the effects of earlier increases in mortgage interest costs which enter the CPI with a lag.

7. Medical care costs were estimated exogenously to rise 3.0 percent in the fourth quarter.

The foregoing assumptions together with actual data through the second quarter serve to provide enough information for the model to generate a forecast of the fourth quarter. The model insures that the outcome is arrived at with some consistency and that all available price, wage, and excess demand information is systematically treated, but the outcome can vary depending on the assumptions introduced. (The model has now been adopted by others who get different answers because they make different assumptions and have extended the model to areas where we prefer to make exogenous estimates because the data from which equation estimates can be derived have been of poor quality.)

The model generates components of both the CPI and WPI, which can be used to form a fixed weighted private GNP deflator (excluding inventory change and net exports) after an estimate of construction costs is made (10 percent annual rate of increase in the fourth quarter). The private GNP deflator together with an estimate of compensation and output per manhour can be used to explore the behavior of labor and nonlabor shares to see if it seems plausible (so often in judgmental forecasts there are inconsistencies). The average hourly earnings index increase at an annual rate of 10 percent in the fourth quarter translates into a similar rise in compensation per hanhour. In other words, the net effect of adding to the increase in the index assumptions about changes in industry mix, overtime hours, fringe benefits and wages and salaries other than those of production and nonsupervisory workers is zero. An increase of 2.0 percent in output per manhour is also assumed. The following view of the wage-price productivity nexus obtains:

TABLE 21.—*Percent change (SAAR) 1974–III to 1974–IV*

Private economy	
Compensation per manhour	10.0
Output per manhour	2.0
Unit labor cost	8.0
Private GNP deflator	7.0
Implied change in labor share	1.0
Addendum: Private GNP deflator less food and directly purchased fuel	7.7

The stage-of process model yields a private GNP deflator increase of 7.0 percent in the fourth quarter. (The total GNP deflator will rise a little faster because of the scheduled Federal pay increase.) This is somewhat less than the projected increase in unit labor costs. The implied reduction in the nonlabor share would bring it down from its second quarter level to about that of the fourth quarter of 1973. Such a development would not be inconsistent with other periods when productivity grew at less than its trend rate. Final prices in private sectors other than food and fuel are projected to rise 7.7 percent so that profits and other nonlabor income will rise a little faster in these sectors.

Senator PROXMIRE. Mr. Stein, you have advocated a policy, as you put it, of firm restraint on demand and you have achieved that by using a monetary policy and a fiscal policy which would perhaps be more conservative than it has been in the past.

Both those areas I just don't find the performance of the last 5 years indicating much hope that this administration is going to exercise that kind of restraint. Let's take the fiscal side first.

Just in the last year, as I indicated, there has been a very, very large increase in spending.

Would you characterize the fiscal policies that we are following right now that the President has proposed for the fiscal year that began a few days ago, July 1, as a firm restraint on demand?

Mr. STEIN. Yes, I would. I want to make it clear, and I think that our statement makes it clear that we don't claim that our policy has been ideal throughout the 5½ years. I pointed to the fact that I think we made an error in an overexpansionist direction and particularly in fiscal 1972 when——

Senator PROXMIRE. Yes, you referred to that fiscal 1972. The big increase has been more recent.

Mr. STEIN. I would say that we have moved since then from 1972 to 1973 and 1973 to 1974 in a more restrictive direction. During earlier years by one measure which seems to me useful, the full employment budget measure, under various definitions we were going through a phase of increasing full employment deficits. From 1972 to 1973 we did not. From 1973 to 1974 we did not. If we succeed in holding the budget to $300 billion, we will have a 10-percent increase in the budget.

If you figure with $305 billion, which is something like a 13-percent increase or something like that, then with $300 billion it would be about a 10-percent increase and that increase would be little less than the growth of GNP at the rates of inflation that we have now come to expect.

Senator PROXMIRE. Well I calculated a much bigger percent increase of $300 billion. If you go from $270 billion to $300 billion, that is $30 billion on a $270-billion base and that would be closer to a 12-percent increase.

Mr. STEIN. That is 11.1. We would propose a relatively smaller increase for the fiscal year that is ahead of us. We think that it is going to be very difficult to hold the $300 billion for fiscal 1975, that budget, to $300 billion. I think we would welcome——

Senator PROXMIRE. I think that is true. Let's get into that. Where are you going to make the cutbacks in the budget?

You say there ought to be a $5 billion cutback and I think there ought to be a $10 billion and there are other figures. But if there is a reduction, where is it going to be? I think the sooner the Congress knows this and we begin to get some kind of agreement on where the cuts are going to be, the better.

Just yesterday the budget that I am handling on "HUD and Space and Veterans" and so forth was marked up by the subcommittee. We marked it up. We did so on the basis of the President's budget that he sent down many months ago. He is not asking for a cutback. It would be very helpful for us to know as soon as possible where he wants the cutback to come from.

I hope we can come in below the budget but we are not going to be very much below it, but a little bit. The House is already $1 billion below the President on the 10 appropriation bills that they sent the Senate. We haven't gotten to foreign aid or defense, which I think are going to be substantially below the budget.

So it would be helpful to us if you could indicate where we are going wrong and where we could make the cutbacks.

Mr. Ash isn't going to appear before this committee during this series of hearing, unfortunately.

Mr. STEIN. Well, was he invited?

Senator PROXMIRE. I don't know if he was invited or not. I hope he would be. I would certainly like to hear him. Maybe we could hear from him a little later, but as far as I know, he is not coming.

Mr. STEIN. I think he is under the impression he wasn't invited.

Senator PROXMIRE. Well, then we will certainly invite him.

Mr. STEIN. I think he would be your best witness on the subject.

Senator PROXMIRE. It was a great oversight by us not to invite him if he was not, but go ahead.

Mr. STEIN. But the only answer I can give to the question you have raised is that, as the President has said, we propose that we will resist increases in spending above the budget that he has proposed and that is now kicking around in various stages in the Congress. In addition we will try by management and by continuous pressure on the agencies to do things more economically to cut out another $5 billion from the budget that was proposed. The President made one specific announcement the other day, about cutting the payroll in a way that would save about $300 million in fiscal 1975. Other decisions will be made continuously in the relations between the Office of Management and Budget and the agencies.

I suppose I would call this program a "saving of candle ends" which is the way I believe Chancellor of the Exchequer Gladstone balanced his budget. But it is an effective way to do it. Within a budget of $305 billion we believe that opportunities will be found, but I cannot be more specific than that. This is a matter of continuous management by——

Senator PROXMIRE. Well, I hope we can get that as soon as possible. We like to be as specific as we can.

The President has proposed to cut the payroll by about 40,000 and that appears logical. But in the first place 40,000 is not very much, as I think you would agree considering the number of Federal employees we have. In the second place as the Wall Street Journal pointed out yesterday, and I quote: "President Nixon's newly ordered 40,000 payroll cutback may do little to reduce Federal costs on the basis of the experience with the 5-percent cutback he ordered in 1971. The General Accounting Office reports that the 5-percent goal is often met by bureaucratic slight of hand with the agencies cost of the overtime creeping up, the agencies using military personnel or outside help and boosting hiring only days after the deadline for cutting and encouraging early retirement costs in a government that needs skills. Those who replace the retirees are not always the best qualified," and so forth.

It just seems to me this really isn't very encouraging. We are into the 1975 fiscal year and we are marking up these appropriation bills. We should have guidance now if we are going to make this cutback at the present time. I hope we can get specific and definite and clearcut indications of where the reductions ought to be.

Now let me ask about another area that I think is very important. I started out by indicating that I hope that there would be some use of Presidential power and authority and influence and leadership to discourage unjustified price increases. The President did say on Thursday: "I shall use every influence of the Presidency to bring about helpful voluntary restraint on the part of business and labor." Well this sounds good, but where is he going to do it? How is he going to do it?

He has met so far with one labor leader. It is very difficult for the President to work with labor these days. It is certainly not entirely his fault, but it does present a serious problem.

At the same time, so far up until certainly a month or two ago, wage increases were not the principal problem involved although maybe they will become that. But enormous price increases, which seem very hard to justify in view of both operations at less than capacity in the basic industries and very high profits, has been the problem. The high profits suggest that the President could intercede where he seems to have considerable influence, and that is with management to roll back prices. Now to do that it seems to me the President needs more than just a generalized counseling. It seems to me he has to focus on particular price increases and identify them and then use some of the power that the Federal Government has to persuade the rollback on those prices.

We have had a 23-percent increase only in the last couple of months in the steel industry, for example. We have had some enormous increases earlier in the oil area. Now is the President going to act specifically in these areas, or is he simply going to have private meetings with business leaders and indicate that he hopes they will restrain themselves?

Mr. STEIN. Of course, the two areas that you mention are cases where there is a great need for the expansion of capacity. I wouldn't at all jump to the conclusion that these increases are unnecessary or undesirable from the standpoint of a long-run development of the economy.

With respect to the question you ask about how the President will operate, I would say that we are still in the process of——

Senator PROXMIRE. Let me interrupt to say they are operating under capacity in the oil industry. It was pointed out the other day that studies show that they are operating substantially less than they were in the last quarter in company after company.

Mr. STEIN. I think it is clear that we have had some decline of domestic crude-oil production but it is also clear, it seems to me, that we need a great expansion of capacity to produce energy including oil in the United States, and that is one of the main objectives of Project Independence. And if that is to be achieved, prices in the United States will have to be remunerative.

Senator PROXMIRE. There has been a decline in the production of gasoline. In the basic industries, which have been operating at a very high level of capacity, they have been reduced from 93.7 to 91.6. There has been this drop coinciding with an increase right across the line in prices. It does seem that there is either some kind of collusion or advantage being taken of the present situation in some way in which the President should be able to move on.

If the free market were working, you wouldn't have production being reduced when the profits were very high and then prices being increased at the same time. It just doesn't add up, does it?

Mr. STEIN. We had a big rise in the price of gasoline as the result of the enormous rise in world crude-oil prices and that increase in the price of gasoline has tended to reduce the consumption of the gasoline in the United States and reduced the production of gasoline in the United States. Now that seems to be perfectly a logical sequence but we are working ourselves back into the position of enormous and growing dependence on foreign sources of supply. This is a situation which it seems to me is or should be our policy to avoid and that we will only avoid getting into that situation to an undesirable degree if the prices in the United States are sufficient to induce the supply of oil and other energy sources here.

Senator PROXMIRE. But it is just so frustrating for the Congress to watch this and the consumers to have to pay it and see this 81-percent increase in profits by the oil companies which they enjoyed in the second quarter over a comparable period last year. There has been a huge increase in the first quarter of this year and then we see the reduced production in the face of this. And it just seems that there is a solution here that the administration doesn't seem to be taking advantage of. Here we still have price controls on oil, legal price controls. They have held the price of 60 to 70 percent of the domestic crude at one-half the level to which it would have risen without controls.

The administration has called on Congress not to extend those controls after next March when they expire and——

Mr. STEIN. I don't think the administration has taken a position on that.

Senator PROXMIRE. Well, John Sawhill made the statement he thinks they ought to expire.

Mr. STEIN. I don't think the administration has taken a position on that.

Senator PROXMIRE. Well if the U.S. oil production now priced at $5.25 changes and the controls are taken off, increasing it to the price of $10 or more, wouldn't that send shock waves through the economy? Why couldn't that happen?

Mr. STEIN. Sorry, I missed the question.

Senator PROXMIRE. If the U.S. oil production now priced at $5.25 under controls, increases to $10 or more, then wouldn't that send new inflationary shock waves through the economy?

Mr. STEIN. I think one of the things that people have to learn is that if they want supplies of product, there are prices that have to be paid for it. We are now facing the consequences of failing to recognize that all over the economy.

We have the utility industry unable to generate funds with which to expand. The people will have brownouts or blackouts 5 years from now because the people are saying to them now why pay additional, and it is unconscionable to raise the rates. So you will find yourself 5 years from now having made no progress whatever in developing the United States——

Senator PROXMIRE. Well I am not saying that about the utility companies, because I think you are right. I think if their costs go up, there is no option except to let the prices go up. And one of the reasons their costs are going up is because you have what seems to be a wholly unjustified and exorbitant increase in what they have to pay for oil in order to permit the utilities to function.

Mr. STEIN. Well I don't think it is exorbitant. It just costs a lot more to get oil, that is, to make oil out of shale or convert coal into synthetics, which we are going to have to do in the next 5 or 10 years to have a domestic source of energy. It costs much more to do that than to stamp your foot on the ground and to get oil in Saudi Arabia, and we are going to have to pay for that.

Senator PROXMIRE. My time is up, but I will be back.

Congressman Brown.

Representative BROWN. Good to see you, Mr. Stein and members of the Council. I wonder if you are all praying for rain?

Mr. STEIN. Well, we have a division of labor and Mr. Seevers is in charge of agriculture, and he does the praying.

Representative BROWN. Where do we stand—and maybe I should ask the question directly—where do we stand now in terms of the impact of the drought on prospective food prices and what is likely to occur if we don't get some improvement in the situation in the next few weeks?

Mr. SEEVERS. We had a meeting in the Department of Agriculture yesterday examining those very questions. I think the answer is nobody knows exactly where we are from the standpoint of the drought. It changes day by day. And it is certainly a serious concern to us.

Our corn crop has gone from a probable output of 6½ billion bushels 3 or 4 months ago to something at the level of 6 billion, or probably lower. The official estimate, which has not taken into account the weather since it was made, estimated corn production from 6.2 to 5.9 billion bushels. So there has been a serious erosion of the corn crop. No one knows exactly what it is going to come in at because no one knows exactly how serious the drought is.

Representative BROWN. I am not a good enough farmer to know, but does that mean that if we get rain in normal patterns from here on, that that can be recovered, or is that damage done and done permanently at this point?

Mr. SEEVERS. I suspect you are a better farmer than that. There has been permanent damage. There is no question about that.

If we get normal rainfall from here on out, we would probably get a corn crop of say 5.7 or 5.8 billion bushels; in that range. Let's use that as a starting figure.

The impact of a crop of that size on food prices would be relatively small surprisingly in 1974. The main reason is because beef production, pork production, turkey production, egg production are pretty well on schedule. There can be some variations in the next few months, depending on the price of feed but not much.

Representative BROWN. You say on schedule and do you mean that the production is equivalent to the current consumption, to the current demand?

Mr. SEEVERS. I mean it is predetermined in the sense that it will not be affected much one way or the other whether we have a 5.5-billion-bushel corn crop of a 6.2-billion-bushel corn crop. That is what I meant.

So that what the outlook is for food prices in the rest of this year is not greatly affected by whether we get the 6.2 or say a 5.5 corn crop. Now there will be some——

Representative BROWN. Now I want to make very clear what you are saying. You are saying that they are feeding out the cattle and turkeys and so forth on the corn and the feed that came in earlier and that the price of that is all pretty well set? Is that right?

Mr. SEEVERS. What I am saying is the feed is available and will be fed for awhile even if prices go up.

Representative BROWN. And the impact on beef and other meat products will not be felt until the price impact of this particular crop works its way through the system, which means in effect the winter of next year? Is that right?

Mr. SEEVERS. That is a good formulation and much better than mine. Now we can observe worldwide an interesting phenomenon, and that is we seem to have excess supplies of animal products all over the world. I say excess supplies in the sense that livestock and dairy producers are getting squeezed. For example, the European community is buying beef and other animal products at a very rapid rate.

Representative BROWN. To do what with; to consume or store?

Mr. SEEVERS. To store. They are supporting the price of farmers by buying beef to store it. Then they try to——

Representative BROWN. That isn't the only reason, is it? Because when these high grain prices come about, if that is the result of what happens because of the weather and if the high grain prices occur, isn't it very likely that the farmer who produces meat products as a result of that, isn't it likely he will have a tendency to cut down on his meat production?

Mr. SEEVERS. Yes, that is the economics of it. I am really talking about the timing.

Representative BROWN. Which mean a potential shortage of meat products. Is that correct?

Mr. SEEVERS. At some point in the future if we have less feed grain to be fed, there will be less livestock and meat products produced. That is right.

Representative BROWN. Could you predict a time in the future?

Mr. SEEVERS. Well I think what has happened is looking only at the deterioration in our own corn and soybean crops, that the outlook for food supplies and food prices is not as promising in the middle of 1975 as it would have been 3 months ago.

I would point out, though, that there has been slippage in this country over the last 2 months in our crops. There has been some improvement in the rest of the world: India's monsoons are coming forward better now. There was some uncertainty about that earlier.

The outlook in China for their crops is better. Their crops are going to be normal whereas earlier there was concern about drought.

In Eastern Europe there was drought and they did get their rains, so their crops recovered some.

The Soviet Union is going to have a very good crop by recent indications. So some of our problems have been offset by improvements in the world.

Representative BROWN. Now let's pause there for a minute. That means that the consuming nations of the world, that the major consuming areas in the world are doing somewhat better, but what about the other producing nations in the world? What about Canada and what about Australia? Are they also in the same problem that we are in?

Mr. SEEVERS. Well, Canada is affected by the same kind of problems we have had, but more with the unduly wet weather earlier in the planting season, so they weren't able to get their crops in as early or as large an acreage as they would have liked.

Australia, of course, is on a different season, but their outlook is for excellent production in the coming year. So, I would say on the whole, the producing countries, with the exception of the United States, are going to expand production this year and will have what I would say would be normal yields.

Representative BROWN. What is happening with reference to the meat that Europe is buying? I understand that may be sold to the Russians. Do you have a picture on that?

Mr. SEEVERS. Well, there have been stories to that effect and I presume there have been discussions between them. I think there has been no confirmation that they have sold meat to Russia, although the Soviet Union has purchased fairly large amounts of meat in the world, not from the European community so much as from other countries, like Argentina and Australia. In a sense, they are a stabilizer to the meat industry in the world in that they are coming in when prices have been depressed and making purchases. They are getting good buys on meat in the world.

Representative BROWN. What commitments against the grain crop that we have been able to produce this year do we have and what are the prospects then, if there are better production anticipations in the consuming nations of the world, for our being relieved of some of the international grain purchases, and thereby not having an additional upward pressure on domestic grain prices?

Mr. SEEVERS. Well, there is quite a bit of validity to your line of reasoning——

Representative BROWN. Really, it is not a line of reasoning. It is an inquiry, because you have given me what you consider to be the prospective facts and what I am trying to determine is where will the grain price be when this crop comes in or soon after it comes in this fall in the United States?

Mr. SEEVERS. Well, our expectation is that exports of grains and not soybeans but grains—wheat and feed grains will be down slightly from last year. If you look at the advance sales, last year by this time we had committed ourselves to upward of 1 billion bushels of wheat to be exported. This year, we have committed ourselves to 350 million bushels, approximately, at this stage.

So that the export outlook is more promising from the consumer's standpoint and a little less promising from the farmer's standpoint than it was 1 year ago.

Representative BROWN. Can you relate that to percentage of American production; those two figures?

Mr. SEEVERS. Well, this year we will produce 1.9 billion bushels of wheat or thereabouts. That is the latest estimate.

Representative BROWN. So about half of our grain; you say 1.9 billion bushels of wheat?

Mr. SEEVERS. Yes, of wheat. And last year we exported 1.1 billion bushels. When I said that our export commitments 1 year ago were upward of 1 billion bushels I would say one-third of our wheat crop by this time last year was already committed, whereas this year a much smaller fraction is.

The supply of wheat is in very good shape. I would say the supply of rice, which probably has more to do with this thing than anything else, is in good shape. Our supply is up, but more importantly, the production level of rice could be up throughout the world.

Representative BROWN. Can you give me figures on corn and soybeans?

Mr. SEEVERS. Last year our commitments to export corn were smaller than for wheat. I don't remember the exact number, but our commitments——

Representative BROWN. Do you remember what percentage of the crop?

Mr. SEEVERS. We will have exported about one-fourth of our corn crop out of the current crop year, which ends September 30.

Representative BROWN. When are those commitments for export usually made?

Mr. SEEVERS. No one knows.

Representative BROWN. Were they made late last year?

Mr. SEEVERS. No, they were made early, because we imposed the soybean embargo on other countries, the prospective buyers became worried and came in and made their purchases very early last year. They are not making them early this year, which is an indication that export demand is less buoyant than it was last year.

Representative BROWN. What about soybeans?

Mr. SEEVERS. I don't remember the figures on soybeans. I do know that our export commitments 1 year ago were much higher than they are at this stage, but I would be happy to get those figures.

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

Through July 28, 1974, export orders for new-crop soybeans were 275 million bushels. Through August 4, 1974, orders were 363 million bushels compared with 626 million bushels through August 3, 1973. For soybean meal, orders were 1,872,000 tons through July 28, 1974, 3,489,000 tons through August 4, 1974, and 6,096,000 tons through August 3, 1973.

Representative BROWN. Do you remember the percentage, though?

Mr. SEEVERS. We will export about 45 percent of our soybean crop this year.

Representative BROWN. One final comment, Mr. Vice Chairman, and then my time is up.

It is a significant factor, I gather, then not only in our balance of payments but a significant factor in our domestic price structure and therefore the impact on our domestic inflation, that is the export amounts that we are putting into the world market. Is that correct?

Mr. SEEVERS. That depends on what theory of price formation and inflation you believe in. I am somewhat skeptical, but that is a major determinative. I think there are a lot of other things that go into determining inflation, especially the money supply and fiscal policy.

If we have an increase in demand for our agricultural exports, that will improve our terms of trade and cause the dollar to appreciate and we will buy imports somewhat more cheaply. So I think one has to be careful in making the translation there.

Representative BROWN. There is a timing lag in all of that, isn't there?

Mr. SEEVERS. There are always time lags or there are usually time lags in economic phenomena, that is true. But, one has to be careful about looking at the price of corn and saying that corn will turn the inflation rate greatly one way or the other.

Representative BROWN. Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Senator Percy.

Senator PERCY. Mr. Stein, I wonder if, inasmuch as the administration does not propose to try any new novel approach to inflation and combating inflation—and I am not sure I can devise any or recommend any—can you tell us what traditional tools will be used and how you intend to use those? The President has now indicated an intention to try to cut the budget some $5 billion and that would still leave a very sizable deficit.

Psychologically, it would appear desirable to try to balance the budget in fiscal year 1975. Will the administration—well, are you prepared to tell us in what areas cuts will be made in the fiscal 1975 budget and also whether or not new revenues will be recommended, new taxes recommended, to try to bring the expense and revenue accounts closer together?

Mr. STEIN. Some parts of that question I can answer and some I cannot. I do regard us as having a new policy, which is to follow the old policy continuously to the degree it is needed.

As I indicated in my prepared remarks, we have not done that in the past. Senator Proxmire and I have discussed the question of where the $5 billion of cuts will be made and I suggested that Director Ash would be a better witness on that.

At the moment, our situation is that we have informed the agencies of our determination to cut and it is the intention of the Office of Management and Budget to manage the weekly flow of expenditures in such a way as to bring this about.

But there has been no decision on the concentration of the cuts in any particular areas and——

Senator PERCY. From a policy standpoint then, when we have such a disparity of opinion within the administration between Secretary Simon and the Budget Director Ash on the amount that can be cut and the amount of the deficit that can be worked on, then from a policy standpoint, what would you advise the President and advise the Congress that we should try to aim toward?

Is it possible to bring, in your judgment, the budget in 1974 into balance as an overwhelming majority of the Members of the Senate indicated they would hope to cooperatively work out with the executive branch?

Mr. STEIN. My understanding is that the overwhelming majority Members of the Senate who voted indicated that they were in favor of balancing the budget, but they did not face the question you just asked me about where they would cut it and there were no specific proposals for cuts made by them. So, that is an evasion of the problem.

I don't think there is any great disparity of views within the administration. We want to look at the budget rigorously and with awareness for the necessity for cutting it, but we recognize (a) that there are a lot of programs which we cannot cut and (b) there are a lot of programs which are important to the country whether or not the legal situation is such that they could be cut.

So we recognize that every prudent policy has to be balanced and has to take that into account. We think that the policy we have proposed, the $300 billion budget for this year and a balanced budget for next year under the economic conditions which we foresee—and with a smaller increase in expenditures between 1975 and 1976 than between 1974 and 1975—that if we do this, accompanied by a policy of monetary restraint and ideally accompanied by some response of the public to the President's appeal for saving, we think that will achieve the desired result with respect to the rate of inflation.

I think the main contribution we should now expect from reducing the budget and reducing the deficit is to increase the supply of funds available for investment and for housing and reduce interest rates somewhat, so as to make the process of disinflation easier. We think that would be very desirable if it could be achieved without cutting out essential Government expenditures.

Senator PERCY. You haven't mentioned increasing revenues?

Mr. STEIN. Oh, yes, well, the President has said we would not recommend a tax increase.

Senator PERCY. You would oppose any surtax being added to make up the difference between outgo and income?

Can you comment on taxation on the oil industry itself, not to be a disincentive for exploration and development, but simply to offset what we now feel to be a very unfair situation where very small amounts of U.S. taxes are paid by the oil companies?

Mr. STEIN. There are several things involved there. We have proposed a windfall profits tax on domestic and crude oil production. We are still supporting that and hope the Congress will act on it.

Senator PERCY. How much revenue is the proposal of the administration's?

Mr. STEIN. The figure I have in mind is something like $1½ billion the first year. I am not sure about that, maybe $3 billion, but it is——

Senator PERCY. Is that really commensurate with the ability of that industry with its huge increase in income this year to bear their fair share of taxes, when some oil companies are paying no more than 1 or 2 percent of U.S. taxes? The largest proportionate amount they are paying, I believe, is up to 7 percent, and most corporations are paying 30- to 40-percent levels.

Mr. STEIN. I think that we are talking now mainly about profits, which have been earned in foreign business and I believe that the host countries are going to take that away faster than you can take it away and that this will not be a significant source of revenue and, in fact, it would not be a significant source of revenue for the U.S. Government or for the oil companies.

We were having a little discussion about oil companies before you came in. I think that we are facing a serious energy problem in the United States and that the energy problem with which we are faced is not that the oil companies make too much money, but that they produce too little energy for the United States.

I think that to attack the profits of this industry where expansion is so urgently needed is a mistake.

Anyway, in response to your question, we have proposed this windfall profits tax on domestic oil production and we have proposed certain changes in the taxation of income earned abroad by oil companies, but beyond that we are not proposing any tax increases there or elsewhere.

Senator PERCY. I have heard some discussion about one great problem, and that is public utilities are having a great problem in getting capital. They are experiencing difficulty there right now.

Would you tell us something of the concerns you may have as to how we are going to provide adequate capital through the private equity market and what, if anything, we can do about it in order to ward off a crisis in lack of capacity in the future, if we don't build the facilities that we need now?

Mr. STEIN. I think that is a very critical problem. We are concerned about it.

The heart of the problem is the failure of the State regulatory agencies to allow utility rates to rise in line with the increased cost of producing electricity and the increased cost of capital—in both the construction costs and interest costs. There is just no other solution consistent with the maintenance of the private utility industry or any industry, whether private or not, in which the customers pay the cost; there is just no other solution than higher rates to be permitted utility companies.

I don't think this problem can be solved by fiddling around with the tax system and so the solution seems clear. It is just apparently politically difficult.

Senator PERCY. I would like to come back to that in the next round. Thank you. My time is up.

Senator PROXMIRE. Mr. Stein, if we follow the policy of the administration—and there is a lot of logic to it, I must say—if we follow the policy of doing your best to increase the supply and doing your best to restrain demand, the cold and hard and classical economic position is that what you do is to give a free rein to business and to management, and you make it as attractive as possible for people to save and invest and you provide incentives, therefore, for people who can save—and they are the upper income people, by and large—and you follow a policy of slowing down the economy, then this puts almost the entire burden on the unemployed and the poor and the people with the lowest incomes.

And when you say that we must pay a price for this, it seems to me that it is pretty cold and hollow comfort for the unemployed to say, well, we will do what we can about unemployment compensation. After all, that means a sharp cut; it means you run out of unemployment compensation if you are unemployed long enough. So that is not a very happy solution.

Now, the administration seems—and I don't want to be unfair here—but it seems to have that as about the only solution. I noticed that Mr. Galbraith says that what we should do is have a surtax on people with incomes over $20,000. Your predecessor, Mr. McCracken, suggests we ought to have some kind of guaranteed income for people with low incomes, so that they don't have to bear such a big burden.

Senator Ribicoff suggests the Government is the employer of last resort. Mr. Burns has some constructive suggestions.

In Britain they have food subsidies. Some people suggest that we index small savings so that as inflation increases, you pay some kind of a subsidy for it.

Others are advocating a subsidy for people with modest incomes who have to pay high mortgage interest.

So there are a whole series of proposals that seem to have been rejected by the administration. You seem to persist in following a policy, which as I say, does seem to be unequitable and unjust and unfair inasmuch as it imposes the entire burden for fighting inflation on those least able to do it.

Mr. STEIN. Of course, it is very easy to make proposals for relieving people of the pain caused by the disinflationary process, and it is very difficult and unpopular to recommend the disinflationary process itself. So, obviously, everybody can cluster around and say——

Senator PROXMIRE. May I just interrupt to say, I think the disinflationary process itself you recommend is not at all unprofitable for business. After all, when you enjoy the kind of profits business is enjoying now, which are enormously high and great increases over the past and huge increases in executive compensation, they are not suffering after all. No wonder they like it.

Mr. STEIN. I think that is wrong. In the first place, these profits are very unevenly divided as you know, and when you add all the——

Senator PROXMIRE. That is true, but overall, by and large they are way up.

Mr. STEIN [continuing]. Profits including the profits made in the foreign oil business, you will find very large profits, that is true. But after all, there are many working people who are almost all employed and almost all of them, or at least a great many of them, are keeping up with inflation.

If you look at profits after allowance for the effects of inflation on the value of their inventories and on the value of the capital stock, you will find that profits are now really very low.

All you have to do is look at the stock market and see whether this kind of an economy is——

Senator PROXMIRE. Well, the stock prices are discounting the uncertainty, the lack of leadership in Washington, the unfortunate outlook. The fact is that return on investment, return on equity, was higher in the first quarter of this year when we had that terrific drop in real income for most Americans, than they have been; that is, profits were higher as a percentage of equity than they were at any time since 1967.

Mr. STEIN. Mr. Fellner has something.

Senator PROXMIRE. Mr. Fellner.

Mr. FELLNER. Senator, if I may refer to the May 1974 issue of the "Survey of Current Business," there it is shown that if you make allowances for the difference between deprecitation at historical costs and depreciation at current replacement costs, profits look very, very different. Also, the accounting profits, which I think you were referring to, include inventory revaluation, which again is not something that should be considered part of profits as I think you interpreted them.

So, you should make those two changes. That is to say, if you allow for the fictitious element in the profits statistics, those are very poor profits in good part. That is what is shown in stock prices and——

Senator PROXMIRE. Now, let me get on the other side of this, Mr. Fellner.

When you became a member of the Council of Economic Advisers, you were a very noted economist and one of the finest in the country and very widely hailed in the economic profession. You were noted particularly for your expertise in the area of public-service employment.

As I understand it, you were an outspoken advocate of a permanent program of public-service employment designed to provide work for those who, because of lack of education and so forth could not find other employment, especially in times when the overall labor market is so tight as to create inflation.

This seems to be a very constructive position that you had. Now, we hear very, very little from either you or the administration on that now, and it seems to me it would be most helpful to us and certainly to those who are going to suffer and pay the main price for increased unemployment, if you could tell us what kind of a program the administration would adopt in this area, or encourage?

Mr. FELLNER. Well, I think that is one of the programs that has been explored and is being explored. Some modest steps have been——

Senator PROXMIRE. Explored and modest steps? That is right. They are awfully modest.

Mr. FELLNER. Yes, but I think it is not very easy to put a good program of that sort into effect, especially during a transition period when you don't know how much of this unemployment is very temporary. Most of it, at the present time, still is very temporary and very short in duration. You don't really want to intercept people between two jobs.

Senator PROXMIRE. But, Mr. Fellner, we were told yesterday by Mr. Rush that the policies of this administration—and this is what I understood him to say, and correct me if I am wrong—were expected to increase unemployment to 5½ to 6 percent.

Now, if that is the case, it seems to me if that is what the administration expects and that is the price that has to be paid, then you ought to have a program in place right now so that as that unemployment increases, we could provide some kind of relief for people who otherwise are going to be thrown out of work and on welfare.

Mr. FELLNER. Well, I think this is indeed something that should be explored, if you ask me, Senator. However, this is not very easy to put into effect and——

Senator PROXMIRE. You say it is being explored? When will it be forthcoming?

Mr. FELLNER. Well, I would first like to see what kind of unemployment situation we get into. At present, practically all is of short duration—well, practically all is perhaps an overstatement, but very little of the unemployment is of long duration. Most of it is just very short in duration. I don't think that is the kind of unemployment that should be taken care of by public-service employment programs. That really means intercepting people between two jobs, when they are unemployed for a very short period.

I think that the situation may settle down in such a way that you will get more longer duration unemployment than we have now. We don't have very much more than we had when the overall unemployment rate was 4 or 4½ percent.

Practically all of it is less than 15-weeks duration at present. I think 15 weeks and longer is 1 percent of the labor force and it never was—it was 0.8 percent when the overall unemployment rate was 4.1 percent. Then the 15 weeks or longer duration was 6.8 percent of the labor force and now it is 1 percent of the labor force.

There hasn't yet occurred that phenomena which might well occur in the future, if that figure rises to a much higher level. So I think that we should then, in my judgment, take care of that part of the problem by making more than very modest steps in the direction of that kind of work program——

Senator PROXMIRE. I think we would have a far better chance in the Congress and with the public if we knew that we had a program that wasn't going to be inequitable, unfair, cruel, on so many hundreds of thousands of Americans. I think if the Government explored public employment with half the energy we are exploring outer space, we would have a pretty good program and we would have it ready right now.

My time is up.

Congressman Brown.

Representative BROWN. I would like to get into this question of profits, because I think we were beginning to get some facts. But then we suddenly shifted gears into how to take care of unemployment. However, I do want to stay on this unemployment thing for just a minute.

If the unemployment average is short-range unemployment, how are we dealing with that problem under the current programs? How long does unemployment compensation last?

Mr. STEIN. It varies somewhat, but the standard duration is about 26 weeks of benefits. In certain exceptional cases, it can be extended, I believe, for 13 weeks. Part of the improvement that we have proposed would extend the duration of benefits in a number of conditions and I don't know why we persist in saying that unemployment compensation is cold comfort.

I men, it is something—and perhaps there are other things that need to be done—but I think it is something that the recipients would prefer to have more rather than less and have it longer rather than shorter.

Senator PROXMIRE. They would prefer jobs.

Mr. STEIN. They would rather have this than not. I don't know why Congress does not move ahead with it, when it is always weeping about the unemployed.

Representative BROWN. Let me ask this question. Is unemployment compensation the only assurance of income that exists for someone who is unemployed? Are there private negotiated arrangements which take care of unemployment in addition to Federal- and State-financed unemployment compensation?

Mr. STEIN. Well, in some industries, notably the automobile industry, of course there is.

Representative BROWN. And the reason I ask the question is related to the automobile industry. As I indicated yesterday, I currently have in one of the industries of my congressional district some unemployment resulting from shortages of materials and equipment necessary to complete orders for trucks. The shop just can't get the equipment.

Now, I understand that the layoffs flow from that circumstance. Perhaps the shortages come from a lack of savings and investment and I am going to get into that soon, because that deals with another question, but I understand that in addition to unemployment compensation, there are some companies' benefits that flow into the man who is off work. Is that correct?

Mr. STEIN. Yes, in the automobile industry there is a system called supplementary unemployment benefits, which in the case of workers with a considerable degree of seniority, it will pay 95 percent of their wages, that they would earn if employed.

Representative BROWN. 95 percent?

Mr. STEIN. Yes, taking the supplement and the State system together, yes, for workers I believe with 20 years of seniority. It varies with the duration of their unemployment history.

But, in any case, as Mr. Fellner was saying, a great deal of the unemployment is of very short duration. A very large part of it is 5 weeks or less.

Representative BROWN. What causes a 5-week unemployment circumstance? Now, are we describing someone here who is laid off of a job or quits a job and then shifts to another industry and another kind of job, or are we talking about somebody who is laid off because of a shortage of equipment, because of a shortage of materials, a shortage of something else that is needed for production in that particular plant?

Mr. STEIN. Well there are all kinds of reasons. The shortage reason can be one, but you must remember that in our unemployment statistics we count as unemployed the people who are looking for their first job, that is when a person first gets out of high school or college or whatever point he is going to enter the labor force and start looking for work, he will be counted as unemployed.

If it takes him 5 weeks to find a job, then he will be counted and our statistics would have him at 5 weeks of unemployment. If a woman returns to the labor force after having a child or for some other reason having been out of the labor force and looks for a job for 5 weeks or 10 weeks, she is counted as unemployed for that period.

We know from statistics which we now have that more than half of the unemployment or let us say less than half of the unemployed are people who lost their last jobs and more than half of the unemployed are people who voluntarily left their last job or just entered the labor market or have reentered, after having been out of the labor force.

Those who have lost their last jobs, of those, many of them are in the situation you describe where there is a material shortage and some of them are suffering seasonal, annual unemployment for one reason or another.

Representative BROWN. Let me go back to the automobile industry for a minute.

What is the percentage of unemployment in that industry? Do you know?

Mr. STEIN. No, I don't.

Representative BROWN. Well, there seems to be here an industry that was severely hit by the shortages of oil, gasoline, and so on. It is therefore an industry which had to change its model production schedules to produce smaller cars.

I am just curious about whether or not that recovery has been good or slow? And if it has been slow, I am wondering whether these people laid off are getting 95 percent of their general wages and therefore perhaps are not dragging quite as much on the economy as you might otherwise have thought?

Mr. STEIN. Well, there was a sharp drop and there has been some recovery in employment in the motor vehicle industry. But in May 1974, there were 860,000 employed in this industry as compared with 950,000 in May of 1973. But I believe that the employment in this industry reached its low in February or March and has since been rising.

Representative BROWN. Let me change to the profit picture now.

How good is that profit picture? As I understand it, a lot of companies are making profits off of inventory because the item that they are selling was brought in at $100 and is sold out at $120 because the price of the next item they have to get to replace it is now $120?

Mr. FELLNER. The same with machinery.

Representative BROWN. You mean equipment for production?

Mr. FELLNER. Yes.

Representative BROWN. So the depreciation rate does not cover the cost of replacement of the equipment?

Mr. FELLNER. And that is so in spite of accelerated depreciation. The effects of accelerated depreciation are outweighed by that factor.

Representative BROWN. Well, certainly inflation doesn't affect what you can buy with your profits, does it, or doesn't it?

Mr. FELLNER. But you have to replace the equipment at a much higher price than that which underlies your depreciation.

Representative BROWN. Are you telling me that businesses in order to keep even with it, require higher profits because of inflation?

Mr. FELLNER. Well, if you define profits in such a way that you will deduct for depreciation only what you find as the depreciation allowance on the basis of historical cost, then the answer is yes. That is to say, if you deduct from your gross revenue, Congressman Brown, depreciation on the basis of historical costs, rather than current replacement costs, then you get a higher profit figure and indeed a higher profit figure in that sense is needed in order to stay in business.

Representative BROWN. Let's say a business makes profit *x* out of raw material *a* and raw material *a* goes up from $100 to $120 on an index of costs, and the *x* product then has to go up to what degree?

Mr. FELLNER. Well, they've got to replace their inventories and they've got to replace their machinery and equipment and their structures.

Representative BROWN. What about their cash position to maintain a relative percentage of cash in the company in order to meet their wage payroll, now does that also have to go up?

Mr. FELLNER. Yes, sir; I think, Congressman Brown, the answer to that is yes, that is profits are calculated in such a way that they do not take account of the fact that in order to stay in business you have to replace your inventories at current prices.

Representative BROWN. Now, what arrangement is made for what they can take off their taxes for depreciation to reinvest in plant and equipment? Does that increase? In other words, can they take more off to pay for this additional more expensive machinery?

Mr. FELLNER. No, what you take off is depreciation calculated on the basis of historical costs—that is of past costs of acquisition.

Representative BROWN. So, if that machine costs $80-some 5 years ago, the current cost of it is $100 and they are going to buy a new item of machinery 5 years hence—and never mind any change in what the machine can do or anything else—that situation exists, in order to make the difference between what they were depreciating it at, $80, and $120, which is what they may have to buy it a few years later, they are going to have to have more money just to keep even. Is that right?

Mr. FELLNER. Yes, the answer is yes.

Representative BROWN. Now, on that basis, what has happened to profits? Are profits up exorbitantly? In other words, are we keeping up with that need for maintaining our capacity to produce in this country or are we falling in behind in terms of profit? Are we keeping even? Are we way ahead?

In other words, are businesses making exorbitant profits and doing something rotten with that money?

Mr. FELLNER. No, I think that on the basis of that kind of calculation for industries as a whole, profits are poor.

Representative BROWN. They are poor?

Mr. FELLNER. If you figure it that way. Now this is not true of all individual industries, of course.

Representative BROWN. Well now, in order to keep jobs in this country, you have to reinvest something in the way of equipment. Even a farmer doesn't go out with his strong back. He buys a tractor or combine and those prices are going up. Overwhelmingly, you know, they have gone up 50 percent.

Now, what happens if we don't keep up our investment in productive capacity in this country? I give you as maybe a great example of that in the steel industry in the United States.

Mr. FELLNER. Well, there is a problem there and——

Representative BROWN. But, what happens? Tell me what happens?

Mr. FELLNER. Well, we know that too little has been invested in the steel industry, probably in the past.

Representative BROWN. But why?

Mr. FELLNER. That is a very complicated question and obviously a question which we can't answer in one sentence.

Representative BROWN. Is it because they took their high profits and did something wrong with them?

Mr. FELLNER. Well, they invested too little.

Representative BROWN. What was their profit picture? What has been the profit picture of the steel industry in the last 10 years, for example?

Mr. FELLNER. Well, I wouldn't know how to answer that question briefly.

Representative BROWN. How does it relate to other profits in companies on the stock market?

Mr. FELLNER. Well, I would imagine that is not one of the very profitable industries, but I don't know the figures on that, sir, to answer that.

Representative BROWN. I can tell you the figures indicate that it is not one of the higher profit companies or industries or industry fields, rather in the market.

Now, is it because the demand for steel in the world has gone down that they have not reinvested?

Mr. FELLNER. Well, they also were up against a competitive situation with the rest of the world and——

Representative BROWN. The investment in steel production has been made elsewhere in the world, hasn't it?

Mr. FELLNER. Probably.

Representative BROWN. As I understand it, it has. It has been made in plants in other nations and not here and not necessarily by American steel companies.

Mr. FELLNER. Well, I wouldn't like to——

Representative BROWN. So, what happens to the American share of the steel industry? I guess that is the question. And if we reduce profits, I think we can tell what will happen in the world production field. It will be other nations in the world who are producing the goods that the world needs and not the United States. I think that is a very, very grim picture for job prospects in the future.

Mr. FELLNER. But what I would suggest is perhaps something more mathematical. I would take the profits and look at them after due corrections. That is to say, I would eliminate the difference between the book value of the inventories and the replacement value of the inventories and I would deduct that part of the book profits which originate in this difference between the book value of inventories and the replacement value of inventories. And I would do the same for machinery and for structures and I would look at that profit figure before I arrived at any judgment as to whether those profits are high or low.

Those are two substantial adjustments. One of those adjustments was estimated—and I think with a great deal of precision—in the Survey of Current Business, dated May of 1974, and it is quite easy to make the other correction for inventories on the basis of data that are available.

You will then find a very different picture for profits than that which came out of the conventional statistics. That is all I was suggesting in that regard.

Now, obviously some industries are very profitable and others are unprofitable.

Representative BROWN. My time is up. I mentioned steel as an example, but if you look at the figures in your own report, the steel industry profit figures run anyplace from 20 percent to 50 percent below the average for all manufacturers, and why the steel industry in the United States has been replicated in other countries.

That explains why we may have some shortages in some of these other areas of manufacture, because we don't have some of the basic industries here anymore, where we have held down their profits over a period of years. Steel has been a good example, because we all know about the knock in the night in the steel industry and some of these others in an effort to hold prices down when we were jawboning on prices a few years ago.

Mr. FELLNER. I think you will find indeed the real wage trend has been unfavorable over the past year. If you make the corrections I suggest, you will find that overall it has been unfavorable also in the profit area.

[The following information was subsequently supplied for the record by Mr. Fellner in the context of the above colloquy:]

Mr. Fellner's statement is based on the enclosed three tables, the first two of which are recently revised versions of tables found in the May, 1974, issue of the Survey of Current Business, and the third of which was also prepared by the Bureau of Economic Analysis of the Department of Commerce. All data relate to profits earned by nonfinancial corporations excluding profits originating in the rest of the world and excluding profits on residential properties.

It can be seen from table III that in 1973 profits before taxes, without the Inventory Valuation Adjustment (IVA), amounted to $95.1 billion. If, as is done in table I, we exclude from these profits that component which reflects merely the difference between the book value and the replacement value of the inventories entering into current output—the so-called IVA—the profits are reduced to $77.5 billion. If in addition we also deduct from the $95.1 billion profits figure that component which reflects the difference between depreciating the fixed capital according to tax regulations at historical cost of acquisition and depreciating it at current cost of replacement, in either case with service lives equal to 85 percent of Bulletin F, then profits are reduced to $65.4 billion or to $72.0 billion. At which of these two figures we arrive depends on whether we apply accelerated depreciation (in its double-declining balance form) or apply straight-line depreciation. On an alternative estimate of current replacement cost the latter two figures become $66.6 billion and $73.4 billion, respectively.

Thus, as a result of rapid price increases these adjustments reduce profits before taxes in 1973 from $95.1 billion to the general neighborhood of $70 billion.

For years of reasonable price stability the numerical significance of these adjustments is very small, but for a year such as 1973 it is large. As is shown in table I, the unadjusted profits figure of $95.1 billion in 1973 was about 45 percent above the 1965 level. However, the roughly 70 billion profits figure for 1973, obtained after adjustment for inventory profits and underdepreciation of fixed capital, was up by only 5 to 10 percent from the 1965 level, depending upon the precise nature of the depreciation adjustments. These figures are expressed in current dollars and hence in real terms (with correction for price changes) the adjusted profits have declined significantly since 1965 despite the increase of the capital stock since that time.

Tables I and II indicate also that regardless of how we measure profits they declined significantly as a percentage of the value of gross corporate product when we compare recent years with the second half of the nineteen-sixties. The extent of the decline depends on how profits are computed but the decline is very substantial in any event.

Finally, it should be added that it is misleading to compare the recent effective corporate income tax rates with those of a period of approximate price stability unless we take account of the fact that the needed adjustments of profits were negligible in periods of price stability but have recently become very large. Taxes are levided on the unadjusted book profits which at present greatly exceed the adjusted profits computed on the principle that replacement costs need to be deducted before we arrive at the true "net" figure. When computed on this principle, corporate profits after taxes are from 10 to 30 percent below the 1965 levels, depending upon the precise nature of the adjustment for underdepreciation. As can be seen from table II, this relates to profits as expressed in current dollars the real value of which was appreciably smaller in 1973 than in 1965.

TABLE I.—PROFITS BEFORE TAXES[1] AND PROFITS BEFORE TAXES AS A PERCENT OF GROSS PRODUCT OF NONFINANCIAL CORPORATIONS: NATIONAL INCOME ACCOUNTS DEFINITION COMPARED WITH PROFITS BASED ON ALTERNATIVE METHODS OF DEPRECIATION, 1965–73

[In billions of dollars]

Line		1965	1966	1967	1968	1969	1970	1971	1972	1973
1	Corporate profits, national income accounts (NIA)	63.6	68.9	64.5	68.4	62.3	50.5	57.8	68.6	77.5
2	Percent of gross corporate product	17.0	16.8	15.1	14.7	12.5	9.8	10.5	11.3	11.4
3	Corporate profits plus depreciation, national income accounts (NIA)	98.1	106.4	105.2	112.6	111.2	103.2	114.5	130.6	144.0
4	Percent of gross corporate product	26.2	26.0	24.6	24.2	22.2	20.1	20.8	21.5	21.2
	Alternative methods of depreciation:									
	Historical cost valuation:									
5	Straight line depreciation, F service lives	71.5	77.2	77.3	77.7	73.0	61.7	69.8	82.4	92.1
6	Percent of gross corporate product	19.1	18.9	17.2	16.7	14.6	12.0	12.7	13.5	13.6
7	Straight line depreciation, 0.85F service lives	69.3	74.8	70.5	74.7	69.7	58.1	66.0	78.4	87.8
8	Percent of gross corporate product	18.5	18.3	16.5	16.0	14.0	11.3	12.0	12.9	13.0
9	Straight line depreciation, 0.75F service lives	67.6	72.9	68.4	72.3	67.2	55.4	63.1	75.3	84.5
10	Percent of gross corporate product	18.1	17.8	16.0	15.5	13.4	10.8	11.5	12.4	12.5
11	Straight line depreciation, F to 0.75F service lives	66.7	71.9	67.4	71.4	66.2	54.4	62.2	74.4	83.8
12	Percent of gross corporate product	17.8	17.6	15.8	15.3	13.2	10.6	11.3	12.2	12.4
13	Double-declining balance depreciation, 0.85F service lives	65.2	69.9	64.9	68.5	63.0	51.1	59.0	70.9	79.7
14	Percent of gross corporate product	17.4	17.1	15.2	14.7	12.6	9.9	10.7	11.6	11.8
15	Double-declining balance depreciation, F to 0.75F service lives	62.9	67.3	62.2	65.6	60.0	47.9	55.8	67.5	76.3
16	Percent of gross corporate product	16.8	16.4	14.6	14.1	12.0	9.3	10.1	11.1	11.3
	Current price (1) valuation:									
17	Straight line depreciation, F service lives	66.6	71.9	67.3	70.3	64.6	51.2	57.1	68.5	76.2
81	Percent of gross corporate product	17.8	17.6	15.8	15.2	12.9	9.9	10.4	11.3	11.0
19	Straight line depreciation, 0.85F service lives	65.1	70.2	65.2	68.3	61.8	48.0	53.6	64.8	72.0
20	Percent of gross corporate product	17.4	17.1	15.3	14.7	12.4	9.3	9.7	10.6	10.6
21	Straight line depreciation, F to 0.75F service lives	61.7	66.6	61.2	64.2	57.2	43.1	48.5	59.5	66.6
22	Percent of gross corporate product	16.5	16.2	14.3	13.8	11.5	8.4	8.8	9.8	9.8
23	Double-declining balance depreciation, 0.85F service lives	61.8	66.1	60.3	63.0	55.9	42.0	47.7	58.7	65.4
24	Percent of gross corporate product	16.5	16.1	14.1	13.5	11.2	8.2	8.7	9.7	9.6
25	Double-declining balance depreciation, F to 0.75F service lives	59.0	63.0	57.0	59.5	52.2	38.0	43.7	54.6	61.3
26	Percent of gross corporate product	15.8	15.4	13.3	12.8	10.4	7.4	7.9	9.0	9.0
	Current price (2) valuation:									
27	Straight line depreciation, 0.85F service lives	65.8	70.8	65.8	69.1	62.6	48.8	54.8	66.3	73.4
28	Percent of gross corporate product	17.6	17.3	15.4	14.8	12.5	9.5	10.0	10.9	10.8
29	Double-declining balance depreciation, 0.85F service lives	62.4	66.6	60.8	63.5	56.5	42.6	48.8	60.1	66.6
30	Percent of gross corporate product	16.7	16.3	14.3	13.6	11.3	8.3	8.9	9.9	9.8
31	Gross corporate product	374.2	409.3	426.9	465.7	499.9	514.5	550.2	608.8	678.2

[1] Includes IVA. Excludes profits originating in the rest of the world and profits on residential propeities owned by nonfinancial corporations.

Note: Seivice life alternatives are 100 percent, 85 percent, and 75 percent of Bulletin F lives, and 100 percent of Bulletin F lives through 1940, then gradually declining to 75 percent of Bulletin F in 1960 and thereafter. Updated: Aug. 1, 1974.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE II.—PROFITS AFTER TAXES [1] AND PROFITS AFTER TAXES AS PERCENT OF GROSS PRODUCT OF NONFINANCIAL CORPORATIONS: NATIONAL INCOME ACCOUNTS, DEFINITION COMPARED WITH PROFITS BASED ON ALTERNATIVE METHODS OF DEPRECIATION, 1965–73

[In billions of dollars]

		1965	1966	1967	1968	1969	1970	1971	1972	1973
1	Corporate profits, national income accounts (NIA)	36.2	39.0	36.4	34.6	29.0	23.1	28.2	35.6	37.1
2	Percent of gross corporate product	9.7	9.5	8.5	7.4	5.8	4.5	5.1	5.9	5.5
3	Corporate profits plus depreciation, national income accounts (NIA)	70.7	76.5	77.1	78.9	77.8	75.8	85.0	97.7	103.5
4	Percent of gross corporate product	18.9	18.7	18.1	16.9	15.6	14.7	15.5	16.0	15.3
	Alternative methods of depreciation:									
	Historical cost valuation:									
5	Straight line depreciation, F service lives	44.1	47.4	45.2	44.0	39.7	34.4	40.3	49.4	51.7
6	Percent of gross corporate product	11.8	11.6	10.6	9.4	7.9	6.7	7.3	8.1	7.6
7	Straight line depreciation, .85F service lives	41.9	44.9	42.4	41.0	36.4	30.8	36.5	45.4	47.4
8	Percent of gross corporate product	11.2	11.0	9.9	8.8	7.3	6.0	6.6	7.5	7.0
9	Straight line depreciation, 0.75F service lives	40.1	43.0	40.3	38.6	33.8	28.0	33.6	42.3	44.0
10	Percent of gross corporate product	10.7	10.5	9.4	8.3	6.8	5.4	6.1	7.0	6.5
11	Straight line depreciation, F to 0.75F service lives	39.3	42.1	39.4	37.7	32.9	27.1	32.7	41.4	43.3
12	Percent of gross corporate product	10.5	10.3	9.2	8.1	6.6	5.3	5.9	6.8	6.4
13	Double-declining balance depreciation, 0.85F service lives	37.7	40.0	36.8	38.8	29.7	23.8	29.4	37.9	39.3
14	Percent of gross corporate product	10.1	9.8	8.6	8.3	5.9	4.6	5.4	6.2	5.8
15	Double-declining balance depreciation, F to 0.75 service lives	35.5	37.5	34.1	31.9	26.6	20.6	26.2	34.5	35.9
16	Percent of gross corporate product	9.5	9.2	8.0	6.9	5.3	4.0	4.8	5.7	5.3
	Current price (1) valuation:									
17	Straight line depreciation, F service lives	39.2	42.1	39.2	37.1	31.3	23.8	27.6	35.5	35.5
18	Percent of gross corporate product	10.5	10.3	9.2	8.0	6.3	4.6	5.0	5.8	5.2
19	Straight line depreciation, 0.85F service lives	37.7	40.3	37.1	34.6	28.5	20.6	24.1	31.8	31.6
20	Percent of gross corporation product	10.1	9.8	8.7	7.4	5.7	4.0	4.4	5.2	4.7
21	Straight line depreciation, F to 0.75F service lives	34.3	36.7	33.2	30.5	23.9	15.7	19.0	26.5	26.2
22	Percent of gross corporate product	9.2	9.0	7.8	6.5	4.8	3.1	3.5	4.4	3.9
23	Double-declining balance depreciation, 0.85F service lives	34.4	36.2	32.2	29.2	22.6	14.6	18.1	25.7	25.0
24	Percent of gross corporate product	9.2	8.8	7.5	6.3	4.5	2.8	3.3	4.2	3.7
25	Double-declining balance depreciation, F to 0.75F service lives	31.5	33.1	28.9	25.7	18.8	10.6	14.2	21.6	20.9
26	Percent of gross corporate product	8.4	8.1	6.8	5.5	3.8	2.1	2.6	3.6	3.1
	Current price (2) valuation:									
27	Straight line depreciation, .85F service lives	38.4	41.0	37.7	35.3	29.2	21.5	25.3	33.3	32.9
28	Percent of gross corporate product	10.2	10.0	8.8	7.6	5.8	4.2	4.6	5.5	4.9
29	Double-declining balance depreciation, 0.85F service lives	35.0	36.8	32.8	29.8	23.2	15.2	19.3	27.1	26.2
30	Percent of gross corporate product	9.3	9.0	7.7	6.4	4.6	3.0	3.5	4.5	3.9
31	Gross corporate product	374.2	409.3	426.9	465.7	499.9	514.5	550.2	608.8	678.2

[1] Includes IVA. Excludes profits originating in the rest of the world and profits on residential properties owned by nonfinancial corporations.

Note: Service life alternatives are 100 percent, 85 percent, and 75 percent of Bulletin F lives, and 100 percent of Bulletin F lives through 1940, then gradually declining to 75 percent of Bulletin F in 1960 and thereafter. Updated Aug. 1, 1974.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE III.—PROFITS BEFORE TAXES [1] (EXCLUDING IVA) OF NONFINANCIAL CORPORATIONS: NATIONAL INCOME ACCOUNTS DEFINITION COMPARED WITH PROFITS BASED ON ALTERNATIVE METHODS OF DEPRECIATION, 1965–73

[In billions of dollars]

Line		1965	1966	1967	1968	1969	1970	1971	1972	1973
1	Corporate profits, national income accounts (NIA)	65.3	70.7	65.6	71.7	67.4	55.3	62.7	75.6	95.1
3	Corporate profits plus depreciation, national income accounts (NIA)	99.9	108.2	106.3	115.9	116.3	108.0	119.4	137.7	161.5
	Alternative methods of depreciation:									
	Historical cost valuation:									
5	Straight line depreciation, F service lives	73.2	79.0	74.4	81.0	78.2	66.5	74.7	89.4	109.7
7	Straight line depreciation, 0.85F service lives	71.0	76.5	71.7	78.0	74.9	62.9	70.9	85.4	105.4
9	Straight line depreciation, 0.75F service lives	69.3	74.6	69.5	75.7	72.3	60.2	68.0	82.3	102.1
11	Straight line depreciation, F to 0.75F service lives	68.4	73.7	68.6	74.7	71.3	59.2	67.1	81.5	101.4
13	Double-declining balance depreciation, 0.85F service lives	66.9	71.6	66.0	71.9	68.1	55.9	63.9	77.9	79.3
15	Double-declining balance depreciation, F to 0.75F service lives	64.6	69.1	63.3	69.0	65.1	52.7	60.7	74.6	93.9
	Current price (1) valuation:									
17	Straight line depreciation, F service lives	68.3	73.7	68.4	74.1	69.7	56.0	62.0	75.5	93.5
19	Straight line depreciation, 0.85F service lives	66.8	71.9	66.3	71.7	66.9	52.8	58.5	71.8	89.6
21	Straight line depreciation, F to 0.75F service lives	63.5	68.3	62.4	67.5	62.4	47.9	53.4	66.5	84.2
23	Double-declining balance depreciation, 0.85F service lives	63.5	67.8	61.4	66.3	61.0	46.8	52.6	65.7	83.0
25	Double-declining balance depreciation, F to 0.75F service lives	60.7	64.7	58.1	62.8	57.3	42.8	48.6	61.7	78.9
	Current price (2) valuation:									
27	Straight line depreciation, 0.85F service lives	67.5	72.6	67.0	72.4	67.7	53.6	59.6	73.3	90.9
29	Double-declining balance depreciation, 0.85F service lives	64.1	68.4	62.0	66.9	61.6	47.4	53.7	67.1	84.2

[1] Excludes profits originating in the rest of the world and profits on residential properties owned by nonfinancial corporations.

Note: Service life alternatives are 100 percent, 85 percent, and 75 percent of Bulletin F lives, and 100 percent of Bulletin F lives through 1940, then gradually declining to 75 percent of Bulletin F in 1960 and thereafter. Updated Aug. 1, 1974.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Senator PROXMIRE. Senator Percy.

Senator PERCY. Mr. Stein, I would like to have the counsel of you and Mr. Fellner and Mr. Seevers in the area of finding ways we can get sufficient capital in the industrial sector to finance our future growth needs. When we entered our colloquoy before, we were talking about the field of energy and power and the public utilities.

Now, backing off from that for just a moment, our overall needs, according to some experts, will require about \$4½ trillion for capital investment to finance our expected growth over the next 12-year period, from 1974 to 1985, inclusive. That compares with \$1½ trillion in the preceding 12 years.

So, our growth rate and needs are very great indeed. Taking into account present profitability conditions in industry, taking into account things that you have mentioned in the field of utilities, where States are regulating our rates, and yet those utilities are subject to increasing raw material costs and labor costs and prices in addition they have environmental considerations and legal considerations involved in the laws that we have passed that hinder their growth, what can the administration offer or suggest for us to encourage capital formation sufficient to meet the needs of the industrial sector of the economy in future years?

Mr. STEIN. Well, Senator, this is a subject which the President has directed the Council to study. We have some people involved in this. It is a difficult question and will take some time and I don't want to prejudge its conclusions, but I think that some general things can be said about this.

If you turn away, as you suggest, from the question of shortages in particular areas and ask about the total supply, about the total investment in American production or in the American economy, I think one thing you have to recognize is that we cannot invest what we do not save. Investment cannot exceed the savings.

And if we are going to have a substantially higher rate of investment in the United States, we are going to have to have a substantially higher rate of savings.

Now, this saving can be divided into two parts: Saving done in the private sector and saving done by government. Now, the saving by government is often negative because the government runs at a deficit and absorbs part of the saving that is done in the private sector, and keeps that saving from being used and invested in the expansion of productive capacity.

So, one important thing that has to be done, it seems to be, is to consider whether it is possible to develop a Government policy which over time will generate surpluses and not deficits, so that the Government will be supplying saving and not absorbing saving from the private sector.

And when we think about this, of course we have to think about large sums of money, because we are talking about an economy that is $1½ trillion, about a budget that is over $300 billion; and we are talking about rates of investment in plant and equipment at $150 billion, or in that neighborhood.

So, we have to think of a $1 or $2 billion surplus, which is quite a substantial surplus.

Senator PERCY. How are we going to increase personal savings and individual savings in light of the present inflationary problems? Don't people feel that unless they get their money into things, that the money they have is going to be less and less and less every year?

Mr. STEIN. I think that is a very good point, and probably should have been the first part of my answer. I assume that we are going to get the inflation problem under control, otherwise we will have to make a lot of different institutional arrangements than we now have for reasons that would comply with what Mr. Fellner said.

The rapid inflationary situation, combined with the kind of track system that we have now, makes it very difficult for industry to develop the internal funds which will enable it even to replace its existing capital, let alone to grow. So that it is essential first to permit business to accumulate the internal funds that are necessary for investment and second to provide some kind of reasonable basis for saving in the forms to which most people are used to saving. We should have a more moderate rate of inflation if we do that.

I think it is the first essential. I think beyond that we have a question of whether—and I assume this would be if we have a fairly stable economy—we know how or can find a way to increase the total saving. Our experience over a long period of time has been that the total private saving, including saving of business as well as saving of individuals, as a proportion of the GNP is quite stable and has been quite stable for many years, even when the economy was operating at full economy. This suggests to me, at least, it is going to be very difficult to increase that proportion, but there may be ways to do it. There may be ways of providing incentives through the tax system or otherwise which will increase the amount of saving.

Beyond that, of course, we have a question of the distribution of total saving and the total private investment between expansion of capacity and other priorities, such as housing. Here you run again to another great choice, which the society has to make about the extent to which we want to promote housing, as we do, and also doing it at the possible expense of expansion of production.

And then you raise a question which is very critical, Senator, about whether we have made wise decisions in the burden being placed upon business for investment in ways that will improve the environment rather than increase output as we usually think of output. Now, improvement of the environment is an output and benefit to the society, but some choice has to be made and it may be we have gone too far in that direction.

Now, it may be the thing that has to be considered is that there are deficiencies in the way the supply of saving gets allocated among different industries and that we have an inefficient calculation of total investment, which holds back the growth of the economy. That is something to be looked at.

I am prejudiced against believing it, but that is a possibility. If it is found to be the case, then corrective measures might be needed to direct the flow of investment, but as I say, I would personally come to that conclusion rather reluctantly.

Senator PERCY. With respect to your comment before about State regulatory agencies and the utilities, would it be your counsel and advice to the regulatory agencies that if they are just looking at the short run, popular thing to do, then they should keep the utility rates down, but they had better well be advised to look at future needs and requirements and sources of supply. The utilities today, at their present rates and their present profitability, simply cannot get the capital for expansion. And if they cannot get this necessary expansion, aren't regulatory agencies in the end really doing a great disservice to the consumer by underpricing the product today and throttling an industry in its growth potential and stopping it from getting the capital that is going to be required for its future needs?

Mr. STEIN. I agree with you. We are potentially building up to a great crisis through unwillingness to face the fact that if the consumers want a supply of electricity, and to some extent gas, 5 years or even 3 years from now, that they will have to be prepared to pay for it, because like other things, you don't get that for nothing and we are not paying for it now.

Senator PERCY. Also, with respect to all other sources of raw material, a shortage of basic raw materials has been cited as one of the major contributors to our current inflationary rates. Last week, the Joint Economic Committee held hearings to investigate such shortages. As you know, the Senate worked together with the administration in creating a special Commission on Commodities to, in the short run, study what policies we should adopt.

Does the administration at this stage have any recommendations or suggestions or comments as to what we can do to insure increased supplies of needed goods in the future?

Mr. STEIN. Well, Senator, you referred to the administration having worked together with the Congress to establish this Commission. As far as I know, we got through the Senate, but the thing seems to be lost somewhere in the House or at least nothing has been heard about it in several months, unless I am mistaken. So that the Commission does not yet exist.

We have worked on it in the administration and in the appendix to the statement that we supplied, we do reflect some of that work.

We do think one thing that we very much hope for is that the trade bill will pass promptly.

The trade bill will, I believe, contain provisions authorizing the administration to negotiate agreements to assure access to important supplies of material, and that would be a useful thing to do. We are concerned and have been concerned about a number of particular things as they arise. We have been concerned with the bauxite problem in the Caribbean and the administration is using its diplomatic efforts to try to assure adequacy of supplies at reasonable prices in these cases.

We are trying to foresee, and we indicate in our testimony we do not see a great many, cases of potential danger of serious disruptions. The oil case does seem to be rather special. But these cases do have to be dealt with individually as they seem to be dangerous at the appropriate occasion.

Senator PERCY. Could you comment on the current credit situation, both domestic and international? Are we on the verge, as I have heard rumored from some knowledgeable sources, of a severe liquidity crisis? Are there in the administration's judgment a number of other large banks, both domestic and international, in the type of difficulties that Franklin National Bank and the Herstatt Bank of Germany have experienced?

Mr. STEIN. Well, I would comment on the domestic situation. I would also ask Mr. Fellner to talk about the international situation.

Representative BROWN. Would you yield merely for an observation? Is the liquidity crisis another name for a bank failure?

Mr. STEIN. Well, it doesn't have to be a bank.

I think we have had liquidity crises which did not result in bank failures, but just a situation in which prices or financial institutions have to cut back very sharply because they could not continue to finance themselves. Now, we are not in the banking business, but I am not aware of any potential difficulty duplicating the Franklin National Bank situation, which was complicated by poor management, added to the general financial situation.

We are concerned about the potential problem of thrift institutions, which have their assets largely tied up in funds yielding interest rates that were set some years ago, and interest rates were lower then. They now may find it difficult to hold deposits in the face of higher yielding alternatives, in the face of higher yielding assets that are available to savers these days. That is one of the reasons why we would like to see the Federal budget closer to balance and why we would like to see an increase in savings by the public, because both of those things would contribute to lower rates of interest and reduce the particular problems faced by these institutions.

In any case, as you know, there are many Government backstops providing for these institutions and we don't visualize any difficulty in general impact arising there, but we are nevertheless desirous of seeing a lower rate of interest if this can be achieved by means which are not self-defeating.

That is to say, we don't just want to try to get the rate of interest down by pumping in more money, which would only accelerate the inflation, in our view, and increase the difficulties.

Senator PROXMIRE. Mr. Stein, you have been identified as kind of the Will Rogers of economics, referring to the fact, of course, that Will Rogers said he never met a man who he didn't like and you have been said to have never met a statistic that you didn't like.

I am referring, of course, to the statistics that often seem to foretell doom. With that in mind, I would like to ask you about the fact that just this morning the newspapers reported the leading indicators for the first time this year are down and it is very interesting to see how they are down. The June downturn—the first, since the 1.7-percent plunge since last December—reflected decreases in four of the eight available indicators: Plant and equipment orders fell 6.9 percent; durable orders fell off 1.7 percent; the average workweek declined 0.5 percent; initial claims for unemployment insurance rose 0.8 percent.

Gaining last month were industrial material prices of 0.6 percent; the ratio of price to unit labor costs, 0.3 percent; stock prices, 0.1 percent; building permits were unchanged.

Now, it is clear that the inflation has distorted this index. If it weren't for inflation, it would be far more pessimistic.

In the light of that situation, what do you foresee for unemployment and for prices and for production over the next 6 months?

Mr. STEIN. It seems to me that we were in the middle of answering questions somebody had asked us, but anyway I will say about the leading indicators, that that is a statistic I don't like for various reasons. I don't like it methodologically, because as you indicated by listing what is in it, because it is just a rag bag of dispersed things which there is no particular way to add up.

Senator PROXMIRE. This is the Government's index of leading indicators. I didn't make it. The Commerce Department issues it.

Mr. STEIN. I didn't pick it either.

Senator PROXMIRE. I am sure you didn't.

Mr. STEIN. We don't publish the leading economic indicators. I don't think you will find it in our annual report.

Senator PROXMIRE. I think they found, on the basis of experience over the last 40 or 50 years, that this has been a reasonably solid basis for anticipating what is going to happen to the economy.

Mr. STEIN. That is what they used to say about the entrails of a goose.

Senator PROXMIRE. I didn't get that. That is what they used to say about what?

Mr. STEIN. The entrails of a goose.

Senator PROXMIRE. Oh, the entrails of a goose? Oh, yeh.

Representative BROWN. Alexander built an empire on it, didn't he?

Mr. STEIN. And where is he now?

Senator PROXMIRE. Well, I hope you produce a goose with a lot of guts for Mr. Greenspan.

Mr. STEIN. Well, let me answer your question.

Senator PROXMIRE. With respect to prices and unemployment and GNP.

Mr. STEIN. Well, we believe, as we have said earlier, that the unemployment rate will rise into the range of between 5½ and 6 percent. We say in the appendix we submitted, Mr. Chairman, that we expect the inflationary rate will decline by the end of the year to the neighborhood of 7 percent.

And in the material we have submitted, we have submitted a fairly complete explanation of the methodology by which we arrived at such an estimate. There is some suspicion that we pick it off the ceiling and that isn't exactly true.

But, we hope that your staff will study that explanation and the way in which we arrived at this projection.

With respect to the GNP, we think that it will be rising during the remainder of this year and next year. We think it will be rising during the remainder of this year, in any case, at a rate somewhat below our normal growth rate, that is, somewhat below 4 percent.

Of course, we found in the second quarter that there are mysterious things going on in this statistic also.

Senator PROXMIRE. Well, the arithmetic of that suggests that we are going to have an overall decline in real production, in real GNP for 1974, because in the first half, we had a drop of 4 percent annual rate and presumably below the 4 percent in the second half will net us out to an actual decline in production.

Mr. STEIN. I think there will be a small minus, yes.

Senator PROXMIRE. A small minus? Well, I don't want to harp on this too much, but I think it is necessary to just spend a minute more on this question of who is going to sacrifice.

Yesterday, we pointed out that the administration has been dominated—the so-called Economic Cabinet, if you want to call it that, and Mullaney in the New York Times listed them on Sunday—he pointed out the administration is dominated by businessmen. Your successor is going to be a man who is retained by 100 of the biggest corporations in the country and he has indicated that he intends to go back to his business after he serves as head of the Council of Economic Advisers.

So, I would think that we can expect the administration will continue to be very sympathetic and understanding and I think unbalanced over on the side of big business.

Professor Eckstein of Harvard pointed out this week that the effective corporate tax rate had declined from 43.5 percent in 1961 to 35.6 percent last year. Now, that is because of the advantage being taken of tax shelters and so forth. It indicates a tremendous easing of the burden on business.

I am wondering, in light of that, when we cut the budget, if we shouldn't think about reducing subsidies to business as sharply as we can, rather than leaning on public assistance to the poor and disabled and medicare and medicaid and food stamps and aid to education and housing and health and so forth?

Mr. STEIN. Well, in the first place, Senator, I guess there are three kinds of questions.

I don't think that the person who has been in business should be regarded necessarily as biased on the side of business, I think that is a matter which will vary with individuals and you would have to know something about the individual in order to answer that question. You can't cast aspersions on a whole class of people.

I think as far as Mr. Greenspan is concerned, he has not been a businessman. He has been a consultant to businessmen. I don't look upon myself as being a businessman or sharing in the prejudices that may be common to them, anymore than I would that a psychiatrist whose clients were mainly businessmen shared their prejudices.

And as far as Mr. Eckstein's estimates go, I haven't seen that and I am not sure whether in calculating the effect of the rate of tax on business profits, whether he made these adjustments for the effect of inflation on profits that we have just been talking about and that Mr. Fellner just talked about.

Mr. FELLNER. I am certain he did not, judging by that figure. I am certain he did not make those adjustments I was discussing a few moments ago. I haven't seen his calculations, but the figure suggests to me that it is the book profits that he is relating this to and those are now significantly overstated.

Senator PROXMIRE. The average effective corporate tax rate declined from 43.3 to 35.6.

Mr. FELLNER. In relation to what profits?

Senator PROXMIRE. That is a sharp drop.

Mr. FELLNER. In relation to what profits?

Senator PROXMIRE. The rate in relation to the profits of 1961 and the profits in 1973.

Mr. STEIN. The question is whether the profits that he is relating the tax to are the profits adjusted for the effect of inflation or the profits not adjusted for the effect of inflation, since this makes an enormous difference in the estimating of the level of profits.

Senator PROXMIRE. Well, it sure does. It makes it inversely so. The fact is, for the average wage earner, that his taxes went up because he has been drawing the same real income now that he was 7 short years ago, and he has to get instead of $10,000, $13,000. The percentage of taxes that he pays of his income is higher and his after-tax income is less.

So, in this case it is the reverse.

Mr. STEIN. No, it is not the reverse. It is the same kind of thing. In the presence of rapid inflation what is reported as $100 of profits may be only a $50 profit, when you have adjusted for the fact that to replace his inventory, it will cost him 20 or 30 percent more than he charged them off at and then to replace his capital may cost him 50 or 60 percent more. There are estimates of that.

All I am saying is we doubt that Mr. Eckstein has made that calculation.

But, anyway, the real key to your question I suppose is: Would I be in favor of reducing the subsidies for business? I would say that is not a general category of expenditures, but I would certainly want to look at them and not consider them sacred cows or invulnerable to cutting.

Congress is now considering something that will not appear in the budget, but this is kind of a preference type thing, and that is a proposal to require that a certain amount of oil be carried in U.S. bottoms. That, I suppose, will help certain classes of business in the United States, but it is inflationary and an unnecessary kind of thing, which we have generally opposed.

We encounter a lot of legislation which is——

Senator PROXMIRE. Well, I think that is right. I think the Congress is at least as much at fault in these areas as the administration and maybe more. I am at fault in some of these areas and other Senators are in others. We get pressure from our constituents.

What I am trying to get at though, is you are the top professional economist in our Government. I want to know where you would advise us to cut, if we are going to cut our budget by $5 billion, which I take it you support. So where are we going to make a cut? You should be able to give us that advice from an economic standpoint faced with the inflation problem and faced with an equity problem.

Mr. STEIN. I don't think that is an economic question. That is a political question.

Senator PROXMIRE. Well, maybe I didn't make clear what I am asking. What I am asking is given the determination to try to meet the inflation problem as effectively as possible, which takes a considerable amount of economic expertise and I think professionalism, and given that assumption, where would you recommend to us that we make our reductions in the budget if that is our purpose, if that is our end?

Mr. STEIN. Well, I think that is a question I can't answer. I don't think it is appropriate for us to answer.

Insofar as the administration has a view, the administration will present it.

As I indicated, it is not a matter that can be answered by technical economic analysis, because technical economic analysis will not tell you how many missiles or how many submarines you need. That is a question to be——

Senator PROXMIRE. You see what I am trying to get at? Is it not true that some forms of Government spending are more inflationary than others and that some do not produce any economic goods, and that some in the form of Government spending, dollar-for-dollar, may result in a greater inflationary impact than other expenditures?

What comes to my mind right away is the area of manpower training. If you can train people who are unskilled so that they can then enter the work force and increase the supply of skilled workers, of workers who are needed, it seems to me that that is a productive expenditure by the Federal Government, and you can increase housing when there is a shortage of housing.

On the other hand, if you build aircraft carriers or a space telescope to see the end of the universe, this may satisfy a certain group and it may be necessary, but from an inflation standpoint, it is not a useful expenditure?

Mr. STEIN. That kind of criteria is not sufficient criteria for making a decision. Because if we should decide that having 1,000 ballistic missiles was more inflationary than having 1,000 vocational training schools, but also that in not having 1,000 ballistic missiles, it meant the end of American civilization, then there wouldn't be much concern about the inflationary difficulties. So you have to take a lot of things into consideration and I am not going to answer your question.

Senator PROXMIRE. Well, we are talking about a $5-billion cut and a 2-percent cut in this budget. We are talking about cutting the marginal programs. There is no reason to think that we are talking about cutting off defense or for that matter cutting off the welfare program.

I am asking for where we feel we can cut marginal programs.

Mr. STEIN. When you say it that way, then the question becomes largely one of more rigorous administration and it doesn't really involve what I think you are saying, or what I get that you are saying.

You are saying what is involved here is not making the choice between the defense and welfare, but seeing whether there is some fat in the welfare program or the defense program and can we cut these things out and that is a problem which has to be met day by day.

The President has said in his speech that he regarded his policy to be applied to all agencies, without exception. I interpreted that to mean without exception, to mean by the Defense Department or anybody else.

Senator PROXMIRE. Well, it is good to hear that. You say including the Defense Department.

Congressman Brown.

Representative BROWN. Mr. Stein, I looked through one of the things that you do publish, which is the "Economic Indicators." I find it very limited in the amount of material given to the question of savings. It seems to me you might get some improvements in this before you return to the academic community, if you would recommend some suggestions and one is some more attention to this question of savings and the encouragement of savings.

You could help, I think, if you would come up with some—since we have real income considered—I think maybe we ought to have a real-profit figure, a real-budget figure, and a lot of other things, but would give us a clearer picture of what circumstances really are basically on inflated dollars presently.

My question is, What are the sources of savings that we can get and how can we encourage savings if we accept the fact that it is a good idea at this moment, and that it will give some encouragement for the expansion of industry to meet the shortages?

To the extent that we reduce shortages, we reduce unemployment attendant to the shortages. So do you have any suggestions?

Mr. STEIN. Well, as I have indicated earlier, this will be a subject for consideration in the study the President has asked to be made on capital requirements and ways to meet them. It is a very difficult question.

The President, in his speech the other day, appealed to the public to increase their savings. I think that was a useful and important thing to do, although it does not appear usually in an economist's list of instruments.

Representative BROWN. As a matter of fact, this statistic would indicate that it is unusual in this inflation time that people have maintained their savings to some extent, rather than living off their savings. The statistics indicated in the figures that you have here that the drop in savings has not been precipitant or as precipitant as it has been in previous times of increasing inflation.

Mr. STEIN. That is true. The savings rate has remained rather high. Of course, as you may know, we have a rather startling revision of the savings which came out just a month ago or a few weeks ago and which totally changed the picture we had of last year's savings. It is possible this may be revised out of our history before very long, too.

But, as I indicated earlier, total private savings do seem to be a rather stable proportion of the GNP. Now with a considerable effort during World War II, Congressman Brown, we achieved very substantial increases in the savings rate. We don't know to what extent this was the result of other factors and forces at work, especially including rationing, but it may be that some public campaign led not only by the President, but by others, would convince people of the value of savings, both for themselves and for the country.

Representative BROWN. Now, may I make one other observation here?

There is also a choice as to where those savings go. According again to your booklet here, published at the beginning of this year, that choice has been fairly clear against investment in corporate equities over the last few years, about the last decade.

The reduction in investment of savings in corporate securities has been notable and it is increasing. It explains to some extent what has happened to the stock market, I assume. Where are those funds going? Are they going into Treasury notes? Do they relate to productivity? Is that what we want in the way of productivity; that is, to have funds flowing out of corporate investment?

Mr. STEIN. No, I would think not. I would think from the standpoint of the growth of the economy that we don't want savings to flow into financing Federal deficits. We want savings to flow into financing business investments, although it must be recognized that there is some part of Federal expenditure which contributes to economic growth.

But, by and large, it would be better, it seems to me, if we weren't absorbing savings in the financing of the Federal deficit.

Now, as far as the equity situation is concerned, I think that this partly goes back to a point which kind of got lost in all of the argument before about profits. That is, that no matter how you measure the profits, even if you measure the profits without adjustment for the inflation effect, that we have a profit rate which as part of the national income has been trending down for quite a long period. I think this has encouraged investment in equities as well as it has reduced the amount of internal funds available for business.

Representative BROWN. Now, the interest rates on servicing Federal debt have been trending upward, so I gather what we are doing is getting people out of investment in businesses in this country and getting them into the investment of Federal funds so that the Federal Government now has this two-thirds share of the capital market. And in a way, by those economic policies, I think we are denying to individual citizens some of their free choices in how they spend their money and we are letting these major decisions about what goes on in our country be made by the Government, aren't we? Isn't that the impact we are having here?

Mr. STEIN. Well, the impact is that we are absorbing through the deficit, some part of the savings that individuals would otherwise invest at their choice, as you have suggested, and largely in business investment, either direct or indirect, but partly in housing.

Representative BROWN. We are discouraging productive investment by our policies?

Mr. STEIN. Yes, I must say we are somewhat mystified by this two-thirds figure, which I heard here; about this two-thirds of whatever it is; this two-thirds of the supply of credit being absorbed by the Federal Government. It doesn't seem to us that can be the net figure, but I would want to look into that a little more.

But, the fact is a deficit absorbs funds that would otherwise be invested. That is the classic argument against deficits.

Representative BROWN. Well, I just jotted down here on a piece of paper sources or methods by which we could encourage savings. I put profits, depreciation, reducing Federal expenditures, which would free capital at least for investment in some more productive method. I put tax policies, which would stimulate market investments by individual citizens.

Finally, I put tax policies, which would encourage money in savings and loans and in bank deposits. I also put policies which would encourage pension plans and that sort of thing.

Now, we have increased our savings in pensions plans over the last few years, but right now we are having a little disinclination to doing that, by taking it out of savings and loans and I assume, to some extent, out of banks if we are running into liquidity problems in the banking institutions?

Mr. STEIN. Yes, well the funds are going into other forms. I think the critical question here is the extent to which these tax devices affect the direction in which the savings go, as distinguished from affecting the total applied savings. The total applied savings seem much more difficult to influence than the direction in which they flow and it is possible that a way could be found to influence total savings.

Representative BROWN. Is our policy of broadening a consumer credit a savings policy or is it a policy that discourages savings?

Mr. STEIN. Well, I find that a hard question to answer. If you look at a person over his lifetime, consumer credit probably does not increase or decrease his total savings. It affects the time in his life in which he makes certain purchases, but it isn't clear to me that it has an effect overall for the economy as a whole in either direction.

Representative BROWN. One final question for Mr. Seevers to finish our discussion of the economic picture.

Some emphasis was given by Mr. Rush yesterday of the impact on the economy in general of inflation and particularly on the increase of acreage and the lifting of restrictions on plantings and so forth.

Can you give me now or later some specific information about what impact that has had both on available produce, in other words, what increases there have been in the grain market or in the grain production because of that, and also what the economic impact of it has been in this first year that policy has been pursued?

Mr. SEEVERS. To answer your question, in short, we have released 60 million acres over 2 years; 33 million acres have come back into crop production. This represents an addition of about 10 percent to crop acreage. Crop production this year is expected to be 8 to 10 percent higher than 2 years ago according to current estimates.

Representative BROWN. One final question to Mr. Stein. Are you going to be happy to get back to the academic life?

Mr. STEIN. Well, this will be a new experience for me. I have never been a professor before. I am sure there are things I would miss, like these hearings.

Senator PROXMIRE. Mr. Stein, I just have one question I want to concentrate on, and then I am through.

The President suggested in his speech that if all of us could save 15 cents out of $10, that this would be a great contribution in fighting inflation. I understand that this is something that you suggested or wrote or at least had something to do with, and that you approve.

Yesterday, Mr. Sidney Jones, who, as you know, is the top staff assistant to Mr. Rush, was here. He, in part, at least, disagreed, and others have indicated that if everybody—well, the President didn't ask everybody, as you pointed out—but they have indicated if most—and the President indicated he hoped most—would follow the President's advice, it could create a serious problem. You already said you expect unemployment to go up between 5½ and 6 percent and you have indicated you expect the economy to grow less than the normal rate in the next 6 months.

Under these circumstances, wouldn't it be better to suggest the areas of shortages in which consumers should not buy, like oil and air conditioners, and that kind of thing, rather than just to save a certain percentage?

If people don't buy many things, it could be disastrous, the housing industry is already in bad shape and automobiles too. Many other industries are far below capacity. As I pointed out, we are suffering an unemployment problem now.

Mr. STEIN. Well, the 1½ percent was intended to indicate that a rather small change of a person's consumption would have an effect that was comparable in size to what we regard as a very big change in the budget.

You have criticized us for not going further in cutting the budget and for not cutting it to $10 billion rather than $5 billion. What this would indicate is that a cut of one-half of 1 percent in consumption expenditures would have an effect that equaled to that extra $5 billion in the budget cut that you would like to make.

Senator PROXMIRE. I think there are quality cuts. You and I may disagree on this, but I think there are unproductive areas and also fat and wasteful programs that the Federal Government can cut out, or areas where the Federal Government can cut.

Mr. STEIN. Yes.

Senator PROXMIRE. On the other hand, if you get the consumers not to buy, it can have an effect in areas where we need employment and where capacity isn't being utilized.

Mr. STEIN. Well, there are areas of fat, I am sure.

Anyway, to go back to your question—we were not suggesting 1½ percent as a guide to anybody, but merely were indicating that a rather small action here would have a significant effect on the economy.

Now, it seems to me there would be three kinds of effects and the most important would be quite the opposite of what you suggest about housing. It seems to me that what housing is now suffering from is the lack of availability of funds and the high cost of funds. So I think a move to increase savings just as a move to reduce the Federal deficit would be beneficial to housing and would also be beneficial——

Senator PROXMIRE. Well, not automatically. It depends on where the savings go. If people put their savings into city corp-type obligations, if they make their savings primarily available to corporations, it is not going to help housing.

Mr. STEIN. But, there is a market at work there. If they put their money into Citi-Corp, then the rates of return on Citi-Corp, the rates of return on the Federal debt, if that is where they put their money in, then those rates are going to decline and they will decline relative to the rates on savings and loan deposits or mutual savings, bank deposits and some flow will then go there. This is a big pool and money flows around.

Senator PROXMIRE. Let me ask you this. When you said that unemployment might go between 5½ and 6 percent, did you make the assumption then that the President's advice would be followed and that people would save an additional 1½ percent of their income?

Mr. STEIN. Well, this estimate was made earlier; this estimate of 5½ to 6 percent was, but——

Senator PROXMIRE. Then what you are telling us if they followed his advice, unemployment might go over 6 percent? Is that true?

Mr. STEIN. No; you haven't let me finish my explanation of what happened. In the first place, $12 billion annual rate is about the value of 300,000 houses or something like that; 300,000 or 400,000 houses. So savings would have this effect, I believe, on housing.

The second effect that we count on is that prices would rise less rapidly. The ideal thing would be that consumers would spend less money and that prices should rise less rapidly and consumers should buy the same real quantity of output at prices which aren't rising as much.

Senator PROXMIRE. But, in so many of these areas, prices are rising even though production is falling and sales are dropping. That is true in oil and it is true in a number of other areas.

Mr. STEIN. Well, that is a matter of more or less. You see, it seems to me that the situation is exactly the same as if you proposed a $5 billion larger budget cut as if we proposed some kind of savings.

I suppose if we should see evidence that this cut in personal savings was of a magnitude that it would seem to threaten a major departure from the unemployment path that we foresee, we would go on television and make another speech.

Senator PROXMIRE. Well, thank you very much, Mr. Stein. I very much appreciate your testimony and I am sorry that you are leaving the Government, but I am hopeful that you will return often and appear before this committee in perhaps a more objective capacity as a professor and continue to regale us with your wit and inform us with your wisdom.

Mr. STEIN. Thank you very much. I hope I will be invited.

Senator PROXMIRE. The committee will stand in recess until 10 o'clock Thursday morning.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, August 1, 1974.]

[The following additional information was subsequently supplied for the record by Mr. Stein:]

"FACE THE NATION" [1]

(Guest: Herbert Stein, Chairman, President's Council of Economic Advisers. Reporters: George Herman, CBS News; Joseph Slevin, the Philadelphia Inquirer; and Mitchell Krauss, CBS News)

Mr. HERMAN. Dr. Stein, as Chairman of the President's Council of Economic Advisers, you've said that what we need to fight inflation is more of that old time religion, the mixture and the course as it is now, continued—continued for how long?

Mr. STEIN. Well, I think we have to be prepared to continue for a long time, and I think one thing that must be said is that we don't really know how long. But I think in terms of years, not months—that is, three, four years, and more or less indefinitely we have to follow a policy of much greater discipline than we have followed in the recent past.

ANNOUNCER. From CBS News, Washington, a spontaneous and unrehearsed news interview on "Face the Nation," with Herbert Stein, Chairman of the President's Council of Economic Advisers. Mr. Stein will be questioned by CBS News Economic Correspondent Mitchell Krauss; Joseph Slevin, National Economics Columnist of the Philadelphia Inquirer; and CBS News Correspondent George Herman.

Mr. HERMAN. Dr. Stein, you've indicated that—your opinion, at least—that we may have to continue on our present course of old time religion, a rather considerable government austerity, for three or four years. My experience watching you economists at work is that nothing is ever static; everything is always dynamic. If we continue on the same course for three or four years, what will happen to our economy, to unemployment, to all the other factors in it?

Mr. STEIN. Well, I think the basic point is that we need a period in which the economy is not in an exuberant boom—exuberant boom in which the economy is not rising too rapidly, in which it is fairly steady with some degree of slack in it. And I think if we have such a period, we will experience lower rates of inflation than we've had. And as we have this experience of lower rates of inflation, there will be an unwinding process. People will expect lower rates of inflation in the future. They will not demand such big wage increases; they will not be running out to buy things in the fear that prices will be so much higher a year from now, and that will make it easier for us to get along, both with a lower rate of inflation and with a very high level of economic activity.

Mr. SLEVIN. Well, Dr. Stein, an important part of your old time religion is very high interest rates. They're at record peaks now; they went up again last week. How much higher is the administration prepared to see these rates go?

Mr. STEIN. Well, of course, the administration doesn't make these interest rates; it doesn't determine what they should be, and it doesn't even determine those aspects of policy which are closest to affecting interest rates—namely, the monetary policy, which is determined by the Federal Reserve. But I think what I would say in answer to that question is that we should have a moderate rate of monetary expansion, and the interest rates will be what they will be; that is, I would not interfere and try to hold them down, either by putting a ceiling on them or by trying to pump in more money, even if they went a good deal higher. But I think the basic point is that as the inflation rate comes down—as we think it will—and as people become more confident that the inflation rate is not going to speed up again, we will see lower interest rates. And that is the only way that we're going to get interest rates down.

Mr. KRAUSS. Mr. Stein, haven't these interest rates, in effect, been inflationary? Business is passing on the higher cost of borrowing its money to the consumer, as it's passing on most other increased costs.

[1] As broadcast over the CBS Television Network and the CBS Radio Network, Sunday, July 7, 1974—12 noon–12:30 p.m., e.d.t. Origination: Washington, D.C.

Mr. STEIN. Well, there are two aspects to the effects of interest rates. There is the cost increasing effect, but there's also the effect of reducing expenditures, reducing business expenditures for investment, as compared with what those expenditures might otherwise be. It reduces housing expenditures, as is well known, expenditures for the construction of new houses. And this tends to restrain the total demand for output, the total demand for labor, and is anti-inflationary in its net effect.

Mr. KRAUSS. But isn't it true that this demand is being restrained on the part of the small buyer, the small person, the middle income person, not on the part of big business; big business has been borrowing at these higher interest rates; its increased its borrowing, it's the small businessman who pays 14 or 15 per cent; it's the small homeowner who can't get a mortgage?

Mr. STEIN. Well, I don't think there's any difference in this respect between the small homeowner and the big homeowner. And I'm not aware, at least, of any evidence of difference between big businesses and small businesses. You know, what you say is that there's a general proposition that it's better to be rich than poor, and that's true now as well as in other cases but—other circumstances—but it's not more true now than in other circumstances. Anyway, we are seeing some restraint in the economy as a result of the tight money policy, which I don't think is excessively tight. I think people have an erroneous idea of how high interest rates really are, because if prices are rising by, say seven to ten per cent per annum, an interest rate or mortgage rate, say, of nine and a half per cent is not an extremely high rate. It's not as high a rate as—as to be paying six per cent mortgage interest when prices are rising by one per. cent.

Mr. KRAUSS. If you can get a mortgage.

Mr. STEIN. Well, you see, it's the hight interest rate that permits you to get a mortgage. Most people who are willing to pay these rates can get mortgages. And if we tried to hold these rates down, you certainly wouldn't be able to get any mortgages.

Mr. SLEVIN. Well, with housing starts dropping as rapidly as they are, there must be a great many people who can't get mortgages, Dr. Stein.

Mr. STEIN. Well, I think there are a great many people who don't feel it worthwhile to get a mortgage, to—and to buy a house at the present interest rates. I don't think we have so much a situation of impossibility of getting the money, as a situation of high rates, which is discouraging some people. But of course, we have—well, you know, we have to discourage some kind of activity. I think that's a basic lesson that we have to tell people about inflation—that it's that we have no easy way out of this. We have no way of getting out of the inflation which permits everybody to go on doing everything that he would like to do, and also hold the rise of the prices down.

Mr. HERMAN. Okay, that brings me back to my original question to you. And what I would like to do, rather than picking at it item by item, is to ask you—as an economist—what is the cost of three or four or five years of old time religion? Who is going to be hurt and how much? What are the prices some people are going to have to pay?

Mr. STEIN. Well, there will be prices which are fairly well distributed among the population. You see, there is a kind of view that if the unemployment rate goes up from four and a half per cent to five and a half per cent, there is a certain number of people—800,000 people out there—who are permanently unemployed and suffering destitution. That isn't the case at all; when the unemployment rate goes up from four and a half per cent to five and a half per cent, what happens is that the average period for which people who are employed—are unemployed—goes up from, say, from eight weeks to ten weeks or something like that. So things will not be quite as easy. It will not be so easy to get a job, but this will mainly affect the duration of unemployment, the problems that young people have, and so on. There will be—business profits will not be so easy to come by, but we think there will be a compensation for the great body of the American people.

And this is, of course, not a choice for an economist to make; the American people have to decide, do they want to go on with an accelerating, with a speeding-up inflation, up to a point where they obviously will not want to continue, or do they want to stop it?

Mr. HERMAN. I understand. The question is, who is going to be hurt? Anything that is difficult to achieve requires somebody to pay some price.

Mr. STEIN. That's right.

Mr. HERMAN. Are certain classes or income groups, for example, going to be more adversely affected than others?

Mr. STEIN. No, I don't think this is a matter that will be—where the consequences will be distributed by income groups. The consequences may be rather erratically, randomly distributed. Everybody will not be equally affected; every individual will not be equally affected. But I don't think one can say that it will be poor people rather than rich people, city people rather than rural people, or any other large class. It will be fairly widely distributed.

Mr. KRAUSS. Well, Mr. Stein, are you saying that the American public is responsible for this inflation? It's their fault?

Mr. STEIN. Well, I think in a basic sense this is true, because government policy operates within the limits of what the American people want and will tolerate. And I think that we've reached a point—I think the critical point in the past—well, we've had several critical points. In the early days of this inflation, in 1965 to 1968, it was considered that the American people would not stand for a tax increase, even though we were increasing government expenditures very much. So the government then in power, responding to what it thought the American people wanted from them, deferred action to raise taxes, which might have slowed down inflation, for about three years. Now this doesn't mean that the American people were voting explicitly for inflation, but being so reluctant to have a tax increase, they created the conditions.

And we had a similar thing in 1971, when we felt—and I think if you'd looked around the country then—that there was great impatience with the slack in the economy, with the rate of unemployment, with the circumstances which were working to slow down the inflation.

Mr. KRAUSS. Well, are you recommending then that people not buy a new car, that they not buy a vacation, that they not spend higher prices for an item that they'd planned to buy, in order to curb inflation?

Mr. STEIN. Well, I don't really have very much confidence in that kind of thing; that is, I think that people should manage their own affairs in the light of what they think is best for them, and that it is the responsibility of the government to create conditions in which their decisions add up to a policy that is best for the stability of the economy. So I'm not one to go around preaching to people about how they should manage their lives for the sake of the national economy. I think, on the other hand, we as a government should not be putting five or ten billion dollars more money into their hands by tax reduction, which they will just go out and spend and bid up the prices of things.

Mr. SLEVIN. Well, if you think people have too much buying power, wouldn't it be a good idea to increase taxes then?

Mr. STEIN. Well, certainly that's a matter that needs consideration. I think—our belief is that by restraint on the spending side of the budget, we will achieve the degree of restraint that's needed. There's one point I should make about the old time religion talk, which is a talk about restraining the expansion of the economy, is not a policy—the old time religion did not involve self-immolation; that is, it did not involve putting the economy through such a terrific squeeze that it creates a depression or a recession. So we want a course of moderation, and we think we can achieve that without a tax increase. But I think it was pointed out the other day, that if the expenditure side is not kept under control, we will have to consider tax increases.

Mr. SLEVIN. But aren't you putting a disproportionate part of the burden on the Federal Reserve System and high interest rates by not having a tax increase and not having a budget surplus?

Mr. STEIN. Well, I don't think so. It's very hard to measure these quantities, as you know. We are having a moderate expansion of the money supply. As we've indicated earlier, there has been a considerable expansion of bank credit and of borrowing; so that we are not now carrying on an excruciatingly tight monetary policy. We are having a policy which is moderate, I think, in both respects.

Mr. HERMAN. Can America do this alone? Is this inflationary pressure that comes from all around the world and that we cannot fight single-handedly?

Mr. STEIN. Well, I think it would be much easier for us if other countries were also engaged in this effort, and I think that one of the most encouraging things about the present situation is that they are engaging in this effort. There is now in the major countries the same kind of realization that there is now here in the United States that the speeding up of the inflation has to be stopped. I find this as I go to international economic meetings that the main governments are taking a line very much like ours, but we are not bound to the chariot of the world inflation. It influences us, but we can have a degree of independence, and you can see that we, and the Germans and some others have much less inflation than the average of the world, much less, say, than the Japanese, and so there is room for some difference in rates of inflation. But it would be better if we all worked together on it.

Mr. KRAUSS. Mr. Stein, a little over a month ago Kenneth Rush was installed as the coordinator of economic policies, sort of a fifth member of this economic policy group that advises the President. Now what has happened since his appointment to change the course of our economic development this year? Has there been any positive benefit in your view?

Mr. STEIN. Well, I think what has happened is that we are kept in a situation in which we have ample discussion among ourselves and in which the President gets our varied views. We have not changed the direction of our policy and I don't think it was intended that Mr. Rush should change the direction of our policy. I think it was intended that he should make sure that we give the maximum consideration to the alternatives, and in fact he is playing a role which was formerly played by Secretary Schultz, so the presence of such a coordinator or leader is not new.

Mr. HERMAN. Is he privy to some arcane economic secrets which we shouldn't know about?

Mr. STEIN. Well, if he is, he hasn't told me.

Mr. HERMAN. I'm just curious as to why he should at the President's order claim executive privilege on these matters of economics which you and all the others disclose so freely, or discuss at least so freely?

Mr. STEIN. Well, I think this is a matter primarily of the precedent which is involved in having a person who is the counselor to the President who is not confirmed by the Senate, who has no agency established by the Congress, and having him testify and respond at the call of a congressional committee. He's indicated that he is quite willing to talk with them informally and tell them everything he knows and what he's thinking, but that he doesn't think it would be a proper precedent for him to cross over this line of the separation of powers with the Senate—the Congress.

Mr. SLEVIN. Dr. Stein, you're an economist. Mr. Rush was a lawyer and then he became a corporate executive. He was in the State Department when the President tapped him for his present job as chief economic advisor. These, as you've just indicated, are extremely difficult times, with rampant inflation, slow production. Does Mr. Rush know enough about economics to be the President's chief economic advisor?

Mr. STEIN. Well, Mr. Rush receives the advice and the contributions, the inputs and the information, from the Council of Economic Advisors, from the Treasury, from the Office of Management and Budget, and from such other agencies as may be involved. He participates in the discussion of them, and he formulates some judgment of his own, and helps to assure the orderly transmission of all of our views to the President, so that he is not in the exclusive position of making these economic decisions, where there are disagreements among us. But of course it has always been the case that in the end the economic policy decisions of government are not made by economists. My great professor, Jacob Viner, used to say about the expert in government that he should be on tap and not on top, and I think that is our position right now.

Mr. SLEVIN. But shouldn't the President get economic advice, not what has been filtered through as the non-work of economists? The work of non-economists?

Mr. STEIN. He is getting the advice of the economists. He is getting the advice of others; after all, the other people involved here have a great deal of experience in the economic world of this—in the economic activity of the United States, and he is not suffering from any monopolization of the advice that goes to him.

Mr. KRAUSS. Mr. Stein, beneath the surface attitude that everything will eventually be all right, isn't there lurking really serious fear that the economy is in worse shape than it appears on the surface? For instance, Alan Greenspan, a man most likely to succeed you, at least his name has been referred to as a possible successor when you leave the Council this summer—has said that we are facing massive economic disruption, conceivably if the present high interest rate level continues, the effect on banks in this country and abroad? We have already seen some indications of a problem of not having sufficient liquid assets. Aren't we heading toward the possibility of a very serious recession if this medicine is delivered in too large quantities?

Mr. STEIN. Well, I don't think so, but I don't want to be in the position of saying that everything is going to be all right. We have a olt of problems. We're in the business of dealing with problems, and there are going to be disappointments, as there always have been. I think that the American economy and the world economy is very strong and I think that we have government policies here and abroad which will assure us that we don't have any world depression or a world recession. In fact, I think the likelihood of that is smaller than it seemed earlier in the year. But we have difficulties. I think there is a semantic problem here, that is, you can emphasize that there are going to be difficulties, but if you look back at the course of history. I think you will have to say that there is every reason to expect that the American people and the people of the developed world as a whole will be better off economically three years from now, five years from now, 50 years from now, than they——

Mr. HERMAN. You mean things couldn't be worse.

Mr. STEIN. —than they are today. No, what I mean is that we are on a rising tide of economic welfare in this country, which has been going on for a long time. We are going through a very, very minor ripple in that rising tide of economic welfare, and I see no reason to think that will change.

Mr. KRAUSS. Mr. Stein, a recent University of Michigan study said that up to 40 percent of the American population were eligible for some form of poverty assistance over the past six years. Now that doesn't sound as if everything is as healthy as you portray in this country.

Mr. STEIN. On the contrary, that's not a measure of the increase in poverty, that's a measure of the increase in assistance. We have fewer people in poverty than we ever did before; we're just more generous in looking after them.

Mr. SLEVIN. How are we going to meet all the demands that are going to be put on the economy over, say, the next ten years, Dr. Stein? We've got electric utilities now that apparently can't borrow enough money. We've got great investment needs for anti-pollution purposes, for welfare. Where is all the money going to come from?

Mr. STEIN. We are not going to meet all the demands that are put on the economy, and we never have—that's the nature of economics. Economics is the science of scarity. The first thing you learn about economics is that things are scarce; if things are not scarce, they are not the subject of economics. And that will be true in the future. Even if we will have 20 years from now twice as much as we have now, it won't be as much as people will want, and the basic problem is to decide which of these things we should do.

Mr. HERMAN. Is part of economics then scaling down the peoples' expectations? Or the rate of speed of their growth of expectations?

Mr. STEIN. A part of economics which is very important in a democratic society, as the society becomes increasingly democratic in its operation, is that people should understand the limits to what they can demand of the system, and if they demand more of the system than it is capable of producing, and get the government to pump out money to them in an effort to permit them to meet these demands, we will have endless inflation, and that is just what is causing the inflation around the world today.

Mr. HERMAN. Dr. Paul McCracken, who was your predecessor in the Council, said recently after a meeting of economists talking about the world inflationary picture that it stemmed in the western nations at least from the weaknesses of their governments in not being able to successfully resist the pressures of the people. Is that an accurate study?

Mr. STEIN. Well, I don't think we expect democratic governments to resist the pressures of their people. We expect that democratic governments should respond to the desires of the people, but should also educate the people, and that's what we have to go through now—I mean, military dictatorships can resist the pressures of their people—they have no inflation by and large, at least no open inflation. We have a more difficult problem. As Thomas Jefferson said, if you expect the country to be ignorant and free and manage its affairs wisely, you should not—you expect something that will never happen.

Mr. HERMAN. It seems to me the military junta in Brazil had the worst inflation in the world for awhile there.

Mr. STEIN. Well, it was the military who brought it down. It went up to 80 percent, and then we got a military dictatorship and brought it down—they got.

Mr. KRAUSS. Referring to Brazil, a country that introduced what is called indexing, tying the cost of living to wages—do you favor having cost-of-living escalator clauses generally in labor contracts, so that the worker tends to benefit, or at least not hurt when prices go up?

Mr. STEIN. Well, I think that's a matter of negotiation between the worker and his employer, and if they come to an agreement about that, I would certainly have no objection to it. I think the question is, how much is the worker willing to pay in the form of wage increase for this additional security, and as far as we can see he hasn't been willing to pay very much. On the question more generally, I don't think we should accept living in a high and rising rate of inflation. We should not at this moment be putting our main efforts in learning to live with that, but we should be putting our main efforts in slowing it down.

Mr. HERMAN. Over the past few years, I gather, from the administration people that I've talked to, labor unions are generally credited with considerable restraint, holding their wage demands down to the government guidelines more or less, advocated by the administration. Now there are no guidelines. The unions are pressing for bigger wages. Do you see any way of slowing down this as a factor in increasing inflation?

Mr. STEIN. Well, it is a matter of great concern to us. I think the basic way in which we will slow this down or prevent its explosion is to maintain a general economic environment in which the demand for output is not so strong that all employers are sure they can pass on to their customers any wage increases they give to their workers. We don't think we can do this by guidelines any more. We don't think that the labor people would cooperate in such a program, and I'm not sure it would be wise even if they would.

Mr. SLEVIN. Do you have a single, very brief suggestion for your successor as Chairman of the Council of Economic Advisers?

Mr. STEIN. Well, I guess I would just urge him to stick with the old-time religion.

Mr. HERMAN. And appear on Face the Nation. Thank you very much, Dr. Stein, for being with us today.

ANNOUNCER. Today on "Face the Nation," Herbert Stein, Chairman of the President's Council of Economic Advisers, was interviewed by CBS News Economic Correspondent Mitchell Krauss, Joseph Slevin, National Economics Columnist of the Philadelphia Inquirer, and CBS News Correspondent George Herman. Next week another prominent figure in the news will "Face the Nation."

THE POLITICS OF INFLATION

(Speech by Herbert Stein, Chairman, Council of Economic Advisers, Prepared for the American Enterprise Institute Conference on Worldwide Inflation, Washington, D.C., May 7, 1974)

At a recent ceremony awarding medals to about ten distinguished American scientists, President Nixon noted that there were no political scientists among them and went on to say, "There is no political science." This has two meanings. The first is that a true science cannot be influenced by political considerations. Probably everybody would agree with that. The second is that there is no science of politics. Presumably everyone except the few people who teach the subject would agree with that. I don't know whether the President would make the same statement about economics. I suspect that sometimes he would and other times he wouldn't.

Even if there is a science of politics I am not a student of it. I suppose I was invited to discuss the politics of inflation here because I have spent some time at the juncture of politics and inflation and can give some touristic impressions of the neighborhood which scientists may be able to verify and systematize if there is anything to them. Perhaps I was invited to give my true confessions.

Despite the emphasis of this conference on the worldwide aspects of inflation I shall talk mainly about the American experience. This is the only experience I have had the opportunity to observe closely. I hope that American experience is sufficiently typical, or if not that sufficiently dominant in the world picture, to justify its inclusion in this conference.

To discuss the politics of inflation has two implications. The first is that the rate of inflation is significantly affected by government policies which are determined by a political process. I suppose that this proposition would be generally accepted, although there would be differences of view about the extent to which the government's role is active or passive and about the channels through which the government's role is exerted. The second implication is that the political process brings about a wrong rate of inflation—presumably too high a rate of inflation. This implication is not obvious in the topic and may not have been intended. However, it is a very common belief among economists, and without it there is little to discuss. If the political process brings about the rate of inflation which is just right, given the economic conditions and background, the political process is a pure transparent medium, and cannot be said to cause or contribute to the inflation in any interesting way.

The important question is whether the political process generates too much inflation, and if so why. A rate of inflation in excess of zero is not necessarily too much. In any given historical situation, at least in the ones we have been living through, there is a cost in getting the rate of inflation down to zero. The benefit of doing this may not be worth the cost. So the mere fact of inflation does not serve to condemn the political process. The question is whether the costs and benefits are properly balanced.

It seems to me that the possibilities can be classified as follows:

First, we may get just the right amount of inflation. What this means is hard to say. One might think of it as the amount of inflation that the public would choose if it foresaw and understood all the consequences. But the public does not foresee all the consequences, and the consequences depend on that fact. The rate of inflation that would be optimum would be different with perfect foresight than with the real-world degree of ignorance. Probably the optimum rate of inflation is the rate the public would choose if they had perfect foresight in their roles as citizens but the actual degree of ignorance in their roles as private participants in the economic process.

Second, we may get the amount of inflation people want, rather than what is good for them or good for the country. That is, we may get the inflation we deserve. The usual explanation for this is underestimation of the evil of inflation, especially in comparison with the evil of the unemployment that may be required, at least temporarily, to avoid the inflation. And the reason usually given for this underestimation of the evil of inflation is that much of the evil will be in the future, especially as a consequence of the tendency of tolerated inflation to escalate. The public is said to be shortsighted and to undervalue future consequences.

I am sure there is a good deal in this theory of how we get so much inflation, but I am not sure how much. It is an overgeneralization to say that the public always underestimates the future. After all, the public supported the expenditure of tens of billions of dollars for space exploration, most of whose benefits will come in the future, if ever. The defense program may also be considered a vast investment in the future. It is true that in both cases there are special groups whose interest is immediate, however distant the national interest may be—the space-science complex and the military-industrial complex. There is no powerful anti-inflation complex, although the life insurance industry has played that role from time to time. Still the American public does have a strong aversion to inflation. All opinion polls for several years have shown inflation at or near the top of the public's list of national problems. Moreover, the American people tend to attribute to the inflation many evils for which it is not responsible. For example, they tend to exaggerate the extent to which the inflation has diminished their real incomes.

Nevertheless, it may be that while the American people rate the evil of inflation heavily they are unwilling to pay the price of stopping it, and this is only another way of saying we get the inflation we want and deserve. If so, the price they are unwilling to pay is not only and perhaps not primarily a price in terms of unemployment. In the period 1965 to 1968 when the seeds of the present inflation were planted the obstacle to anti-inflationary action was only partly fear of unemployment, which had fallen below the level even then considered a reasonable goal. On the budget side a tleast there was aversion to raising taxes on the simple but effective ground that taxpayers do not like to have their taxes raised. Again in 1973 there was consideration of a tax increase as a means of checking inflation. While there was much doubt that such a step would be timely, in view of the economic prospects, there was no doubt that the taxpayers would dislike it and Congress would, for that reason, almost certainly not enact it. This year we are faced with a suggestion for a tax reduction which carries with it the danger of more inflation. This proposal is being rationalized as necessary to combat unemployment, but if it is adapted it will be as much because people like to have their taxes reduced as because they are eager to stimulate the economy.

A third possibility is that we get not only more inflation than we should but also more than people want, but not more than the government officials, who are politicians, regard as optimum. There are at least two reasons why this might occur. First, the popular aversion to inflation makes it important for a government official to appear to be a champion in the struggle against inflation. This means that he must be associated with what the public regards as effective anti-inflationary action, which is not the same as really effective action. Specifically, for some time price and wage controls were popularly regarded as the height of anti-inflationary policies. Thus a political figure could gain the political advantages of an anti-inflationary posture by espousing controls without incurring the onus of more effective but less popular measures, and without delivering the restraint of inflation the public wants.

Second, while the public generally may have a strong interest in restraining inflation, particular sectors of the population may have even stronger interests in particular policies which are inflationary. These particular interests may weigh more in the political decision than the more general interest. Thus, we can go on for a long time following policies which push up food prices despite a general interest in controlling inflation. There is nothing surprising about this, and it is not necessarily wrong.

The fourth and last possibility I shall list is that we get not only more inflation than we should and more inflation than the public wants but also more inflation than the government officials or politicians want. This excess inflation would be pure error. It would be a mistake to underestimate the importance of error in the explanation of economic affairs. Two kinds of errors seem to me important. One is error in the estimation of inflationary consequences of particular policies. If the government official is told, and believes, that a certain course of action will lead to an inflation rate of three percent and he follows that course of action only to end up with an inflation rate of ten percent, the official can hardly be said to have chosen an inflation rate of ten percent. I think it has been quite generally true in the United States in the last ten years that policy makers had what turned out to be an unrealistically low estimate of the inflation that would be associated with the policies they chose, and that they got more inflation than they bargained for. I think it is probably also true, although this is speculative, that if the prospective rate of inflation had been more accurately foreseen the anti-inflationary policy would have been more rigorous.

This kind of explanation invites the question whether the forecasts were not themselves politically motivated for the benefit of the policy-maker to help him rationalize an inflationary policy to himself and to others. How else, one might ask, could we explain that the errors were always in the same direction? I do not want to deny that something like this may go on, at least for other people, perhaps subconsciously. But I do not think that is the whole story. For one thing the period of rapid inflation in the United States is too short to be called "always" and to justify an expectation that the errors of overestimation and underestimation would balance out. Moreover, in a situation of accelerating inflation it would be quite natural that public officials for some time would think each higher inflation rate achieved to be abnormal, and based on special factors, which will pass away. This view probably would not persist forever, but it could last for a significant period. Also, the economic environment may be such that an equal distribution of overestimation and underestimation of the inflationary prospect would lead to an inflationary result, because prices would respond less, or less rapidly, to a mistakenly deflationary policy than to a mistakenly inflationary policy. Some developments affecting inflation in the recent period—such as world grain crops and the oil embargo—were not predictable by the means available to economists. In any case, it seems to me clearly true that for a good deal of the time in the past several years policy decisions were based on an erroneous view of the inflation rate that would flow from any given policy decision.

Another source of error in recent years has been looseness in the ability to manage policy instruments. Particularly, we have on several occasions had significantly larger rates of monetary growth than the money managers wished.

To recapitulate, we have had in recent years a higher rate of inflation than was good for us. We got it in part because the public wanted it, in the sense that it undervalued the costs of inflation relative to the costs of preventing it, either in the form of unemployment or in the form of specific anti-inflationary policies. We got it in part because government officials wanted, or were willing to tolerate, a higher rate of inflation than the public wanted, either because of the political influence of particular sectors of the economy or because the public mistook symbolic actions, like controls, for effective anti-inflationary policy. And we got it in part because of plain error, of forecasting or of management.

To my discussants: I will probably say more than this but I haven't been able to write it down.

EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

THURSDAY, AUGUST 1, 1974

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire, Humphrey, and Percy; and Representative Brown.

Also present: John R. Stark, executive director; John R. Karlik and Courtenay M. Slater, senior economists; Richard F. Kaufman, general counsel; William A. Cox, Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, L. Douglas Lee, and Larry Yuspeh, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

Opening Statement of Senator Proxmire

Senator Proxmire. The committee will come to order. This morning we continue our economic situation and outlook review with two most distinguished economic experts.

The hearings that we have had so far have impressed this committee and those who have followed them with the serious inflationary problem and growth problem that the economy faces at the present time. There isn't any question in my mind that this is the worst inflation we have ever had. And what makes it specially bad is that the previous inflations have occurred either during or right after war periods, and, of course, have been understandable, expectable, and finite. This is an inflation that seems to go on.

Just this morning in the papers it was reported that in July farm prices increased by 6 percent in that 1 month. The Wall Street Journal reported on Friday that they expect wholesale prices to increase in July by 3½ percent, which would be the biggest increase in recent history as far as I know.

This is a larger increase in a single month than occurred in 2 or 3 consecutive years in the sixties or fifties.

So this is an appalling inflation. And it occurs at a time when all the expectations are that the growth of our economy is likely to slow down.

We have listened patiently to the statements by Mr. Rush and Mr. Stein, who are very able men, very good men, but they offer in my view nothing at all, literally nothing. I went over their recommendations in every area, and I could find nothing that was promising and constructive that could meet anything like the size of our present inflation problem.

Last night a member of this committee, Senator Lloyd Bentsen, appeared on television and made what I thought was a most constructive series of recommendations. They were limited and moderate. And they included credit allocation and a voluntary program of price and wage constraint, plus a meaningful program of budget restraint. And I think for all the diversity in our party—and this is as diverse a party as you can get——

Senator PERCY. Except for my party.

Senator PROXMIRE. It is not that chaotic, it is true, it is more diverse, but less chaotic.

Senator HUMPHREY. Join the club.

Senator PROXMIRE. I have always wanted Senator Percy to join my party. At any rate, I ask unanimous consent that Senator Bentsen's speech be printed at this point in the record.

[The speech of Senator Bentsen follows:]

REPORT ON THE ECONOMY

(Speech by Hon. Lloyd M. Bentsen, Jr., a U.S. Senator From the State of Texas, Washington, D.C., Wednesday, July 31, 1974, 7:30 p.m.)

Good evening. I'm Senator Lloyd Bentsen. For a few minutes tonight I want to talk about the price of food. About the cost of buying a house. About good times and bad times. In short, about our national economy and the way it affects your household.

Last week the President spoke to the Nation about his his economic efforts. Perhaps you lisitened, as I did, while the President sought to explain his most recent ideas for dealing with inflation and recession.

As a former businessman, I looked for guidance from the President on how long we must suffer the soaring interest rates that are stalling economic growth. But I didn't find it.

As a Member of the Senate, I hoped for a clearly outlined legislative program—explained in frank terms to Congress and the people. But I didn't hear it.

As a consumer, I looked for action to reduce the 11% inflation rate. But I heard nothing to reassure me.

Finally, I looked to the President—as you may have—for national leadership—leadership from the top to give us the unvarnished facts and a clear sense of direction. But here again, you and I were disappointed.

For the President offered us more of the same: high interest rates, tight money, slow growth—business as usual.

It seemed to me, as I listened, almost as if the clock had been turned back 40 years. Once again we could hear a President telling us, "Prosperity is just around the corner,"—when most citizens perceive not a corner, but a blind alley.

The President told us that our present economic troubles are everyone's fault—except his and his advisors'. He blamed international conditions . . . wild spending by Congress . . . the extravagance of citizens who spend money rather than save it. I felt that I was hearing the language of economic cover-up.

Tonight, speaking from my vantage point as a Democrat and a Member of Congress, I want to express a different point of view.

I want to outline, briefly, a six-point program to restore our economic health. It bears the stamp of the Democratic Party. But I believe it merits the support of both parties; of businessmen and workers; of every family concerned about its savings—about foods costs and college tuition and money for retirement.

Two charts tell the story of the economy in recent years—and the story is one of contrasts.

Under President Kennedy and President Johnson, the economy showed an average annual consumer price increase of less than 2½%. I need scarcely tell you how different things are today. During the Nixon Administration, that average annual price increase has soared to 7%.

In 1968, Mr. Nixon campaigned against inflation. Well, the inflation that year was 4.7%, the highest of the Kennedy-Johnson years. Compare that to the 11% inflation we suffered last year.

If you are a typical citizen, your real weekly earnings—your wages after inflation was taken out—grew six times faster in the Kennedy-Johnson years than they have grown during the Nixon years. In the last 12 months, in fact, the real value of your paycheck has fallen sharply. I need not tell you what such inflation means to older citizens; to the working poor and others who have little hope of increasing their earnings.

The President promised us in January that we have "no recession in 1974." But since then we have gone through two quarters of economic decline. According to most experts, that is the way we define—a recession.

Clearly, for you and me and millions of Americans, "business as usual" offers little hope—and no solutions. This is a time for strong initiatives. We are suffering not only inflation, but recession; not just fever but paralysis.

Yet, last week, the President offered only one new suggestion. He appealed to you and me to have our money; to stop spending so much of it.

I thought, as I listened to the President, "That may be good advice for the well-to-do. But the President should realize that most American families have middle incomes—or less. By the time they pay inflation-swollen prices for food and clothing, for house payments and other necessities, they just don't have much left to save."

I thought, as I listened to the President, about a letter that came to me some time ago from a women in Texas. In 1970 her husband retired from his job as fireman on $450 a month. They could get by on that in 1970. In 1974, they can't. So her husband is out looking for part-time work. And at his age, jobs aren't easy to find.

Inflation and stagnation are making moonlighters out of millions of Americans.

In my judgment, the President's advice sadly misses the point. And his advice implied that the American people—the teachers and policemen and retired citizens of this country—are the villains responsible for inflation.

I don't beileve that—I don't believe that Congressmen and Senators are the villains wholly responsible for our economic troubles.

Perhaps it would serve us better to abandon this pointless search for culprits—and begin a more hopeful effort: a bi-partisan search for solutions: practical solutions that all of us—Democrats, Republicans, businessmen, workers, even the White House—can embrace and enact.

In fact, the major cause of this inflation has not been your greed or wastefulness. It has been shortages—shortages of gasoline; shortages of food; shortages of raw materials; shortages of basic goods from steel to fertilizer.

The real solution to this kind of inflation does not lie in further crippling the ability of families like yours to buy the things they need. Nor does the solution lie in clinging to the most exorbitant interest rates since the Civil War: for higher interest rates actually cripple the farmer, the home builder, the energy producer. The real soluiton to inflation lies in increasing the supplies of the goods we need: food, gasoline, housing and manufactured goods.

So I wished, as I listened to the President, that he would offer us less in the way of slogans and rhetoric—and more in the way of fresh solutions and action. It should be clear by now that serious problems cannot be solved by public relations; they can only be solved by public responsibility.

My purpose tonight is to outline a workable program for economic recovery. A program—not a panacea.

We are a rich and resilient nation. Surely we can recover our economic health; surely, with better policies and clearer leadership, we can put this nation back on the upward road of economic growth.

We owe it—to the tens of millions of American families who are not rich; who do not have unlimited resources—to launch a program of economic action.

Six steps, in my judgment, could put us back on the road to economic health.

First, three short-term measures that can help right away. And next, three long-term measures that will protect our economic well-being for many years to come.

The first step is action—decisive action—to channel loan money in the most productive directions. We need urgently to expand the output of America's factories and industries—so that they can supply more houses; more energy;

more food. One way to do that is to make it possible for essential industries to get the loan money they need.

In my judgment, the President should waste no time in communicating with banks, insurance companies and other lending institutions. He should urge them to launch a voluntary program of credit discipline—aiming the new loans they make toward the neediest and most potentially productive areas—like the housing industry. He should urge the great lending institutions to hold back on loans that do not contribute to the creation of items in short supply.

To reinforce this program of selective credit, Congress should act to give the Federal Reserve more flexibility—enough flexibility to guarantee a reasonable level of loans to encourage home building, to expand manufacturing capacity and to help small businesses.

Meanwhile, we should look, with a careful eye, at the flow of dollars away from the United States into foreign banks and treasuries.

Earlier this year all restrictions on the outflow of U.S. investment money were lifted. Since then, our own banks have increased their loans to foreign customers by $2½ billion. Those loans, called flight money, are flying away when they could be used at home.

It seems to me that when millions of Americans can't get home loans, when American businessmen can't get financing, we should put some restraints on the flow of our dollars out of the country; we should cut back on loans and government grants to other countries. Certainly we have obligations abroad. But our first obligation is to our own people, here at home.

Second, the President should establish, right now, a Cost of Living Task Force—to keep track of price increases and wage settlements in the coming months—and to offer guidance to business and labor about what is best for the Nation.

I would not advocate a return to wage and price controls. But the President has no machinery for telling business and labor what is responsible. If he does not seek legislation to establish a Cost of Living Task Force, then Congress must move on its own.

A third immediate step: we must step up our efforts to rein in Federal spending. The President last week paid tribute to budget reform legislation recently passed by Congress. He did not mention that this legislation was initiated wholly within Congress; approved overwhelmingly by both the House and the Senate—without leadership or encouragement from the White House.

The United States Congress, in my judgment, is serious about fiscal responsibility. But I think it is fair to ask, how serious is the Administration? The President complains about spending; he blames Congress for spending. But his Administration requests—more and more spending.

In 1969 the President inherited a $3 billion budget surplus from President Johnson. Since then he has recommended to the Congress more deficit financing than any President since World War II. Mr. Nixon is the first President to propose a $200 billion budget—and the first to propose a $300 billion budget.

The appropriation bills acted upon by the House earlier this year—and those currently before the Senate—represent a reduction from the President's request of almost one-half billion dollars. I think I can assure you that further reductions will be made.

Some Administration spokesmen, for example, insist that there is no room for any reductions in the Pentagon budget. I support—and almost every Democrat in Congress supports—a strong national defense. But an Armed Force that has more Lieutenant Colonels than Second Lieutenants; an Armed Force with one of the highest ratios of support troops to combat troops has room for some real budget savings.

My final three proposals are long-range measures. But they are equally vital to our long-term well-being—to your hopes for your family.

Point number four: We should act now to reform our tax system. When the President spoke last week, he did not mention taxes—except to say that they should not be raised or lowered. He ignored one of our most pressing economic opportunities: tax fairness—fairness in laws for the families who pay their taxes—and fairness in enforcing those laws.

It makes no sense to offer a few prosperous citizens tax loopholes and tax shelters for unproductive investments. We should remove such shelters. By doing so, we can spur investment in areas where money is needed to increase production and bring down prices. Eliminating unfair tax shelters will increase tax revenue—and give a break to low and moderate income taxpayers.

Certainly we should end tax breaks for building factories in foreign countries. I think our tax laws should encourage businessmen to build plants here at home. Our goal should be to send our goods abroad and keep our jobs at home. We should end tax breaks that send American dollars to build factories in foreign countries.

Most important, when it comes to this principle of fairness: we should stop using our tax laws to encourage foreign oil and gas production. The energy crisis has taught us that if our nation is to be secure and self-sufficient, we must produce more energy here at home. And we must depend less on oil from the far corners of the world.

The fifth item in this six point program is an action plan to increase the productivity of our business and industry.

In my judgment, the working people in this country have an excellent record of cooperation in the fight against inflation. Wage increases during the last few years have been modest in comparison to price increases. Strikes, work stoppages, and labor disputes have been surprisingly few over the same period.

Yet, the President, on nationwide television, has told us that people are wanting too much—and working too little. I disagree.

What is the real way to increase our nation's productivity? One way is to devote more attention—and more money—to research and development, especially in food production. Our farmers have become the most productive and efficient in the world. And research is the reason why. Research to develop higher yields of food and fiber has meant more income for the farmer—and cheaper food for your table. But since the 1950's, unfortunately, a shrinking portion of the Agriculture Department's budget has been devoted to research. That was a kind of economic myopia. This Congress turned that trend around—and that is good news. Because research to increase food production is one area where Federal spending helps fight inflation—by lowering prices.

Meanwhile, we should make a major national commitment to job training—to provide more people with skills they can use. Because education—vocational education and retraining programs—have always provided a high return to the Federal treasury. They increase the number of Americans making a productive contribution to our national life. And most important, these programs take people off the unemployment rolls and put them on payrolls.

My sixth and final point is perhaps the most important of all: the Administration must put its own economic house in order.

President Nixon spoke last week about the need for steadiness in fighting inflation. "The key to fighting inflation," he said, "is steadiness."

Certainly he was right. Nothing can more quickly undermine a President's economic efforts than the appearance—or the fact—of vacillation; of inconsistency; of desperate trial and error.

That is why so many of us in the Congress have been troubled, for the past five years, by the drastic fluctuations in the President's economic efforts: the on-again, off-again controls; the sudden freezes and phases; four Treasury Secretaries, four budget managers, six wage and price controllers, five energy chiefs, three Chief Economic Advisors. And now, another newly-created post: an "Economic Counselor." The President's economic efforts have seemed to be—or have been—a patchwork.

Too many changing policies, replacing one another.

Too many conflicting voices, contradicting one another.

Too many trials—and far to many errors.

Sadly only four things have really been steady: steadily rising prices; steadily dwindling confidence; steadily cheeful assurances from the Administration—followed by steadily worsening results.

This is the steadiness of failure—not success.

The Russian Wheat Deal and the energy crisis are just two examples of the failure of government to look ahead and provide wisely for our own economic security. Whatever happened to those shrewd Yankee traders? The wheat deal sharply increased the price of bread for your family. And your government's failure to foresee and forewarn us about the energy crisis helped put you in a long gasoline line last winter.

The Federal Export-Import Bank—to cite another example—borrows from our hard-pressed money markets so it can lend Russia $180 million for a fertilizer plant. It makes another loan to Algeria for 20 oil drilling rigs. Yet here at home, shortages of fertilizer and a scarcity of drilling rigs are hindering our efforts to produce more food and fuel. To make matters worse, the Export-Import Bank offered these loans at one-half the interest rate a U.S. company would have to pay. That is neither fair nor wise—and we should stop making such mistakes.

For every man, woman and child in the United States, there are ten Federal forms to be filled out each year. Just filling out government forms cost this nation's small businessmen about $18 billion a year—most of which is passed on to you at the cash register. A bill is presently moving through the Congress to cut down this expensive burden of paperwork. I think the Federal government should make a complete review of other laws and regulations—with an eye toward scrapping or changing those that cost more than they're worth.

Six steps toward economic health. Some small, some large, some for the short-term—some for years to come. Certainly this six-point program does not exhaust the possibilities for action and decision. But it underscores the fact that there are things to be done—more than the Administration is doing now.

In every moment of difficulty we have lived through as a nation, we have saved ourselves by summoning up wise and honest leadership—and then we have tackled our difficulties in the active, not the passive, voice. That is what we must do now.

There used to be a saying that Democratic Administrations were good for wage earners while Republican Administrations were good for business. The past five years prove the emptiness of that myth. For this Administration's economic policies have been bad for everyone.

Ask the man who is holding two jobs to make ends meet.

Ask the businessman who has tried to raise capital for a new plant; ask one of the 52,000 businessmen who have been forced to close their doors in the last five years.

Ask the homemaker standing at the cash register watching her $20 bill buy one lonely sack of groceries. Ask you neighbor who is poor, or old, or out of a job tonight.

Of all the shortages in our country today, our most critical shortage is the shortage of leadership—sound, effective leadership.

For sixteen years before I came to the United States Senate. I was a businessman. In my experience I found that when the average working man and working woman in this country do well, business does well—the country does well.

So I reject the old "trickle down" economic theory of the President and his economists.

Any gardener knows that you do not water a plant on its leaves and hope it will trickle down to the roots. You nourish the roots.

Well, the roots of this great nation are its working people. They pay most of the taxes to support our public institutions. They fight our wars when the need arises. They provide the muscle for all of the progress we have enjoyed through our rich history.

Let us provide broader opportunities for them to become consumers, jobholders and taxpayers. Then, perhaps, the leaves will turn green again and the entire economy grow more productive.

The answer to our present difficulties must be to nurture and encourage the working families of America—not to ignore them; not to patronize them with empty promises and slogans.

The program I have described tonight offers us—I believe—a way up and out of our difficulties. It emphasizes growth rather than stagnation.

As President Kennedy used to say: A rising tide lifts all boats. I have spoken frankly about the difficulties we are facing—because I believe that nothing can be gained by papering them over, or covering them up.

I hope you will accept my assurance that none of us in Congress are blind to the difficulties that you and your family are facing. Many of us are trying to act responsibly in the face of some deeply disturbing national problems: to lead wisely, and candidly.

And I hope you will accept my assurance that we in the Congress are working—sometimes against great resistance—to lift all the boats—and to put them on a steadier, more hopeful course.

This program is one way to begin.

Senator Proxmire. And again I want to welcome two of the finest economists in the country, Mr. Walter Heller, and Mr. James Duesenberry. Mr. Heller, when he was chairman of the Council of Economic

Advisers, was a brilliant exponent of teaching the President, the Congress, and the country economic policy. Nobody has done more to articulate economic policy in understandable terms than he has.

Mr. Duesenberry is a most distinguished economic expert who has given this committee and the Congress excellent advice in the past.

You are the first witnesses, gentlemen, who have not been representing the administration. So it is good to get some comment from outside critics.

Senator Percy.

Senator PERCY. I would just like to join in welcoming our witnesses, and to indicate that when I chose my career, and especially chose economics, one of my professors was a past distinguished member of this committee, Paul Douglas. I didn't always agree with his point of view, but I looked upon him as a man who contributed a great deal to the public understanding of economic issues.

And I think that the field of endeavor we are working with now is going to be the field that will dominate thought for many, many years to come. Certainly the whole strength of this Nation and the free world depends upon our ability to be sound economically and proceed in a way that will keep our economic balance.

And certainly we are very grateful indeed for the contribution through the years of our distinguished witnesses. They could not be here at a more appropriate time.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. I just wanted to make one observation, as a reflection upon the testimony previously taken by the committee.

We were told earlier this year that food costs would be down. Some of us at that time disputed it. I considered the Government forecasting to be grossly inadequate, and self-serving. In the agricultural area the Secretary of Agriculture has seen fit to give this country for several months production figures that were unrealistic. When you forecast a corn crop of 6,250 million bushels based upon optimum conditions, weather, and fertilizer, of all the inputs that are necessary, I think that is misleading the public. And quite frankly, that crop will be down to about 5,600 million bushels, which will have a tremendous inflationary impact, as we witness already with farm prices going up.

And they are only beginning to go up. Beef prices will be much higher than they are, particularly in the supermarket. And dairy prices will be up considerably, because dairy herds will be liquidated by the thousands. There is a shortage of these products, because dairy farmers cannot afford the feed that they have to buy for their cattle at the price that they get for their milk or their dairy products.

The Chairman of the Council of Economic Advisers told this committee last spring that we could expect the inflation to moderate not later than the third quarter, and hopefully earlier. At that time, Mr. Vice Chairman, you may recall I took sharp exception to those remarks—I saw no indications that would bring about such a conclusion.

I also disputed Mr. Stein a year ago when he felt that inflation would be down to around 4 to 5 percent, and it ended up on an average of about 8 percent. And this year he said it would be down, in the third quarter, to about 7 percent. It is up to 11 percent.

Forecasting has to be better than that, because the great decisions are made on forecasts, decisions in the marketplace.

It is interesting to note that most of the private analysts, Mr. Vice Chairman, in the field of foods and commodities, and most of the private economists working for private industry, have made forecasts that are much more reliable than those of the Government.

It would seem to me that a government that depends so much on private enterprise would occasionally take some advice from the people in private enterprise. But it has not. I think it is a serious problem when Government agencies make predictions and forecasts that are in such variance with the private forecasts, only to end up finding out that the Government was in error, and the private forecasters were closer to the mark. And I would hope that this committee in due time would take a good, hard look at the kind of machinery that we have or the kind of tools that this Government has to make these forecasts. Because forecasts determine market conditions in many areas.

Senator PROXMIRE. Mr. Heller, you go right ahead.

Incidentally, if you do want to abbreviate your prepared statement in any way, your prepared statement will be printed in full in the record.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. HELLER. Thank you. In my prepared statement I first respond to your request for suggestions as to the lines of inquiry you might pursue with respect to the forthcoming inflation study.

I must say I am delighted that you are tackling this problem. It is high time for the kind of authoritative and sober and balanced analysis that the Joint Economic Committee can bring to the inflation problem.

We are clearly in the grip of an inflation psychosis. In a recent survey 87 percent of the public listed inflation as their No. 1 concern. In the face of dangerous double-digit inflation, and given our almost traumatic state of mind about it, I think we run substantial risk of overreacting, of practicing one-dimensional economics that counts, or overcounts, the benefits of tight money and budget austerity without adequately weighing the costs. This is a clear case of what we don't know will hurt us.

Judicious inquiry by your committee can help us attain a balanced perspective on the problem. It can help us avoid that worst of all worlds: Selling our soul—full employment and fair sharing of benefits and burdens—to that devil, inflation, and not getting deliverance in the bargain.

In my prepared statement I offer a series of suggestions for your inflation study. But to stay within my time limit, let me turn directly to the material in my prepared statement where I deliver myself of a few thoughts on the handling of the inflation problem. I will draw on the earlier pages as seems appropriate in that discussion.

Clearly there is no quick fix for inflation in 1974, and one is tempted to say in 1975—and perhaps not until 1976. We can look for some ebbing of inflation as the run up in fuel, raw materials, and food prices tapers off, and as the post-control surge subsides. But get-ahead price increases and catch-up wage increases are translating a lot of the one-shot food-fuel-commodity inflation into a new price-wage spiral.

Mr. Vice Chairman, you mentioned the numbers that were given in this morning's paper. I thought the most chilling number was actually that for the rise in unit labor costs in the second quarter. True, productivity increased slightly, but unit labor costs rose so rapidly, the most rapidly for any quarter since 1951, that we had a 13-percent rate of increase in unit labor costs in the second quarter, and 9 percent in manufacturing alone. And that is a very ominous figure.

Although the present 12 percent rates of inflation may have a soft core, I now fear, especially in the light of these developments in the second quarter, that we will find a hard core of cost-push inflation in the 7 to 8 percent range next quarter. And that may well be on the optimistic side.

The "old-time religion" of sky-high money costs and tight budgets will be relatively ineffectual in taming inflation short of draconian budget slashes, tax boosts and dangerously tight money. Here the specter of 1969 and 1970 hausts us, when we tightened first the fiscal and then the monetary screws, thereby generating a recession. And 6 percent unemployment did not prevent inflation from steadily worsening, until prices and wages were frozen in August of 1971.

Why the game plan that failed so miserably in 1969-71 should suddenly be resurrected and offered as our economic salvation in 1974–75 is a mystery to me.

I don't want that misinterpreted, by the way. We have to exercise restraint on both the fiscal and monetary side. But there is a very great difference between restraint and strangling the economy.

I might note, by the way, that very careful econometric analyses by James Tobin in the most recent Brookings papers, and by Otto Eckstein in the publications of Data Resources, Inc., agree that if we simply go the fiscal monetary route to squeeze out inflation, we would have to endure unemployment of 8 percent for at least 2 years.

And in one of Tobin's scenarios it is much longer than that, or about 1980, to cut inflation back to a 4 percent rate.

Relying solely on monetary-fiscal restraint, then, would condemn us to deep and prolonged unemployment, huge losses of production, profits, and income, and financial crisis. And those are costs that a democratic society won't and shouldn't tolerate.

Now, such costs will become more and more painfully evident this summer and fall. The 1974 economic slump will be clearly revealed for what it is, not an energy spasm, not a pause that refreshes, not a reflection of supply shortages, but a corrosive stagnation born of a short-fall in demand. The inventory overhang, as we now know from the startling revision of the 1973–74 inventory numbers, is more of a threat than we thought. Shortages are diminishing as capacity grows and production falls. Just bear in mind, a 28-percent drop in automobile sales in terms of the number of units, when you think of the chew-up of materials, is more than that, because they have lost more of the large car sales than the small car sales. The sag in housing, the drop in new construction contracts, even the drop in new orders, all add up to a big cutback in this chew-up of materials.

And underneath the veneer of high prices, high profits, and bulging order books, I detect growing signs of softness. In talking with manufacturers—at least in our home State of Minnesota, Senator Humphrey—I find that even though orders may not be canceled, some manufacturers are being asked to hold up shipments for which their customers were begging just a few months ago. They in turn are cutting their forward material commitments. More and more find that they have attained satisfactory inventory levels. So that is not the source of demand we have had in the past. Anyone who has convinced himself that this is simply a shortage economy, and speaks glibly of a phantom recession, is missing the point.

Debate over the semantics and politics of recession merely diverts attention from the real problem; namely, how far below output and employment potentials we are going to drive the economy in our war on inflation?

I think the present course of policy is more likely to bring us, if we stay on it, closer to 7 percent unemployment in 1975 than 6 percent—that is, if we stick to as brutally tight a monetary policy as we are now following.

Sustained stringency in fiscal and monetary policies, in addition to its direct costs in jobs and output, will undermine some of our natural defenses against inflation.

First, it will deny us the short-run productivity offsets to cost increases that we normally reap from a rising volume of sales and output. The longer we stunt productivity growth by choking off recovery, the more likely it is that slower productivity growth, and hence higher unit costs, will be built into conventional price mark-ups.

Second, unswerving devotion to the "old-time religion" will worsen the environment for the business capital spending and technological advance that boosts productivity and capacity in the longer run. Investment, innovation, and risk-taking thrive in an atmosphere of expansion and wither in stagnation. Current policy specially in the form of hard-as-nails credit restraint, in its effort to throttle inflation, is strangling recovery. This undermines the health of equity markets, pushes money costs skyward, and threatens both profits and financial stability.

In the face of this policy of calculated stagnation, no program of tax gimmicks or special incentives will induce the high investment needed to boost productivity, expand supplies, and ease price pressures.

What we need is not a hell-for-leather program to put the country through the wringer in the misguided hope that we will squeeze the inflationary water rather than the economic life blood out of it. Instead of a one-dimensional policy of throttling inflation by choking off recovery, we need to take our blinders off and adopt a balanced and comprehensive approach to the inflation problem.

What are the components of such an approach? First, counting not just the benefits but the costs of sustained monetary-fiscal austerity, we need to back off from this policy of excessive restraint to one of more moderate restraint. Notice the word "restraint" still remains.

Second, recognizing the limitations of traditional monetary and fiscal instruments of demand management, especially in the face of an inflation that is characterized by supply shortages and growing cost pressures, policy needs to respond accordingly. Given the self-propelled nature of the renewed price-wage spiral, policy should seek to restore an atmosphere in which an economic détente between business and labor, on behalf of the consumer, might be possible.

This won't be easy after the botch the administration made of its late lamented controls. But without some kind of a wage-price monitor and a new set of wage-price guides, backed by powers of inquiry, publicity, suspension, and in outrageous cases, even rollback, the outlook for inserting a circuit breaker in this new round of cost-push inflation will remain bleak.

Next, in the light of our traumatic experience with shortages and bottlenecks in the past couple of years, we need to explore the potentials of supply management ranging all the way from better information devices like shortage alerts and prompt export reports or licensing to the use of special financial aids—not in the form of new tax shelters—and the milder form of credit rationing.

On that score, the rationing of credit by price alone is channeling too much of our limited financial resources into speculation in inventories, land, precious metals, and foreign exchange, to the detriment of investment in productive capital. And as always, super-tight credit is squeezing small business, housing, and State and local borrowers. Both to curb inequities in the present allocation of credit and to curb speculative uses in favor of productive uses of credit, Federal Reserve policy should couple a gradual retreat from competitive tightness with the use of more selective methods of making credit available.

By the way, one of the contributions this committee could make would be a careful study of just what are the potentials of selective restraints. There is a great deal of controversy, as you know, Mr. Vice Chairman, in the economics profession about selective credit controls, qualitative controls. We all know they have been advocated by Governor Brimmer and by others. Some say that the limited reach of the Federal Reserve System and the fungibility of money put very substantial limits on those selective credit controls. This committee could perform a very useful function in its study by a careful delineation of what can and cannot be accomplished. It is extremely important to distinguish between the various uses of credit and to restrain those that really represent speculation and nonproductive investment.

And I think the Government should gradually phase out regulation Q ceilings that shortchange the smaller saver and distort the flow of financial resources.

A White House and Congress that are dead serious about fighting inflation ought also at long last to take political risk—in terms of stepping on the toes of articulate and well-heeled pressure groups—to put an end to the laws, regulations, and practices that make Government an accomplice in many cost-and-price propping actions.

If ever we had an opportunity where the country would be receptive to this kind of change, it is right now, in the face of the severity of the inflation problem, as the vice chairman stated it. I think it is high time to change our anticompetitive methods of regulating transportation rates, and our inadequate antitrust enforcement. I hate to mention it, but we ought to abolish fair trade or resale price maintenance, and the Davis-Bacon and Robinson-Patman Acts. We ought to eliminate import quotas and many of the tariffs, and the Buy America Act. These restrictions in the aggregate deny the American consumer substantial benefits in price and wage moderation.

Third, and in many ways the most neglected part of the discussion of inflation these days, the fight against inflation has to be taken out of the narrow framework of simply stamping out inflation at all costs, and the devil take the hindmost, and put in a far broader perspective. What we need to recognize is that the major damage inflicted by inflation, and particularly inflation arising in large part out of fuel and fuel price explosions, is its distributional inequity. The 1973–74 inflation is different. Where inflationary pressures are generated by vigorous monetary fiscal expansion that tightens job markets, the poor tend to gain in increased job and income as much as or even more than——

Senator PROXMIRE. Mr. Heller, I am going to have to interrupt this for a minute. I am informed that I have an amendment that I have to speak on on the floor. I regret this very much. There are no two economists that I would rather hear than you two. I am going to have to leave for at least 20 minutes or a half hour, and perhaps an hour. I hope I can get back, because I have some questions that I am extremely anxious to ask both of you. In the meantime, Senator Humphrey will chair the hearing.

Mr. HELLER. Before you leave, Mr. Vice Chairman, may I urge special attention to the last paragraph of my prepared statement, which was written with your latest denunciation of tax cuts in mind. I urge your careful, considered, and specal attention to that paragraph. I do not think I will persuade you, you understand, but I think you should be exposed to that cogent thinking.

Senator PROXMIRE. There is no one who would be more likely to persuade me on this subject than you, Mr. Heller. But I do not think you will persuade me.

Mr. HELLER. I have made a good forecast for a change.

Senator HUMPHREY [presiding]. Go right ahead, Mr. Heller.

Mr. HELLER. What I was saying was that the 1973–74 inflation was different from most United States inflations. Usually, inflation is accompanied by very tight labor markets, where lower income groups tend to gain more in jobs and higher incomes than they lose in higher prices. But this time around, runaway fuel and food prices eroded their real incomes without any compensating benefits in jobs and earnings.

One of the ironies of today's inflation is that both the nature of the price explosion and the nature of the weapons we are using to fight it tend to discriminate against the lower income groups. They are the victims of a double whammy.

Their vulnerability to unemployment and income loss in a slack economy is well known. And apart from the usual built-in biases of monetary policy, budget policy has been squeezing social programs while enlarging defense outlays. So there again they are the victims of policy. And tax policy, except for that minor relief that is now tentatively approved by the Ways and Means Committee, shows far too little concern about those who are being short-changed by inflation.

Now, a truly balanced attack on inflation would couple the restraints of fiscal and monetary policy with measures to redress the grievances of inflation. More generous unemployment insurance and a greatly expanded public service jobs program are a vital necessity under a policy which is "taking the cure" of unemployment and economic slack for the disease of inflation. The vicious inroads of food and fuel price run-ups on the real income of lower income groups and wage earners—the statistics on erosion of the real incomes of wage earners and on declining relative incomes of blacks serve as disheartening testimony on this score—call not only for more generous food stamp and housing allowances but relief from payroll taxes for the working poor and increases in personal income tax exemptions, standard deductions and low income allowances. And now I wind up with that paragraph I commended to Senator Proxmire's attention.

It is particularly important to put this proposed tax relief program in proper perspective.

First, what is contemplated is just a reduction of $6 to $8 billion out of the total personal income and payroll tax revenue of $215 million.

Second, for the longer pull, such revenues could readily be made up by a program of long overdue tax reform, and will in any event be more than offset by inflation's impact on income tax revenues.

I agree with what Professor Duesenberry is going to say, that we do need to run full employment surpluses. But we are bound to get those full-employment surpluses in part by the unhappy route of inflation.

Third, as liberal critics need to be reminded, this carefully targeted tax relief would in itself be part and parcel of a program of fiscal and social justice just as much as a program of positive government outlays to the same groups. We tend to think of our social outlays only in terms of positive government outlays and not in terms of negative tax impact. And I think that is a fallacy of incomplete projection.

Fourth, as conservatives need to be reminded, most of the tax benefit would not pour gasoline on the raging fires of inflation, but rather serve as a nourishment for a sagging economy characterized by increasing slack and widening areas of excess capacity.

And in that connection, by the way, I do suggest that an objective study by this committee matching the spending patterns of the beneficiaries of such tax relief, with the patterns of supply, that is, where there are shortages and where there is excess capacity, in the areas where the money will be spent, would substitute reason for emotion on this issue.

Thank you.

Senator HUMPHREY. Thank you very much, Mr. Heller.

[The prepared statement of Mr. Heller follows:]

PREPARED STATEMENT OF WALTER W. HELLER

In addition to the customary review of economic developments and policy, Senator Proxmire has asked for suggestions on aspects of the inflation problem that the Joint Economic Committee should examine in response to the Senate resolution instructing it to undertake an emergency study of the state of the economy with special reference to inflation. I will open with a list of such suggestions and continue with a statement of my own conclusions and convictions concerning the handling of the inflation problem in the light of the steadily worsening outlook for economic recovery.

At the outset, let me say that, with or without a Senate (and House) resolution, it is high time for the kind of sober and balanced analysis that the Joint Economic Committee can bring to the inflation problem. We are currently in the grip of an inflation psychosis. In a recent survey, 87% of the public list inflation as their number one concern. In the face of our dangerous double-digit inflation and given our almost traumatic state of mind about it, we run substantial risks of over-reacting, of practicing one-dimensional economics that counts—or over-counts—the benefits of tight money and budget austerity without weighing the costs. A judicious inquiry by your Committee can help us maintain a balanced perspective on the problem. It can help us avoid that worst of all words: Selling our soul—full employment and fair sharing of benefits and burdens—to that devil, inflation, and not getting deliverance in the bargain.

In the process of its investigation, the Committee will face an agenda of unrelentingly hard questions. Let me list some of the major ones, together with occasional suggestions as to where the answers seem to lie.

An obvious starting point of the inquiry would be to sort out the causes of our current inflation, attempting particularly to distinguish between the endemic and epidemic aspects of the problem. The particular causes of the 1973–74 inflation will tell us at least something about the appropriate cures. If inflation today is really in large part the lingering legacy of excess domestic demand, a policy of super-tight money and budget restraint is more appropriate than if, as I suspect, much of it has a one-shot character associated with food, fuel, and raw commodity price explosions. This is not to say that understanding how the inflation genie got out of the bottle will tell us how to put him back in. In particular, the Committee will want to determine how much of the one-shot inflation is being built into the fabric of the cost and price structure through the gathering momentum of a new price-wage spiral.

As already implied, a closely related question is whether inflation will succumb to the pressure of tight money and austere fiscal policy. Here, the spectre of 1969–71 haunts us. Tightening first the fiscal and then the monetary screws, thereby generating a recession and 6% unemployment, did not prevent inflation from steadily worsening until prices and wages were frozen. Careful econometric analyses by James Tobin (in the most Brookings *Papers on Economic Activity*) and by Otto Eckstein (in publications of Data Resources, Inc.) identify the heavy price we would have to pay for "staying the long course." Eckstein estimates that we would have to endure unemployment of 8% for at least two years to cut inflation back to a 4% rate if we rely solely on monetary and fiscal restraint. He rightly dubs this "overkill" and concludes that " the financial system would collapse before we cracked inflation."

Since a large part of the damage done by inflation is distributional—inequities between those on fixed and those on responsive incomes, between the poor who spend a high percentage of their income on food, fuel, and housing, and the well-to-do for whom such outlays are proportionately much smaller, and so on—an important part of the Committee's inquiry should focus on who gains and who loses from inflation (for which the study by G. L. Bach in the July/August 1974 *Challenge* is a good point of departure). But two caveats are in order:

> The 1973–74 inflation is different. Where inflationary pressures are generated by vigorous monetary-fiscal expansion that tighten job markets, the poor tend to gain in increased jobs and income as much as, or even more than, they lose through higher prices. But this time around, runaway food and fuel prices eroded their real incomes without any compensating benefits in jobs and earnings.
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> The inquiry must extend beyond the costs inflicted by inflation itself to the costs implicit in a policy of fiscal-monetary austerity to combat it. The evidence may well show that certain groups—especially in the lower income and wage-earning categories—are hit by a double whammy in this process.

Accompanying the analysis of distributional questions should be a parallel appraisal of the damages and costs of inflation balanced against the damages and costs of a more and more openly avowed policy of induced economic slack and torpor to check inflation. The costs of this policy in terms of ouput, jobs, productivity, profits, and financial stability are potentially huge. No one in the Administration seems to doubt that the game is worth the gamble. But many critics, myself included, feel that in their efforts to throttle inflation, they will strangle recovery, endanger financial stability, and retard the capital spending and productivity advances that promise longer-run relief from intense price pressures and shortages. Who is right? The country will be looking to the Joint Economic Committee for the answer.

In seeking that answer, the Committee will also have to judge whether the Administration is right in dismissing the current slump as an "energy spasm" or shortage phenomenon rather than a reflection of inadequate demand. In my view, the combination of contractionary monetary and fiscal policy and the demand-deflating effect of skyrocketing oil prices supports the latter explanation—and this will be increasingly so as Federal Reserve policy squeezes demand even harder. Given the sharp upward revision in the statistics on inventory accumulation and, with a few notable exceptions, diminishing evidence of shortages, deficiencies of demand and growing excess capacity will become increaisngly evident. Debate over the politics and semantics of "recession" merely divert attention from the real problem, namely, how far below our output and employment potential are we going to drive the economy in the course of our war on inflation?

This leads directly to a series of policy questions on which the Committee inquiry can shed important light:

Since policy for the "new inflation" cannot limit itself to demand management, the Committee's study can make an important contribution by appraising the possibilities of supply management, ranging from better information devices to means of anticipating and averting.

An objective evaluation of the possibilities of selective credit policies is also very much in order. Given the inequity of present credit restraints and their failure to distinguish between productive and speculative investment, one needs to take a hard look at policies that go beyond reliance on high prices to ration credit. Given the fungibility of money, what steps can the Federal Reserve Board take to help on this score?

On the wage-price front, any light the Committee could shed on two basic questions would be most helpful. The first is that hardy perennial: Where *is* competition a good policeman, and where is a government presence needed to counteract the excess market power of key unions and big business and make them behave in a more competitive way? Second, what are the possibilities of economic detente between business and labor? In the absence of any White House attempts (and ability) to bring about some kind of an economic disarmament agreement, Congress should develop an agenda that might lead to a mutual de-escalation of labor and management demands.

Various proposals for tax relief such as boosting income tax exemptions, converting such exemptions into tax credits, and exempting the working poor from payroll taxes would clearly serve the ends of equity, but are opposed on grounds that they would worsen inflation. An objective study matching the spending patterns of the beneficiaries of such tax relief with the patterns of supply—shortage versus excess capacity—in the areas where the money will be spent would substitute reason for emotion on this issue.

Let me turn now to ome observations on anti-inflation policies and their costs in the light of current economic prospects.

There is no quick fix for inflation in 1974. We can look for some ebbing as the run-up in fuel, raw materials, and food prices tapers off and as the post-controls surge subsides. But get-ahead price increases and catch-up wage increases are translating a lot of the one-shot food-fuel-commodity inflation into a new price-wage spiral.

The old-time religion of sky-high money costs and tight budgets will be relatively ineffectual in taming inflation, short of draconian budget slashes, tax boosts and dangerously tight money. Such measures would condemn us to deep and prolonged unemployment and losses of production, profits, and income—costs that a democratic society will not and should not tolerate.

Such costs will become more and more painfully evident this summer and fall. The economic slump will be clearly revealed for what it is: not an "energy spasm," not a pause that refreshes, not a reflection of supply shortages, but a corrosive stagnation born of a short-fall in demand.

In addition to the direct costs in jobs and output, sustained stringency in fiscal and monetary policy will undermine some of our natural defenses against inflation. First, it will deny us the short-run productivity offsets to rising costs that we normally reap from a rising volume of sales and output. The combination of accelerating wage boosts and lagging productivity will build more cost-push resistance to the downward pressures of lagging demand. The longer we stunt productivity growth by choking off recovery, the more likely it is that slower productivity growth and hence higher unit costs will be built into conventional price mark-ups.

Second, unswerving devotion to "the old-time religion" will worsen the environment for the business capital spending and technological advance that boost productivity and capacity in the longer run. Investment, innovation, and risk-taking thrive in an atmosphere of expansion and wither in stagnation. Current policy—especially in the form of hard-as-nails credit restraint—undermines the health of equity markets, pushes money costs skyward, and threatens both profitability and financial stability. In the face of this policy of calculated stagnation, no program of tax gimmicks or special incentives will induce the high investment needed to boost productivity, expand supplies, and ease price pressures.

What we need now is not a Hell-for-leather program to put the country through the wringer in the misguided hope that we will squeeze the inflationary water rather than the economic lifeblood out of it. Instead of a one-dimensional policy of throttling inflation by choking off recovery, we need to take our blinders off and adopt a balanced and comprehensive approach to the inflation problem.

First, counting not just the benefits but the costs of sustained monetary-fiscal austerity, we need to move from excessive to moderate restraint.

Second, recognizing the limitations of the traditional monetary and fiscal instruments of demand management in the face of an inflation characterized by supply shortages and growing cost pressures, policy needs to respond accordingly:

> Given the self-propelling nature of the renewed price-wage spiral, policy should seek to restore an atmosphere in which an economic détent between business and labor—on behalf of the consumer—might be possible. This won't be easy after the botch the Administration made of its late lamented controls. But without some kind of a wage-price monitor and a new set of wage-price guides—backed by powers of inquiry, publicity, suspension, and (in outrageous cases) even rollback—the outlook for inserting a circuit-breaker in the new round of cost-push inflation will remain bleak.
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> In the light of our traumatic experience with shortages and bottlenecks in the past couple of years, we need to explore the potential of supply management ranging all the way from better information devices like shortage alerts and prompt export reports or licensing to the use of special financial aids (not in the form of new tax shelters) and the milder forms of credit rationing.
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> Rationing of credit by price alone is channeling too much of our limited financial resources into speculation in inventories, land, precious metals, and foreign exchange to the detriment of investment in productive capital. And, as always, a super-tight credit is squeezing small business, housing, and state and local borrowers. Both to curb inequities in the present allocation of credit and to curb speculative in favor of productive uses of credit, Federal Reserve policy should couple a gradual retreat from excessive tightness with the use of more selective methods of making credit available, together with a gradual phasing-out of the Regulation Q ceilings that short-change the smaller saver and distort the flow of financial resources.
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> A White House and Congress that are dead serious about fighting inflation ought at long last to take the political risk—in terms of stepping on the toes of articulate and well-heeled pressure groups—to put an end to the laws, regulations, and practices that make government an accomplice in many cost- and price-propping actions. Running from anti-competitive regulation of transportation rates and inadequate anti-trust enforcement to resale price maintenance and Davis-Bacon and Robinson-Patman Acts and embracing import quotas and many tariffs and the Buy-America Act, to name but a few—these restrictions in the aggregate deny the American consumer substantial benefits in price and wage moderation.

Third, the fight against inflation has to be taken out of the narrow framework of stamping out inflation at all costs—and the devil take the hindmost—and put in a far broader perspective. What we need to recognize is that the major damage inflicted by inflation—and particularly an inflation arising in large part out of a food and fuel price explosion—is its distributional inequity. Coupled with this is a sense of grievance and alienation, an undermining of morale and social cohesion that may be inflation's greatest cost. One of the ironies of today's inflation is that both the nature of the price explosion and the nature of the weapons we are using to fight it tend to discriminate against the lower and middle income groups. Apart from the usual built-in biases of monetary policy, budget policy has been squeezing social programs while enlarging defense outlays. And tax policy—except for the minor relief to low income groups tentatively approved by the Ways and Means Committee—shows far too little concern about those who are being short-changed by inflation. A truly balanced attack on inflation would couple the restraints of fiscal and monetary policy with measures to redress the grievances of inflation:

More generous unemployment insurance and a greatly expanded public service jobs program are a vital necessity under a policy which is taking the "cure" of unemployment and economic slack for the disease of inflation.

The vicious inroads of food and fuel price run-ups on the real income of lower income groups and wage earners—the statistics on erosion of the real incomes of wage earners and the relative incomes of blacks serve as disheartening testimony on this score—call not only for more generous food stamp and housing allowances but relief from payroll taxes for the working poor and increases in personal income tax exemptions, standard deductions, and low income allowances.

It is particularly important to put the proposed tax relief program in proper perspective. First, it contemplates a reduction of $6 to $8 billion out of total personal income and payroll tax revenue of $215 billion. Second, for the longer pull, such revenues can readily be made up by a program of long overdue tax reform and will, in any event, be more than offset by inflation's impact on income tax revenues. Third, as liberal critics need to be reminded, this carefully targeted tax relief would in itself be part and parcel of a program of fiscal and social justice just as much as a program of positive government outlays to the same groups. Fourth, as conservatives need to be reminded, most of the tax benefit would not pour gasoline on the raging fires of inflation but rather be fed into a sagging economy characterized by increasing slack and widening areas of excess capacity.

Senator HUMPHREY. Mr. Heller, I have a few questions here which were to have been asked by Senator Proxmire which I will ask.

I want to make note of your fine commentary in the final part of your prepared statement. As you know, there was an effort made here in the Congress to do something about the tax reduction, and some tax reform. We ran into an immovable object, so to speak, in the form of a filibuster for a while, and frankly, we were unable to get the votes that we needed, because the old time religion seems to have quite a few followers, even in a Congress that is supposed to be a rather liberal orientation.

I do think that the points that you have made here need to be constantly reemphasized. We had studies made by the Joint Economic Committee and the Consumer Economics Subcommittee of this committee, good substantive studies, showing that insofar as any real inflationary impact of the tax cut for the lower and middle income brackets, it would be negligible, or insignificant, but that the impact of the tax cut could do a great deal to stimulate the economy, and to get it back into production.

Some of us believe that there is a recession. But this has not as yet reached what I would call official circuits. The recession is ignored as an economic fact.

Let me just put it directly to you. Do you believe that we are at this time in some stage of recession?

Mr. HELLER. At the very least we are in a growth recession. And while Geoffrey Moore of the National Bureau of Economic Research, who is the anointed authority on this subject, is not yet willing to call this officially a recession by the National Bureau's standards, looking at it from the standpoint of what the policy responses should be, we are in a recession. And as I stressed in my prepared statement, I really do not think that the argument should be about the semantics and the politics of recession. The argument should be about how far we are going to fall below our economic potential. It seems to me that if our economic potential grows at, say, 4 percent a year, and we hold steady or grow at one-half of 1 percent, as forecasts now suggest, for several quarters in a row, the consequences for policy are the same whether or not we call that a recession. And so I hope the debate is going to get off the question of label and onto the question of shortfall from our potential and its consequences.

Senator HUMPHREY. Mr. Heller, I have just been informed that the vice chairman has proposed that we proceed with Mr. Duesenberry before we have additional questions. We will do that, and then Senator Percy and I will question.

Mr. Duesenberry, please proceed.

STATEMENT OF JAMES S. DUESENBERRY, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. DUESENBERRY. It may be an ill omen that I am here. I notice that the first time I testified here was in 1958, and I always seem to arrive in the midst of some disastrous problems.

I do not want to take time to go on about how important it is to control inflation except to emphasize two points. First, our problem now is that we have had accelerating inflation for almost a decade. And I think the emphasis wants to be on the word "acceleration." I think it is pretty clear that we cannot continue to have inflation going at higher and higher rates each year, because there is so much inequity in it that the public will eventually support the most drastic measures to bring it to a halt, and second, because an accelerating inflation in itself causes instability in our economy that could bring about a recession or even worse.

But I think one wants to distinguish between bringing a halt to the acceleration of the rate of inflation and trying to bring inflation itself to an early halt.

I believe that we cannot get inflation down to 4 percent in 2 years. I think we have to dig in to working it down gradually for a relatively long time. And our policy should be directed toward producing enough deceleration so that we have some margin of safety against an unexpected surge of demand or some more bad luck, given raw materials and food prices, or something like that, but I do not think we should be aiming for a quick end to inflation, but rather for a gradual slowdown.

Now, there are many people who feel that we should take drastic measures to end inflation quickly. They propose large reductions in Federal spending, tax increases, and severe restraint on the money supply. If the present inflation were the result of widespread excess demand, whether generated by private demand or public spending, those increases might be appropriate. But it is not. It is true that there are capacity shortages in some industries. It is true that demand grew too rapidly from mid-1971 to early 1973. But neither capacity shortages nor rapid demand growth played the dominant role in the most recent acceleration of inflation. The increases in the prices of food and fuel were not due to changes in aggregate demand. Much of the increase in raw material prices was due to the expansion of demand in other countries, though the United States certainly contributed. Devaluation was also a factor. In any case, whatever the cause, excess demand is not the problem at the moment. Most forecasters agree that the rate of growth of real output for the next 12 months will be very slow. Capacity utilization is likely to decline even in the materials processing industries where there are still shortages. Unemployment is expected to rise to the neighborhood of 6 percent. Nonetheless, inflation is expected to continue at a rapid rate. Earlier increases in materials prices are still being passed through the system. Labor is demanding and obtaining large wage increases in an effort to make up for cost of living increases. A rise of 7½ percent in the GNP deflator and more in the CPI are expected for the next 12 months and that may be optimistic.

A rapid inflation without excess demand poses a policy dilemma. It will not be easy to find the right course of action. But certainly we ought to begin our search for wisdom by recognizing that this inflation is not primarily due to profligate spending or excessive money creation either now or in the past. If the budget had been a little smaller or the rate of monetary growth had been a little lower in 1972, the rate of growth of output would have been lower. That would have removed only one of the many causes of the step-up in the rate of inflation. Given the rise in food and fuel prices the step-up in inflation could only have been avoided by reducing other prices. To bring that about would have required a very substantial contraction in total demand and widespread unemployment.

Some people are prepared to argue that there is no other way to escape the cycle of price increases leading to wage increases, wage increases leading to price increases and so on. They are prepared to take strong measures to restrict demand in order to halt the spiral quickly. Unfortunately, the drastic measures proposed by some are likely either to fail or to produce a cure that is worse than the disease.

In the present circumstances budget cuts or tax increases would surely bring on a substantial recession which left to itself would last for a considerable time. A major recession would certainly tend to check inflation, but what next? Three outcomes are possible. The public in its zeal for inflation control—the 8 percent for 2 years that Walter Heller just referred to—might tolerate a major recession for a couple of years, and policymakers might engineer a gradual recovery with no renewal of inflationary pressures. That strikes me as the least likely possibility. Our experience suggests that recessions and high unemployment are no more popular than inflation. A few months of recession are likely to produce a shift toward expansionary policy and a new surge of demand which would cancel the anti-inflationary effects of the recession. A third possibility is that a severe recession would turn into a major depression. Many firms and financial institutions are now in much weaker positions than in 1958. They have far less liquidity and much more debt. A major recession could produce bankruptcies and financial panic which would lead to reductions in both investment and consumer expenditures. These could not quickly be offset by fiscal policy measures. The odds of success are too small, and the costs of failure too great to justify a drastic "cold turkey" approach to curing inflation.

Now, other people rely on trying to grind down inflation by using a formula for monetary growth and simply holding that brake in a fixed position until the inflation is licked.

Some monetary theorists argue that regardless of what happens to food prices, oil prices, or other specific prices, the underlying cause of inflation is monetary accommodation. If there is a surge of demand, originating in fiscal policy or in the private sector, the Fed lets interest rates go up a bit but also raised money growth to partially accommodate increased demand. If the rise in real demand leads to rising prices, the Fed accommodates that too. If Murphy's law works and supply changes lead to price increases, the Fed gives way again. On this view the only way to limit inflation is to limit the growth of the money supply. There will then be—in spite of some give in velocity—an upper limit to the growth of money demand. If there is a lot of inflation the rate of real growth will be low and that will check the inflation. That is a perfectly logical position, and there is a great deal of truth in it.

But there are a number of difficulties in the use of a monetary limit as the primary basis for inflation control. First, we do not really know what rate of growth of money supply will produce a specified rate of growth of money demand. Estimates of the response of GNP—other things equal—vary widely. Other factors besides monetary growth do affect GNP so other things are not going to be equal. To put it another way, annual changes in velocity vary widely and we do not have fully satisfactory explanations of the change.

Finally, there is uncertainty about the definition of money. Are NOW accounts money or not? In an era of high interest rates, substitutes for money may proliferate.

Second, even if we did have a more or less satisfactory estimate of the appropriate trend of growth in the money stock, sole reliance on adherence to that trend could produce very unsatisfactory results. Inflationary pressures from other sources working against a limited money supply might first drive up interest rates and velocity, permitting the inflation to continue for a considerable time and then, when velocity reached its limit, lead to a monetary crunch. Then we would either give up the monetary limit or face a financial panic.

Now, those remarks are cast in slightly academic terms. But they seem to have a fairly immediate application.

If I read the Times the other day correctly, Arthur Burns stated that he believed that the Federal Reserve should hold to a 6-percent rate of growth of the money supply for, as far as I could tell, an indefinite period until the inflation was clearly beaten. I do not want to misquote him, but I think that is the sense of it. It seems to me that that represented something very close to the doctrine I have just mentioned. And while I do believe that we have to be very cautious about the expansion of the money supply, I feel that there is considerable danger in the attitude or rigidly holding to a fixed growth rate.

The calculations by Professor Tobin that Walter Heller referred to a few minutes ago suggest that probably in an economy in which we really need something like 10-percent growth in nominal GNP for a minimal rate of real GNP, that we probably need a growth in the money supply of something in the order of 7½ percent. Now, as I have already said, the science in this math is very limited. And it may very well turn out, given the very fast rise in interest rates in the past few months, that people will economize on money. Perhaps a 6-percent growth will be sufficient to allow interest rates to recede. But in the present circumstances, I think it would be a mistake to guide monetary policy so rigidly on a monetary growth target as I thought Auther Burns was suggesting. So I may not be quoting him accurately.

The essence of it is that a monetary limit low enough to choke off inflation when demand pressures are strong would starve the economy for money when demand pressures are weak.

I believe there is no simple formula for controlling inflation on the demand side, and I am driven to conclude that the gradualist approach to control of demand is the right one even though it does not promise quick or sure results. What I shall call the gradualist approach seeks to limit demand just enough to bring about a slow deceleration of inflation without a recession or a great rise in unemployment.

The gradualist approach calls for: (1) a period of slow growth with rising unemployment and declining capacity utilization during the next year; and (2) a modulation toward a rate of growth somewhat higher than the rate of growth of potential output which would lead to a very gradual reduction of the unemployment rate. The theory is that in the first phase new capacity in the materials processing industries would get a chance to catch up with demand. Unemployment would rise as a byproduct of the low rate of growth. Higher rates of unemployment would moderate the wage pressures generated by cost of living increases. Nonetheless, large wage increases would continue so that the rate of inflation would diminish very gradually. To be successful the gradualist program requires that the fiscal and monetary policy be conducted in such a way as to avoid any new surges of demand which could generate inflationary pressures.

More concretely, my view is that the gradualist approach implies that, one, the current administration budget proposals are about right—and I am going to say something later about the composition as between expenditures and taxes and within the expenditure components. But just in terms of the level of surplus and deficit, I do not feel that a drastic change in either direction is needed at this point, although I am open to being convinced if the economy becomes softer than the 2-percent rate of growth which I mentioned above.

Second, for reasons which I will come to in a moment, new expenditure initiatives affecting future years be severely limited in view of the strong demand for capital.

And third—and this brings me back to the monetary point. If we have the kind of budgetary level that I suggested, there should be room for a significant decline in short-term interest rates to permit a recovery of housing production. And that would be the first step in producing that gradual modulation for the higher rate of growth after a period of very slow growth.

Now, looking a little bit further ahead, but perhaps it is relevant now, making fiscal and monetary policy always involves taking risks.

The art of forecasting is just not very good. And so we are very often faced with a situation in which we know that if we pursue a policy which is sure to avoid recession, we then have to take a substantial risk that the rate of growth will be too high. And on the other hand, if we pursue a policy which insures that the rate of growth will not be too high, then it may turn out to be too low and we will have a recession.

I think that the economists like Walter Heller and me for many years have always had a very strong resistance to taking anything which we regard as a significant risk of recession.

I think that in the coming years, until we have had a real slowdown in the rate of inflation, we are going to have to switch our attitudes toward risktaking and take a somewhat higher risk of recession in order to avoid the surges of demand. And I am very sorry to say that, but I think that is true at this point.

Now, let me return to the point that I believe we have to be very cautious about new initiatives in the expenditure field.

My colleague, Barry Bosworth, and I have nearly completed a study for the Brookings Institution in which we have estimated U.S. capital requirements to 1980. Taking account of our needs for plant and equipment, new energy sources, housing, pollution abatement, and mass transit, we conclude that it will be necessary to maintain a substantial full-employment surplus for the next few years if these needs are to be met. Moreover, the existing commitments in the Federal budget will absorb most of the revenues to be expected from economic growth, even including the extra revenue that comes from the fact of inflation. There is, therefore, little room for new expenditure initiatives or tax reductions in the next few years. If we maintain fiscal restraint at the level I have suggested, then I think we should have some movement in monetary policy toward a decline in short rate.

Now, I agree with Walter Heller that fiscal and monetary measures are not sufficient to solve our inflation problems. We do need other measures. Those measures are a necessary condition, but they are not a sufficient condition. And I think my list is somewhat similar to Walter Heller's. I believe we need to do something on the price and wage front. Market power is a reality. And price-and-wage increases are not required by supply and demand considerations.

In the present situation with so many capacity problems and so many distortions in the wage structure I cannot recommend a return to mandatory wage-and-price controls. Nonetheless, I think we ought to maintain some surveillance over market power. We should have a mechanism for monitoring wage and price changes by big firms and big unions. Controls pose all sorts of difficulties but it never does anybody any harm to have to account for his actions. Public review of major wage and price increases should be reinstituted. It will not be a major factor but it will cut off some certified outrages and will be well worth the cost.

Second, we should be looking at the cost and productivity problems of particular industries, especially the health and construction industries. The Government pays for a lot of the output of those industries and should take some responsibility for them.

Third, the Government should examine its own activities in the areas in which it regulates or directly influences prices. Walter Heller gave you a list of some suggestions. And I might remind you that in the 1967 Economic Report there was a whole chapter which went through a list of actions which the Government could take to put its own house in order. And I recommend it to you.

Fourth, our labor markets could certainly be improved. There are many opportunities for improving the operation of the employment service in the simple task of matching workers with job opportunities to reduce vacancies, turnovers, and frictional unemployment. Beyond that there appears to be something fundamentally wrong with the transition between school and work for many of our young people, particularly those who do not go to college. I have no panacea to offer, but the Congress should be prepared to fund generously experimental programs for building bridges between school and work and for providing continuing educational opportunity for those who do not go to regular colleges.

Finally, if we accept the necessity for containing demand and for living with a relatively high unemployment rate for a time, we will need to expand training programs and have some form of public employment. I think we have to proceed on an experimental basis. I think it is not easy to design a public-employment program which will be really helpful to the people who need it, and simply turning on a million public-service jobs and letting it go at that will not do you much good. It has to be geared to training programs and to the problems of different types of individuals and their long-term occupational needs.

Now, I am here departing from my statement, because I could not get this done in time. I turn to the budget and tax question again. I suggest that the level of surplus, if you measure it on a full employment basis, or a deficit on an actual basis, in the budget is more or less right. But I think there is room for expenditure cuts in some particular places. And I think the Congress should examine the Defense budget very carefully. And if it can find room there to do something about it, I think there is also room for tax reform. If we can obtain some revenue from tax reform, and if we can make some cuts in budgets, then I think it would be extremely helpful to make a reduction for low-income people, possibly in the form of some change in the social security tax, but in any case, in such a form that would put more into the pay envelopes of workers. And I think that would be important not only from an equity point of view, but also from a point of view of slowing down inflation, because much of the pressure for wage increases comes not from a calculation of what the gross wage rate is adjusted for the cost of living, but on what is the real value of what is actually in that paycheck. And if you can make the paycheck a little bigger by a tax reduction, you will reduce some of the pressures for wage increases.

But I can only recommend that if the resources for it are obtained from tax reforms or reductions in some other categories of budget expenditures.

Now, if the forecasts change and we move toward a softer economy, then it is possible that there may be room for it. But at the moment I would prefer to hold to the budget level and provide the room for easing monetary policy before I came to a net tax reduction, unless it were financed in the manner I suggested.

And finally, the committee has asked about the credit allocation. And I think I have probably taken up my time, so I will be very brief, and simply say that most of the credit allocation proposals that I have seen will turn out to have relatively little net effect, and will probably damage our financial system, by diverting funds out of the sectors of the financial system which are now well regulated and well supervised, and into unsupervised channels.

I think if we really want to make room for social program expenditures, what we need is a fiscal policy which provides room for them in a national budget consistent with our overall employment objectives, and then while there are various things that we can do to improve the operation of our financial markets, I think the need for specific credit allocation will go away.

But I will be glad to respond to the questions in detail on those points.

Thank you.

Senator PROXMIRE [presiding]. Thank you very much, Mr. Duesenberry.

[The prepared statement of Mr. Duesenberry follows:]

PREPARED STATEMENT OF JAMES S. DUESENBERRY

I first testified before the Joint Economic Committee in February, 1958. At that time we were all fearful that the recession could turn into a real depression. In the intervening years recessions have not been our problem. For a decade the rate of inflation has been accelerating in this country and in most industrial countries. The process cannot go on indefinitely. Accelerating inflation causes all sorts of social friction because some people gain and some lose. The losers are justifiably angry and frustrated. It endangers the existence of firms and financial institutions, which cannot change prices readily or quickly adjust existing contracts. At the same time some firms and individuals are led to make commitments which can only be justified if inflation continues or continues to accelerate. If inflation continues to accelerate there will be increasing public demand for drastic action to bring it to a halt and the cost of disinflation will become progressively greater. To permit a further acceleration in the rate of inflation is to risk a major depression.

It is less important to bring the rate of inflation down rapidly. Even a very gradual deceleration would permit everyone to adjust and would take the profit out of gambling on rising rates of inflation. But we need to exert enough downward pressure on the rate of inflation to be sure that some miscalculation or piece of bad luck does not cause a renewed acceleration.

I shall comment very briefly on the causes of the present inflation and on the short term outlook before turning to a discussion of fiscal and monetary strategy for containing inflation. I shall then raise some questions about other types of policy for dealing with inflation and unemployment. Finally, I have a few comments on the problems of credit allocation.

There is no quick safe cure for inflation. Some people feel that we should take drastic measures to end inflation quickly. They propose large reductions in Federal spending, tax increases, and severe restraints on the money supply. If the present inflation were the result of widespread excess demand, whether generated by private demand or public spending, those increases might be appropriate. But it is not. It is true that there are capacity shortages in some industries. It is true that demand grew too rapidly from mid-1971 to early 1973. But neither capacity shortages nor rapid demand growth played the dominant role in the most recent acceleration of inflation. The increase in the prices of food and fuel were not due to changes in aggregate demand. Much of the increases in raw material prices was due to the expansion of demand in other countries, though the U.S. certainly contributed. Devaluation was also a factor. In any case, whatever the cause, excess demand is not the problem at the moment. Most forecasters agree that the rate of growth of real output for the next twelve months will be very slow. Capacity utilization is likely to decline even in the materials processing industries where there are still shortages. Unemployment is expected to rise to the neighborhood of 6%. Nonetheless inflation is expected to continue at a rapid rate. Earlier increases in an effort to make up for cost of living increases. A rise of 7½% in the GNP deflator and more in the CPI are expected for the next twelve months and that may be optimistic.

A rapid inflation without excess demand poses a policy dilemma. It will not be easy to find the right course of action. But certainly we ought to begin our search for wisdom by recognizing that this inflation is not primarily due to profligate spending or excessive money creation either now or in the past. If the budget had been a little smaller or the rate of monetary growth had been a little lower in 1972, the rate of growth of output would have been lower. That would have removed only one of the many causes of the step up in the rate of inflation. Given the rise in food and fuel prices the step up in inflation could only have been avoided by *reducing* other prices. To bring that about would have required a very substantial contraction in total demand and widespread unemployment.

Some people are prepared to argue that there is no other way to escape the cycle of price increases leading to wage increases, wage increases leading to price increases and so on. They are prepared to take strong measures to restrict demand in order to halt the spiral quickly. Unfortunately, the drastic measures proposed by some are likely either to fail or to produce a cure that is worse than the disease.

In the present circumstances budget cuts or tax increases would surely bring on a substantial recession which left to itself would last for a considerable time. A major recession would certainly tend to check inflation, but what next? Three outcomes are possible. The public in its zeal for inflation control might tolerate a major recession for a couple of years, and policy makers might engineer a gradual recovery with no renewal of inflationary pressures. That strikes me as the least likely possibility. Our experience suggests that recessions and high unemployment are no more popular than inflation. A few months of recession are likely to produce a shift toward expansionary policy and a new surge of demand which would cancel the anti-inflationary effects of the recession. A third possibility is that a severe recession would turn into a major depression. Many firms and financial institutions are now in much weaker positions than in 1958. They have far less liquidity and much more debt. A major recession could produce bankruptcies and financial panic which would lead to reductions in both investment and consumer expenditures. These could not quickly be offset by fiscal policy measures. The odds of success are too small, and the costs of failure too great to justify a drastic "cold turkey" approach to curbing inflation.

There is no automatic monetary formula for insuring prosperity without inflation. Some monetary theorists argue that regardless of what happens to food prices, oil prices, or other specific prices, the underlying cause of inflation is monetary accommodation. If there is a surge of demand, originating in fiscal policy or in the private sector, the Fed lets interest rates go up a bit but also raised money growth to partially accommodate increased demand. If the rise in real demand leads to rising prices, the Fed accommodates that too. If Murphy's law works and supply changes lead to price increases, the Fed gives way again. On this view the only way to limit inflation is to limit the growth of the money supply. There will then be—in spite of some give in velocity—an upper limit to the growth of *money* demand. If there is a lot of inflation the rate of real growth will be low and that will check the inflation.

That is true, but there are a number of difficulties in the use of a monetary limit as the primary basis for inflation control. First, we don't really know what rate of growth of money supply will produce a specified rate of growth of money demand. Estimates of the response of GNP (other things equal) vary widely. Other factors besides monetary growth do affect GNP so other things aren't going to be equal. To put it another way, annual changes in velocity vary widely and we do not have fully satisfactory explanations of the change. Finally, there is uncertainty about the definition of money. Are NOW accounts money or not? In an era of high interest rates, substitutes for money may proliferate.

Second, even if we did have a more or less satisfactory estimate of the appropriate trend of growth in the money stock, sole reliance on adherence to that trend could produce very unsatisfactory results. Inflationary pressures from other sources working against a limited money supply might first drive up interest rates and velocity, permitting the inflation to continue for a considerable time and then, when velocity reached its limit, lead to a monetary crunch. Then we would either give up the monetary limit or face a financial panic.

Finally, a monetary limit low enough to choke off inflation when demand pressures are strong would starve the economy for money when demand pressures are weak.

I am driven to conclude that the gradualist approach to control of demand is the right one even though it doesn't promise quick or sure results. What I shall call the gradualist approach seeks to limit demand just enough to bring about a slow deceleration of inflation without a recession or a great rise in unemployment.

The gradualist approach calls for: (1) a period of slow growth with rising unemployment and declining capacity utilization during the next year; (2) a modulation toward a rate of growth somewhat higher than the rate of growth of potential output which would lead to a very gradual reduction of the unemployment rate. The theory is that in the first phase new capacity in the materials processing industries would get a chance to catch up with demand. Unemployment would rise as a by-product of the low rate of growth. Higher rates of unemployment would moderate the wage pressures generated by cost of living increases. Nonetheless, large wage increases would continue so that the rate of inflation would diminish very gradually. To be successful the gradualist program requires that fiscal and monetary policy be conducted in such a way as to avoid any new surges of demand which could generate inflationary pressures.

More concretely, the gradualist approach implies that (1) the current administration budget proposals are about right, (2) new expenditure initiatives affecting future years be severely limited in view of the strong demand for capital, and (3) that budgetary restraint will permit a significant decline in short term interest rates to permit a recovery of housing production.

In addition it must be said that we must make a change in our philosophy of risk taking. For a good many years liberal economists have felt that recessions and high unemployment are costly in terms of our social problems as well as in terms of lost output. Our concern for those social problems has always led us to try if at all possible to find policies to insure against recession. Since forecasting remains an uncertain art we often find ourselves in a position in which policies required to insure against recession entail a substantial risk of too much demand. At the same time, policies required to insure that demand will not grow too fast entail a risk of recession. Many of us while fully recognizing the nature of the choice have preferred to take the risk of too much demand rather than the risk of recession. I believe that to insure against further acceleration of inflation we will have to shift the balance of risks the other way. Believe me, I don't like to say that, but I am afraid its true. That implies of course that in the next few years we will have higher average levels of unemployment than we have previously accepted.

I shall take a moment to amplify my observations on capital requirements. My colleague, Barry Bosworth, and I have nearly completed a study for the Brookings Institution in which we have estimated U.S. capital requirements to 1980. Taking account of our needs for plant and equipment, new energy sources, housing, pollution abatement and mass transit, we conclude that it will be necessary to maintain a substantial Full Employment Surplus for the next few years if these needs are to be met. Moreover, the existing commitments in the Federal Budget will absorb most of the revenues to be expected from economic growth. There is therefore little room for new expenditure initiatives or tax reductions in the next few years.

If the very severe fiscal restraint implied by those remarks is actually applied, there should be room for an early easing of current very high short rates and—depending on our progress in decelerating inflation—a gradual reduction in long term rates. As to the conduct of monetary policy, I have already indicated that I do not believe a predetermined rule will work. I do think, however, that a less accommodating policy than we have had in the past will be necessary. That means smaller swings in the rate of growth of reserves to money supply even though the direction of those adjustments is still based on economic analysis and forecasts.

OTHER ANTI-INFLATION MEASURES

A degree of fiscal and monetary restraint sufficient to prevent inflationary pressure from the demand side is a necessary condition for a deceleration of inflation. It is not a sufficient condition. Inflation has become a way of life, everyone is sensitive to it, everyone wants to beat it by getting there first with his wage or price increase. Angry workers whose real wages have fallen can create a wage explosion even when demand is weak and unemployment high. Bad crops and other random events can drive up the cost of living even when total demand is under firm control. Even if we have fairly good luck the task of turning the inflationary spiral around is a long and difficult one. Monetary and fiscal policy could use some help and there are some things that can be done.

Market power is a reality. Price and wage increases not required by supply and demand considerations can occur. In the present situation with so many capacity problems and so many distortions in the wage structure I cannot recommend a return to mandatory wage and price controls. Nonetheless, I think we ought to maintain some surveillance over market power. We should have a mechanism for monitoring wage and price changes by big firms and big unions. Controls pose all sorts of difficulties but it never does anybody any harm to have to account for his actions. Public review of major wage and price increases should be reinstituted. It won't be a major factor but it will cut off some certified outrages and will be well worth the cost.

Second, we should be looking at the cost and productivity problems of particular industries especially the health and construction industries. The government pays for a lot of the output of those industries and should take some responsibility for them.

Third, the government should examine its own activities in the areas in which it regulates or directly influences prices.

Fourth, our labor markets could certainly be improved. There are many opportunities for improving the operation of the employment service in the simple task of matching workers with job opportunities to reduce vacancies, turnover and frictional unemployment. Beyond that there appears to be something fundamentally wrong with the transition between school and work for many of our young people, particularly those who do not go to college. I have no panacea to offer, but the Congress should be prepared to fund generously experimental programs for building bridges between school and work and for providing continuing educational opportunity for those who do not go to regular colleges.

Finally, if we accept the necessity for containing *demand* and for living with a relatively high unemployment rate for a time, we will need to expand training programs and some form of public employment.

CREDIT ALLOCATION

The committee has, very properly, been concerned with the allocation of credit among sectors of the economy. When monetary policy is used to restrain total demand, the allocation of expenditures as well as the total is affected. In particular, tight money has always affected housing more than any other type of expenditure. Housing has been sensitive to monetary conditions because mortgage financing depends heavily on thrift institutions which lend long and borrow short. They compete for deposits against short term credit market instruments whose rates are volatile. But the rates offered by thrift institutions are limited by their earnings which are based not on current market rates but on the average mortgage rate over a long period. When short rates move up deposit inflows to thrift institutions decline or become negative.

Rates have fluctuated on a rising trend in the last few years and the thrift institutions and mortgage market have been badly hit in 1966, 69, 73 and right now. The expansion of FNMA and GNMA activities and longer term advances by FHLB have helped to cushion the blow. Thrift institutions have been partially protected from bank competition by rate ceilings and from the credit market by the $10,000 minimum for treasury bills. It is difficult, however, to prevent competition indefinitely. Short term security offers by bank holding companies, and money market mutual funds are natural responses to limitations on competition for funds. Were these devices to be ruled out by legislation, others would be found.

While the immediate monetary prospect is poor, there is reason to hope that the situation of the thrift institutions will improve. With reasonably sensible fiscal policies, short term rates can be reduced from their current peaks. Thrift institution earnings will rise as the weight of high rate mortgages in their portfolios increases. Their competitive position should tend to improve. Nonetheless, they are likely to remain vulnerable to any episode of tight money and rising rates, even a temporary one.

In the long run the mortgage market should become less dependent on thrift institutions which lend long and borrow short. FNMA, GNMA guaranteed bond issues, and longer term security issues and advances by FHLB can be further developed, though this may require that mortgage yields rise above bond yields once again. Thrift institutions have already made considerable progress in lengthening their liabilities. They should continue to do so. They should also be given the right to issue NOW accounts in competition with commercial banks and to compete in the consumer credit market. In short, the thrift institutions should become a good deal more like commercial banks in the retail market. The mortgage market should become less dependent on short term deposit financing. Finally, the thrift institutions ought to develop larger liquid reserves to deal with short term rate fluctuations.

These moves, together with a fiscal policy that leaves room for adequate capital formation, should solve most of the mortgage and thrift institution problems. Nonetheless, there will be times when it is necessary to take action to restrain short run surges of demand. If we use monetary instruments for that purpose, housing and the thrift institutions will be in trouble. Can we do anything further?

We can take measures to relieve monetary policy of some of the short run stabilization burden. It is not a very good instrument for that purpose. Variable taxation of investment in consumer durable purchases would operate more quickly without the side effects of monetary restraint.

There are a variety of proposals for more direct measures. Differential reserves against bank assets, e.g., low reserves for mortgages, higher ones for commercial loans would work in essentially the same way as taxes on borrowing. However, they would apply only to banks. Moreover, if the differentials were significant they would encourage a shift of financing activity into unregulated organizations especially in the large bank holding companies.

Measures to require financial institutions to invest certain proportions of their assets in mortgages have worked in other countries. However, our financial markets are larger, more complex and more flexible than those in other countries. A positive requirement that certain types of financial institutions invest given percentages of their resources in (say) residential mortgages may be workable, but would have drawbacks. Such a requirement would, of course, tend to widen the gap between the returns from mortgage lending and other investments. Indeed, the shift (by comparison with the situation in the absence of the proposed control) of (say) insurance company funds out of other markets into mortgages would push up other rates relative to mortgage rates. The result would be to weaken the competitive position of specialized mortgage lenders vis-a-vis the open market, causing a decline in mortgage lending from that source. The situation would be analogous to FNMA operations. And as in the case of FNMA operations, the regulations probably would have a net favorable effect on the supply of mortgage credit though smaller than the gross effect. But it hardly seems desirable to get snarled up in a new set of regulations to create a set of unwilling mortgage lenders. If the quantities involved were significant, lenders would be encouraged to reorganize their activities so as to move them out of the regulated sector, and other sorts of evasion would appear.

CONCLUSION

If it is desired to channel credit directly into the mortgage market, it would be better to do it through further development of financing through Federal agencies, or if absolutely necessary through direct Treasury purchases of mortgage backed securities.

To sum up, further improvements in the competitive position of mortgages can and should be made. But no financial rearrangement can be successful unless fiscal policy leaves enough capital resources available to permit us to meet all our capital requirements at reasonable interest rates. In view of the strong demand for capital which we expect in the next few years, fiscal restraint is required to fight inflation and to solve our credit allocation problems.

Senator PROXMIRE. I wish I could have been here to hear your full presentation. But I have had a chance to go through your prepared statements.

I hope you will accept my remarks as not being personally critical, because I have great admiration for both of you. But I can't resist the impression that we get from the administration of a do-nothing policy, and we get from you almost exactly the same thing. The rhetoric is different, the talk is different. The administration talks about restraint, and how we have to exercise a greater restraint than we did, but that doesn't give you anything to do it. You talk about economic justice, but you don't prescribe medicine to deal with inflation.

The President's budget for the current fiscal year calls for about $305 billion in spending. That represents a $35 billion, 13-percent increase in Federal spending over last year. It is by far the biggest increase in the peacetime history of our country, and one of the biggest percentage increases ever. And yet I get from both of you gentlemen the notion that this is something that we probably should not cut back, and if we cut back at all, we have to be very, very careful about it.

Let me say, the case for cutting it back seems to me to be very strong. No. 1, Congress buys it. The Senate voted for exactly that kind of a $10-billion cut when it supported my amendment to do precisely that by a 74-to-12 margin.

No. 2, the public buys it. I got returns from my State of Wisconsin from a questionnaire I sent out, and they voted for it 10 to 1. They vote like that for a $10-billion cut. And I asked them for specific areas in which they would make their cuts, and they were specific about it—military spending, foreign aid, public works spending, welfare, is where they would cut. You may agree or disagree on those areas, but they want the expenditures cut.

And the commonsense view is, when you have inflation, and you have this colossal increase that the President of the United States has been asking for in spending, that you make a reduction in it.

Now, if we cut it back $10 billion you still would have a 9-percent increase in spending over last year. I can't see why in the world a 9-percent increase in spending over last year is being parsimonious or cruel or insensitive, and why it should precipitate a recession by itself, if we recognize other things we have to do.

Mr. Heller, would you respond?

Mr. HELLER. First of all, both your Library of Congress research staff and the National Industrial Conference Board analysis of the budget suggest that when you take into account offsetting revenues that cut down the net expenditure numbers shown in the budget, this is not a record rise this year. The rise last year was actually bigger than the rise this year. That may be a quibble.

Senator PROXMIRE. I am not so sure that is correct either. Last year's rise was from $246 billion to $270 billion, and this year's is from $270 to $305, this is bigger in absolute size and in percentage terms.

Mr. HELLER. But I am speaking of those program revenues which don't count as revenues in the budget, but count as offsets to expenditures, in other words, they shrink expenditures. And when you count the 2 years and make adjustments for those offsetting program revenues, this is not a record rise. But as I say, I think that is merely a quibble for correcting the record, as I understand it.

Senator PROXMIRE. Let me go a little further and say, mandated expenditures required of private industry by Federal programs, programs for which I voted, including the OSHA program, the air-pollution program, and the water-pollution program add up to billions and billions of dollars of mandated expenditures for social purposes which mean higher prices, because the corporations have to pass those on. I say, I voted for them, and I would vote for them again. But I have to take that into consideration, too.

Mr. HELLER. I grant you that. And that is why I characterize this as a statistical quibble rather than a fundamental, substantive point which you are raising. I think that the emphasis ought to be put on the net full employment surplus or deficit situation. And in that respect the President's move—and I have said this a number of times—from a deep full-employment deficit a couple of years ago to something closer to a balance this past fiscal year, and a large potential surplus in the current fiscal year——

Senator PROXMIRE. Let me just interrupt you, Mr. Heller, to say this. The argument has been made by many—and you have been Chairman of the Council of Economic Advisers, Mr. Greenspan is going to be in that position shortly—that you can cut Government spending without necessarily increasing employment, without necessarily having an adverse effect on growth. One of the effects would be, of course, as you cut Federal spending, the Government is no longer borrowing $10 billion additional, and therefore driving up interest rates. This would tend to some extent to moderate interest rates, and it would help housing. As you help housing you provide more employment in the private sector.

Furthermore, as you know as a sophisticated economist, when you cut $10 billion in spending, you don't get that many net layoffs in the economy, because there are offsets.

Mr. HELLER. You are anticipating my exact point, which is that you have to relate the net full-employment surplus or deficit in the budget to the prevailing monetary policy. I suppose that in part one's attitude on the budget is conditioned—and there is a chicken-and-egg problem here, by the tightness of Federal Reserve policies. If we had a real tradeoff, if there were a kind of détente here between the Congress and the Federal Reserve, and you had a deal with Arthur Burns, he would let up if you tightened down.

Senator PROXMIRE. Given the same monetary policy, if you reduce Federal spending, it would tend to ease the demand for money, and therefore tend, without any change in force by the Federal Reserve, to make funds more available in other areas.

Mr. HELLER. And if this were permitted to let funds become more available, and let interest rates ease, then we would have an offset——

Senator PROXMIRE. Mr. Burns has made that as clear as he can, he called for the $10-billion cut as you know. And he has indicated that in his view this is a precondition necessary to provide for a more constructive monetary policy.

Mr. HELLER. But we cannot look at either of the policies in isolation, we agree to that.

Now, third, an awful lot depends on where the cuts are made. I understand that Secretary Schlesinger has at one point said that about $5 to $6 billion of the defense spending was designed to help us guard against recession. If that is true, that $5 or $6 billion represents almost the worst kind of Government response to dangers of a recession. We have it on the authority of Admiral LaRocque of the Center for Defense Information that we can keep our national defenses up at a considerably lower cost.

We also have it on the authority of the Brookings Institution that the defense expenditures are rising in real terms, and are scheduled to rise throughout the rest of the seventies. And they are protected against inflation and are spoken of in terms of protecting against recession. At the same time, the social grant programs, a lot of the programs that do help the lower income groups, are declining in real terms. So that when you talk about budget cuts, I get nervous about the distribution of those cuts. I think on this inflation question, on the tax cut question, we have to keep our eye on that distributive pattern, because I am deeply concerned that the minority groups, the disadvantaged groups, the lower income groups generally, are going to get hit by a double or triple whammy; that is, both by inflation itself and by the policies that are taken to cope with inflation. So I can't just endorse a $10 billion budget cut without knowing where it will occur, and without knowing what will occur with respect to tax policy or monetary policy.

Senator PROXMIRE. Unfortunately I have to go to the floor again.

With the permission of the committee, Mr. Duesenberry, I will study your response. I apologize for this, but I have no choice. Senator Humphrey will preside.

Senator HUMPHREY [presiding]. Go ahead, Mr. Duesenberry.

Mr. DUESENBERRY. I think I have already answered that question in part, that if the Congress would find budget cuts of which I would approve—I agree with Walter Heller about the necessity of being careful as to where the cuts are—if for example, we take something off defense, I would be delighted to have that done.

As to what happens next, I think we have to recognize that we would get some benefit in terms of monetary policy, though I think there is some room for a shift in monetary policy even now. If we have to adjust to a very large budget cut, then we have to recognize that monetary policy has its effect, in my judgment, very slowly, and that we might get a turn in short-term rights, and that would benefit housing fairly quickly. But the turn in long-term rates will take a very long time. And therefore, it would have the negative effects of the budget cuts while only getting part of the positive effects from changing the monetary policy.

And that leads me back to what I suggested when I gave my statement, that it would certainly be desirable if the Congress could reduce the expenditure side of the budget, and return part of those savings in the form of some sort of low-income tax reduction.

So that the total balance of the package as between monetary policy and tax reduction is something that you can't discuss here without a lot of numbers in front of us.

Senator HUMPHREY. Might I just add before Senator Percy questions that the whole problem centers around the failure of the Congress and the executive branch to have any central plan for inflation control. We go at it piecemeal. We take an aspirin, and we put on a bandaid, and we go get a chiropractic treatment, and we see a general practitioner. And we don't do anything in a synchronized manner.

For example, we voted a spending ceiling of $295 billion in the Senate without any regard to tax policy, monetary policy, what kind of budget cuts it would be. The Federal Reserve Board goes its way and willy-nilly comes over here twice a year and tells you what it is doing, and never consults anybody. The executive branch goes its way, and has a fine time lousing up things. We sit over here as confused as somebody that has been put in a merry-go-round with an accelerated pace. It is really ridiculous. There is no economic planning.

I think these hearings only reveal one thing when we are all through. We get all kinds of remedies, all kinds of proposals, but no one ever puts them together, the Congress doesn't and the executive branch doesn't. We thank you for your testimony, and you go on your way and we go on our way. When you get the budget cuts that depends on what you want to cut.

Now, my constituents have got real ideas about what ought to be cut. I will tell you, they don't agree with what a lot of other people here think ought to be cut. As long as we don't have a policy, as long as everybody is out on the law of the jungle, taking care of himself, I intend to take care of Minnesota. I intend to take care of Humphrey's views. But I would prefer that we do something else.

So let's just lay it on the line. I think no one has a policy. We have a series of policies like a bag of popcorn, that is what it amounts to. There is no substantive nature to it at all.

Senator Percy, I know you have got some more intelligent questions to ask, and more intelligent observations to make. But I have my prejudices grounded on years of observation.

Senator PERCY. I would say that we all have our prejudices. Our differences probably go back to whether we should continue to try to control prices of commodities, and whether to regulate the free market that we have. We must admit that we are pretty poor planners from the standpoint of running an economy.

Mr. Heller, I would like to start on an area where we do agree very strongly. In your prepared statement you have indicated that you favor a greatly expanded public service job program. I do feel, and I think Mr. Burns agrees with us, that this is far preferable to other means of stimulating the economy, tax reductions, or whatever it may be. It is just a very direct and immediate way. I have talked to a lot of mayors, and they can put people to work right away on needed and necessary work. It goes right to the heart of the problem when a man is out of a job or wants a job. Would you agree that it would be desirable to do this especially if we could pay for those jobs through other revenue-raising devices? For example, Senator Long and I are working on legislation that would provide for more jobs, but at the same time provide the revenue for them by just simply repealing the deductability of State and local gasoline taxes. This favors the higher income people. The standard deduction people are not affected by it. We can pick up $600 million. There is a lot of fraud in it, we know that. That is $600 million but I don't think not more than $10 or $15 a family. They are not going to be injured by it. The only large amounts are really in high income areas.

Wouldn't that be another way that you can finance public service jobs?

And possibly if you need more money, you could just reform the minimum income tax such as was recently proposed by the Treasury Department, by which this year we could pick up $745 million. You probably wouldn't need that many public service jobs, but wouldn't it be desirable now, rather than say, let's spend more money, to say, we are now going to raise taxes sufficiently to pay for those extra services that we provide, and not just add to the deficit.

Mr. HELLER. Let me come back to Senator Humphrey's proposal, that we take a comprehensive view. I think what you are proposing on the gasoline taxes, and what you are proposing on the minimum income tax—which is a weak reed if ever I saw one—is to try to capture some revenue primarily from the upper income groups. You can go beyond that; by the way, you can talk about taxes on the oil companies——

Senator PERCY. I am just limiting it to public service jobs. But as we now add cost items, it is a matter of principle, add the revenue to pay for those services.

Mr. HELLER. Either that or cut out chunks of the defense budget that we are assured by qualified experts are not needed. This fits with the general philosophy that both Jim Duesenberry and I have supported on the budget; namely, that the overall budget targets are about right. I wouldn't mind bending them a little bit for the time being. But when I propose tax cuts for lower income groups, I also propose matching those with the kinds of tax reforms you are talking about in terms of balancing off the revenues.

We can't, of course, use those same revenues for a half dozen different uses, we tend to go the easy way in thinking about it.

So, I am in accord with your general philosophy in this respect.

But let me just add, since your question does give me that opportunity, that there are, I should think, rather limited chances that a full-scale tax reform bill could get through the Congress this year—given certain other activities that seem to be occupying the Congress at the moment—even if the bill gets out of the Ways and Means Committee and through the House. But it would seem to be unconscionable if we don't do something about oil company profits, particularly in the form of eliminating percentage depletion here and now.

There are also other opportunities for raising revenue, such as a graduated tax on automobiles according to horsepower, gasoline consumption, and so forth.

Yes, there are many opportunities for raising those revenues. And I certainly would not object to the matching of these increased expenditures or tax cuts with such increased revenues.

Senator PERCY. I would like to ask you about some of the specific proposals for both increasing revenues and reducing expenses, to see whether or not you wouldn't agree that it would help psychologically, even though I recognize reducing the deficit by $10 billion in a $1,300 billion economy is not significant—I wonder whether psychology doesn't enter into this much more than we give it credit. The mere fact that we are asking everybody to do something should help. If the people of this country see the Congress really now begin to balance the budget, that would be a significant statement to them. They have got to do it at home, but they always think of us down here as having no regard for doing that, and they blame us a great deal for a lot of the pressure in the economy. If we could just now start in to say, limit the foreign tax credit for oil production income, which would assure that the U.S. oil companies would pay a fairer share than they are now, we could pick up half a billion dollars right there very easily. We could also phase out the domestic depletion allowance which has been a Ways and Means Committee proposal over a period of years.

Recent oil prices have provided, it would seem to me, plenty of incentive now for drilling that would allow us to pick up $620 million this year. And it is on an increasing scale. If we could just simply add a provision on heating fuel to eliminate tax fraud on the use of it as diesel fuel, we could pick of $½ billion to $1 billion right there. We know there is that much fraud in that program.

We could repeal foreign depletion allowances. We are now encouraging foreign drilling. We could pick up another $500 million there.

I can list $3½ to $4 billion in 5 minutes that we could pick up. Would it be a worthy objective for us to really try this year, in the fiscal 1975 budget, to add a certain amount of revenue in those areas where I don't think it is going to be a repressant on the economy at all.

Mr. HELLER. We have to distinguish between the microfiscal and macrofiscal policy, if you will. I am with you all the way on every one of the points that you made that we ought to pick up the revenue. But whether we ought to make that a net addition to the full-employment surplus, so to speak, in other words, whether we ought to tighten the fiscal policy to that extent, is a much more dubious proposition. The prospects are really for a slack, sluggish economy. With the present policies we are not going to achieve even the 2-percent growth rate that I agree we probably ought to endue for a while. It looks more like a half a percent growth rate in the next few quarters under present policies.

Under those circumstances, to tighten fiscal policy further, unless we had a pact signed in blood by Arthur Burns to make compensating adjustments in monetary policy, is not—in other words, on the macrofront—something I would subscribe to.

But again, you do have to balance fiscal and monetary policy. And perhaps it can be part of an overall package.

Finally, on this question of the symbolism of the Federal budget and putting your house in order and having a balanced budget, and so forth, I find that is talked about a great deal here in the halls of Congress and by businessmen, but I don't find in this day and age there is very much public sensitivity any more to the question of a balance in the Federal budget. I really don't believe that that would have the symbolic significance that you expect. I am not saying that you shouldn't do it, I am saying that the psychological payoff isn't all that great. On the other hand, the total environment of something like the Kennedy administration's calls for sacrifice in the country, a spirit of giving a little bit to the other fellow, or of an economic disarmament agreement among different groups in the economy is badly needed. I doubt that we have much of a chance of getting it before 1976. But that is desperately needed in this country to end some of the alienation, the lack of cohesion, and so forth, that is being exacerbated by inflation.

Senator PERCY. I think we disagree in two areas. I think maybe you possibly, Mr. Heller, with all respect, could be 3 or 4 months behind the mood of the country.

Mr. HELLER. That is possible.

Senator PERCY. I really feel that you have slipped a little bit. I feel that when I told my young colleagues, Senator Kennedy and Senator Mondale, that there would be no possibility of increasing the personal exemption. We never in an election year have failed to reduce taxes. But I said to them, that is the old style economics and politics in my judgment. The people of this country would be aghast today in this day and year if we added to our debt $6½ billion by a personal income tax reduction when there are billions of people below the poverty level not paying taxes at all who would just get the brunt of any inflationary pressure that might be put.

I do feel that there is a psychology here. We are so close, we came within $3½ billion of actually balancing the fiscal year 1974 budget. I would hope we would never use that "full employment balanced budget" term again. It is a term I discredit. I was sorry to hear you use it. I don't think the people of this country believe in that concept any more, and I am glad they don't. I think if we could bring the budget into balance it would be psychologically uplifting. But to do it we would have to cut out the pork barrel. And I am not prepared to do it, not for flood control, but the kind of soft, long-term, hundred-year projects that the Corps of Engineers have. I don't think we can justify those expenditures today. And I think that would then mean to a community here or a community there that we are going—beginning to really cut down, we are going to sacrifice—you are going to have to sacrifice a little bit to somehow take the pressure off money and everything else.

But I would hope that maybe there is more to the psychology, that we can bring the budget back into balance.

And in the second area that I think we do disagree on is how bad the economy is. I can't agree that those who are investing capital funds for the future—and the business community has increased its capital expenditure from $11½ billion to almost $20 billion this year, building new capacity, buying new equipment and new machinery. They are thinking of consumption demand in the future. I hope we are not in as bad an economic condition as you might feel. And, therefore, I think we do basically disagree as to how we should respond to it.

But I think the debate is extraordinarily helpful. I intend to go

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back over your testimony in greater detail to see what the areas of agreement and disagreement are.

Mr. HELLER. I hope you are going to let Professor Duesenberry comment on these points.

Senator HUMPHREY. Please go ahead. We are going to try to keep the members to a 10-minute rule in their presentations.

Mr. DUESENBERRY. Let me answer the two points of Senator Percy.

First, $10 billion is not—it is true that the GNP is $1,500 million—but what is important is the annual rate of growth. And if you offer a multiplier, then a $10 million difference in Federal expenditure, a $10 billion difference in revenue, can make a difference over a couple of years of a couple of percent in the GNP. There is a great deal of difficulty as to whether the GNP grows in dollar terms 8 percent next year, or 10 percent, or 12 percent or 8 percent, if you are going the other way. So, do not knock $10 billion. It is important even though it is a very small fraction of the total GNP.

Second, there is a problem about all sorts of tax reform measures in terms of how we view their economic impact. In these days I think it is probably fair to say that if you take revenue from oil companies you are not affecting their expenditures or anybody else's expenditures. It may be desirable from an equity standpoint to get that revenue, because that in the end has something to do with the distribution of wealth.

So, I am all for the measures that you have suggested. I don't think they permit us in themselves to make a change in expenditures somewhere else, at least not in the short run, although in some longer period they may have a depressing effect.

Let me stop there.

Senator HUMPHREY. Congressman Brown, now is your chance.

Representative BROWN. I am glad that Senator Percy took on Mr. Heller, because I haven't had a chance to go over Professor Heller's testimony. I have gone over Professor Duesenberry's testimony.

I hope I can find some area of agreement, but so far I have been without a great deal of success.

I gather that we are in a time when everybody gets after everybody else, given our experience in the last couple of days with spokesmen from the administration who received a little bit of chastisement from Senator Proxmire. I thought certainly we would get a little bit more common agreement today on what ought to be done, but here we are doing the same thing to each other that we have been doing since the beginning of the hearings.

Maybe out of all of this some profit will come.

One of the things that I am concerned about, Professor Duesenberry, if I read your prepared statement correctly, is that you are not concerned about what I and I think many private citizens consider to be, the inordinate growth of government. I don't mean just the growth of the Federal Government, but also the State and local government. The States and the local government though, seem to be doing better balancing their income expenditures than the Federal Government does. This growth has been somewhat sharper than the growth in investment in productive capacity in this country over the last 20 or 25 years. According to the economic report of the President which we got in February of this year, the growth in the Federal Government's budget from 1947 to 1975 is in the range of about nine times the growth of the budgets of State and local governments from 1948 to 1971 and if you include the period 1946 to 1971, it is 15 times.

But, of course, I think the 1946 figures might be a little unfair to use in that area.

If you look at the growth in the investment in manufacturing and capital formation from 1947 to 1972, there has only been a sixfold increase. If you look at retained earnings equity, fiscal assets and financial assets together, it has only been five times in that period.

Now, it seems to me that growth is out of balance in some way. And you mention the fact that we have had inflation over these last many years. In your statement you referred to 1958 as a time when we were concerned about recession. I seem to remember 1956 and 1957 as being rather highly inflationary periods in the Eisenhower administration as we were trying to control what happened in the Korean war then.

Is there no relationship between this sharper growth of government and reduced growth of private enterprise in this country and our inflationary pattern since World War II and the Korean war?

Mr. DUESENBERRY. I am sure there is one. And in the State and local governments there is no question but what the increased taxes often enter quite directly into the cost of living indexes. I am not without experience in that area. I have sat in on Finance Committee meetings, and in the form of government where we have them, town meetings. I have said that we are constantly appalled at the increase in the town's expenditures. It turns out that on the whole there our citizens want schools, and recreation facilities, and they want all sorts of things, and they know in that form of government that they are going to have to pay for them.

Representative BROWN. I take exception to that just to this extent. They know that they are going to have to pay for them eventually. But what they have to do is borrow the money to get them, just the same as we do here in Washington, we literally put it off in terms of payment. We have all developed this sort of counsellor finance philosophy which says, you don't have to pay for it now, you just stack up the debt. Isn't that where we are now in terms of this inflationary period? You indicated that you and Mrs. Bosworth are doing a study on the need for capital formation in private industry. I think the figures, the increases that I have recited to you, indicate why there is that need for capital formation. This has not been the case in other countries such as Japan and Germany, France, and some of those which did less well during World War II than we did. They have had their capital formation in private industry up rather sharply. We have devoted our funds and our attention to public needs that are unrelated, it seems to me, to productive capital formation, and stacked up a whale of a lot of debt that now we need even more severely than we needed before private industry to pay taxes to finance. We are a little bit down at the heel in some of our private industry.

Mr. DUESENBERRY. It is a very long story, Congressman Brown.

First, let me say as to State and local governments, State and local governments are very severely restricted in their borrowing. And they are mostly restricted to borrowing for capital projects. And when a local government needs a school that is going to last for 30 or 40 years, it is not too sensible a thing to have to pay for it out of current taxes.

Second, I don't think we ought to regard all of public capital as being unproductive. There is a lot of doubt about people's calculations about the productivity effect of education. But I think, by and large, the evidence is that the capital we put into education, both in buildings and in human capital, has been a contribution to productivity. That is also true of roads and port facilities and things of that sort.

Now, there are things, of course, which are not going to add to productivity in the ordinary sense of productivity. We are going to have very large expenditure for pollution abatement, and that is productivity in some sense, but it is not productivity that is going to show up in the GNP score as we now keep the books. But one has to make a value judgment as to whether it is more important to have that kind of productivity which we don't measure, or more physical goods which we do measure. And that is a choice the public has to make.

Representative BROWN. May I just stop you at that moment to ask a question, because I am concerned not about the objective, I think the objective in pollution control is laudatory and wholesome. We have been doing the other thing for the last 200 years or so in our society, and that is, living off of our environment. We have been getting our water out of the streams freely, and we have been putting our effluent back in freely. And the result has caught up with us. But the question, I guess, is once again of gradual system. You made reference to that in your testimony. What is this speed with which that sort of thing should be done? I think we could foul up the economic system by the rate of monetary formation. You indicated in your testimony that you are concerned that we can foul it up by the rate of fiscal responsibility that we show; fiscal budget balancing limitation. I guess maybe the same thing is true of our rate of establishment of nonproductive investment, is it not, in terms of pollution control, education, and some of those other things that are desirable in and of themselves, but nevertheless have a rate factor in them which may get us out of balance to some extent?

Mr. DUESENBERRY. I think there is a genuine problem in pushing costs off on someone else in these areas. Senator Proxmire made that point very quickly, that in some areas we legislate cost increasing requirements on industry. And that does not seem like a tax, but in fact it is exactly the same as though we levied a tax, because somebody is going to have to pay for it. You are not going to squeeze it out of profits to any serious extent, because there is not that much to squeeze, and so it is going to show up in prices. We do have a limit as to how far people are willing to take the reduction in their growth of real income that is required in order to provide those facilities. They expect to get a 3-percent increase in real income if somebody is doing something which is going to slow the productivity down. So we do need some recognition, that some sacrifice is required to slice those things.

On the other hand, I do not feel that there is any evidence that most of the time American industry has been starved for capital. We happen to have had a cycle in the investment some of the basic materials industries. There is quite a good analysis of that in the Goldman-Sacs letter recently reviewing the whole history of prices, profits, and investments in some of the basic raw materials. But that is the peculiarity of those industries. But if you look at the record over the last 20 years, I do not have the impression that American industry has on the average been unable to obtain resources for capital which would yield a good productive return.

Representative BROWN. Could we stop right there and let me ask my final question, because my time is up.

In your prepared statement you said: "Many firms and financial institutions are now in much weaker positions than in 1958." I would concur. And I would ask why?

In 1958 the American economy generally dominated the world, and now we are not quite as dominant. It seems to me that they are in a weaker position, that we as a nation are in a weaker position as a result.

But specifically, in your prepared statement, you indicate that you are studying the need for estimated U.S. capital requirements in 1980. I gather you mean for productive industry and not for the Federal Government.

So if I can, I would like to ask you as a factual matter to indicate what you think our capital needs by 1980 will be, and where those capital formation funds are going to come from, if we keep absorbing so much of the available capital in this country in governmental uses.

Mr. DUESENBERRY. Let me say, first, that our estimates do indicate that a larger share of GNP will have to go to capital formation than has been the case in the previous couple of decades.

And second, that our estimates indicate that very substantial Federal surpluses will be required if we are to have the resources available to the private sector. Perhaps I can send you a page or two of a summary.

Representative BROWN. I would like to see it, because I think we have found our area of agreement.

Thank you, Senator Humphrey.

Senator HUMPHREY. I would like to first of all, just make some comment about what I have heard here, that just as there may be some agreement between the two economists out there, and some disagreement, there is some disagreement up here. I regret that Senator Percy has left. But he reads the record very carefully. I think he said that we ought to let the free-market forces work. That is some of the old time religion. And I would like that, providing that everybody goes to church. But the trouble is, they do not go. There is not very much free market.

I noticed the other day that the gasoline companies, the oil companies, decided to cut gas production instead of cutting price. They had overproduced. Their inventories are too high. Their inventories are way up. So they just cut production.

Out my way, when the chickens produce too many eggs, we reduce the price of eggs. They have got free markets out there. But it does not work in the oil business.

I notice the car sales are down, but steel prices and profits are up. I notice here that car sales are down, but the prices go up.

When we had a few extra products in Humphrey's drugstore, we had a sale and got rid of them. But not the automobile industry. General Motors is not reducing the price. Ford Motor Co. is not reducing the price. They have announced that they are going to have a new price increase rather than reducing it.

So I do not buy that old time economic religion, because folks have quit going to that economic church.

I get back to what I was trying to say a while ago—and maybe it was said in too much jest, but I said it in seriousness. I think the great need in this country is an organized, harmonized economic policy. We do not have it. In my judgment, the greatest contribution to inflation today is uncertainty. This has resulted in people buying up heavily in their inventories and never knowing what tomorrow is going to offer. It surely has been the case in commodities, where there is a feeling that there would be a shortage, and people may do panic buying, to put it in simple terms.

There is the lack of any consistency in policy, as Senator Bentsen said in his remarks last night. And the need of getting away from this piecemeal approach I think is absolutely essential.

Here was the Senate voting the $295 billion budget ceiling. I voted for it. How can you vote against it? It is like voting against your mother. But no one really took time out to talk about what kind of tax reform you are going to have, or tax policy, what is the relationship of the budget to monetary policy, and where are the cuts going to be made, what is going to happen in the private sector in wage-price decisions. It just is not being done. And hopefully, this committee can be helpful in this. But there needs to be a national economic council of some kind to bring together the thinking in this country relating to what we need to do about this problem of inflation and recession, because we have both, we do not have just inflation, we have recession. This is a new development, a new phenomenon, in other words. We have had recessions before, and generally when we had recessions, we had lower prices. We have had inflation before, but we generally had actually overemployment. For example, in Western Germany you had a high degree here a few years ago, and they had overemployment, they had to import workers. The Japanese did the same thing with high employment. But we have inflation, raging inflation with increasing unemployment.

Quite frankly, I do not think that any of the economic doctors have pooled their knowledge from a governmental point of view to come to formal governmental policy. Governmental policy may be more than governmental expenditures. What is the policy going to be? What can you depend on?

So I come back again to the necessity of us doing something about it. I do not think it can be done without a President that is willing to do something about it. This Government is not a congressional government, it is a Presidential government. And we ought to knock it off and quit trying to con the public into believing that we can run it from the Congress. you cannot do it, and everybody knows it. Congress cannot even run its own affairs, much less run the country. The most that we can do is help carry out a basic policy. We tried that Congress thing about 200 years ago when the Articles of Confederation broke up in the Continental Congress. So we have a Presidential system.

What did we get for the Presidential message? The old time religion, tighten your belts.

But I did not notice him telling us to lower the interest rates. And I did not hear anybody say that we ought to tighten the belt on the oil companies. In fact now we have it out from the administration as to whether we ought to have a renewal of the Petroleum Allocation Act. If we do not have a renewal of the Petroleum Allocation Act, all the petroleum prices in this country will go up to the world prices, and the Arabs will set the price of oil, and you will really have some inflation.

On that basis, I would like to ask you gentlemen what is your forecast for the balance of the year? I know that we have got a backache and a headache, and we have got a slight case of economic dysentery. But what do you think is going to happen from here on out? What is the forecast?

Mr. HELLER. Dysentery is a very persistent disease.

Senator HUMPHREY. Yes, particularly if it is amebic.

Mr. HELLER. That is right. I do not know that we are going to have any quick fixes for the economy any more than you have quick fixes for dysentery.

I think we are condemned to a sluggish economy. We are condemned to continuing inflation at close to the double digit numbers. But I would hope that the prospect of, say, getting down to that hard core of 7- or 8-percent inflation by next winter is a realistic one.

Senator HUMPHREY. May I interrupt there on that?

Mr. HELLER. Yes.

Senator HUMPHREY. Why do you say that when you see that food costs are inevitably going to go up, Mr. Heller? I can predict for you certainly that there will be a higher price for wheat, for beef, for protein, every single commodity is going to be in short supply. The crop predictions are cockeyed, the Government has aided and abetted in the biggest fraud that has taken place in this country for years, and the unconscionable and ridiculous predictions that they have made. With that, and knowing that bauxite is going up, and that copper is going up, and that nickel is going up, and that the Kuwaitis have just raised the price of oil, I want to know how you feel that we are going to get down to 7 or 8 percent.

Mr. HELLER. OK, I will tell you. There are some forces, thank heavens, that are working in that direction.

Let me take first of all oil, which is after all a substantial part of our inflationary problem last year. We are not going to be relieved of high prices, and we are not going to have another oil price explosion. We might even have some easing—and you ought to ask Secretary Simon about his optimistic statement on that—the other day he said it was not a forecast. He said he expected the price of oil to go down $2 or $3 a barrel, but that was not a forecast, you ought to ask him to explain that.

Senator HUMPHREY. I ought to have a bet with him. I had one with Mr. Stein when he gave me some of those jellybeans that they passed around here. I do not believe that at all.

Mr. HELLER. I admit that George Meany was right when he said that Herbert Stein never saw an economic statistic that he did not like. And that is true of the administration rather more generally. Even I have somewhat of a reputation as an optimist.

Senator HUMPHREY. Me, too. I was the town's optimist here for 20 years. All at once I found that I am not.

Mr. HELLER. That is right. We do not hold a candle to that. But I do think that the price explosion in oil is going to taper off to a plateau and work its way through the economy, and not be a source of future inflation.

Although there are some raw material oligopolies that are going to hold us at gun point for higher prices, I think the worldwide movement on commodity prices is down, not up. Granted, the crop prospects have worsened materially. Those of us who come from that part of the country are much more aware of what has happened as a result, first of deluge, and then of drought to the crop prospects. We have to be more pessimistic about food prices than we were, say, 3 months ago, there is no question about it. But world commodity prices as a whole, as a result of the relaxing pressure of expansion and production in the world, the reduced chew-up of materials, as I suggested earlier, will be coming down. And there will be some help on that score even though there will be significant exceptions.

As I say, I think that a lot of this softness is only now beginning to appear, and a lot of businessmen and a lot of the optimists in the administration who talk about a phantom recession and about shortages in the economy, and so forth, are going to be very unpleasantly surprised by how quickly shortages turn into surpluses, how quickly bottlenecks turn into excess capacity. This will give us some relief on that score.

Finally, the pop-up effect of removing controls, which was more serious by far than the administration expected, both on wages and on prices, and more serious to some extent than we expected, especially when neither the Congress nor the administration would keep John Dunlop in Washington——

Senator HUMPHREY. I wanted to keep him here.

Mr. HELLER. I know. But it was just unconscionable to let some of those price agreements fall by the wayside. The corporations got their relief. Then they did not have to hold to their agreements after April 30. We have no Government presence to exert any moderating influence.

So that we have this huge pop-up effect to but that will diminish.

Now, the really tough question is how much of these relatively temporary, one-shot influences on the price mechanism, are going to be built into this wages-chasing-prices and pricing-chasing wages kind of spiral. I am more pessimistic on that score today, considerably more pessimistic, than I would have been 3 months ago. We are right on the border between wage erosion and wage explosion. That is why I have had to up my estimate of the inflationary pressures next winter to about an 8 percent rate rather than the 6½ percent or so that I was contemplating several months ago.

Senator HUMPHREY. Mr. Duesenberry, do you want to give some estimates of your forecasts?

Mr. DUESENBERRY. I think I will differ from Walter Heller about being more pessimistic about the next 6 months. But I think the basic story there is that we are passing from a situation where we had a step-up in the rate of inflation because of food, fuel, and other raw materials, to a phase in which there was a passthrough from the cost-of-living increases that occurred in that first phase with respecct to wages. It is true that fuel prices are probably going to level out, and they may even go down a little. In the nonfood raw materials the trend probably will be down. But we still have in the next 6 months not only the trouble which you have already mentioned in the food area, but in addition, a lot of the past increases in raw materials have not been fully passed through the system, have not reached the retail level. So that in the next 6 months we are going to see bad news from that front, plus bad news from the food front, and getting wage increases at the same time. But I think that that passthrough phase will be completed by the end of this calendar year. And we may then get some benefit on the other side in some of the raw material areas. So that if we do not have a real wage explosion—and thus far they have just risen at a fast clip, I think the labor market remains in good order—we should see some deceleration in the first half of next year.

So I see 8 or 9 percent in the last quarter of this year in terms of cost-of-living index, and then a slowing down in the first half of next year. I will probably be quoted as being asinine and foolish if I give you a figure for the first half of next year.

Senator HUMPHREY. Can you give us any estimation on what employment will be or the real GNP?

Mr. HELLER. May I add, you will notice I hedged very carefully. I said some time next winter. I am referring to Minnesota winters, which gives us a little longer period.

Senator HUMPHREY. That takes us up to about May.

Mr. HELLER. Are you trying to keep people out of Minnesota?

Senator HUMPHREY. Gentlemen, we are happy out there, we do not need anybody else.

Would you care to give us any estimate on the unemployment?

Mr. HELLER. On the unemployment side, last December, George Perry and I, who joined forces in our forecasting undertaking, projected a top of 6 percent. We have had to rethink that in terms of a change in policy of the Federal Reserve compared to what we had projected. Senator Proxmire, who is not here, likes to beat us around the head about the inaccuracy of our forecasts. Unfortunately, part of the forecasting game is that of forecasting policy. We missed the boat in forecasting that King Arthur and the Knights of the Federal Reserve Roundtable were going to not only squeeze until it hurts, but squeeze some of the lifeblood out of this projected recovery. As I said in my prepared statement, I feel that if we persist in the present policies, that the unemployment peak will rise closer to 7 percent than 6 percent. But that is a big if. Will the Fed back away, or will it stay on this super-tight course? If it does, we are looking down the gun barrel at an unemployment closer to 7 percent than 6 percent before the Minnesota winter is over.

Senator HUMPHREY. The real GNP?

Mr. HELLER. The real GNP, sort of chugging along at almost a plus-minus situation. In other words, a little bit on the plus side, I suppose. If I had to give you my guess—I have not made a recent full-scale revision—but my guess would be under a 1 percent annual growth rate for the next 3 or 4 quarters, again under present policies. If we shift, we might do better. But under present policies, a very sluggish, slack economy.

Senator HUMPHREY. Mr. Duesenberry.

Mr. DUESENBERRY. If they assume that we continue at the present levels of short-term interest rates for the next 12 months, I agree with Walter Heller. I have always made the calculations by assuming some turn-around to bring those rates back and give housing a chance to revive. I must say the time for the turn-around has passed. So I think there is still some prospect of getting up to a 2-percent rate of growth. I am worried not only about the housing, but I think there may be some problem in the inventory area which is connected with what Walter Heller was saying earlier about the turn-around in the inventory and raw material price situation. There may also be some weakening in the plant and equipment. I think that is not at all clear now, but there are some signs that there may be a little cutback in capital appropriations.

But while we are on the subject of Federal Reserve, I think we can say a kind word too, because I recall that in the beginning of the year a number of economists are saying, the Federal Reserve System should not be afraid of rates of growth of money supply like 7½ percent, or something like that. We at that time anticipated that that kind of rate of growth of money supply would get interest rates down.

Now, the need for money has moved very peculiarly. We have had quiet rates of growth in money supply over the first 6 months with very high interest rates. I am not sure that in these circumstances of this much inflation that you can be surprised that the Fed was unwilling to go beyond an average of 7 percent or so for the first half of the year, even though interest rates were rising. But I would like to see from here on out, now that the demand for money seems to have slackened off a bit, maintenance of something like the 7½ percent in the growth of money supply to bring those rates down. I do not think we can flog them so much for the first half.

Mr. HELLER. May I say just a word there?

I agree entirely with what Jim Duesenberry has just said. And indeed, over the years I have been a defender of Arthur Burns' Federal Reserve Board much more often than I have been a critic. I just think things have been pushed too far in the last couple of months.

Senator PROXMIRE [presiding]. Congressman Brown.

Representative BROWN. I would like to pursue that point. I would like to make the observation that I am sitting here trying to figure out whether our economic dysentery comes from absorbing too many jelly beans. I am confused by some of the analogies that we have had this morning.

Are you suggesting that we might have some increase in our money supply to accommodate the need for the economic expansion in productive industrial capital that we need in the future? Professor Duesenberry, what are the money supply indications with reference to our long-range needs, and what are the money supply indications with reference to our short-range needs in terms of meeting the current inflation? Can you balance those either in terms of amounts or in terms of timing of the change of policy?

Mr. DUESENBERRY. I will put it this way. Looking at it from an interest rate viewpoint, I do not think anyone could tell you that an economy in the current state of demand requires prime rates in the 12-percent ballpark. So that from that point of view——

Representative BROWN. That demand you are identifying as a not excessive demand, in other words, it is a modest amount?

Mr. DUESENBERRY. Right. Even allowing for a willingness to see some slack developed in order to contain inflation.

Now, the difficultly seems to be that some people calibrate monetary policy in terms of interest rates, and some people calibrate in terms of money supply. The relationship between the two, while there is one, is very erratic in the short run. The Federal Reserve is in the situation, at least many people have been in the situation, of feeling that they simply could not supply 10-, 12-, 13-percent rates of growth of the money supply in the face of that much inflation, and they simply felt that you had to draw the line somewhere and let the rates go up. I think on the whole, looking at it from the standpoint that in the circumstances of this spring, caution in terms of how much expansion you can allow was the correct view, that they were correct in doing that. I think now that the whole outlook has shifted so much on the side of weakness in demand that the need for caution has diminished a good deal in the last couple of months. Therefore I would like to see them be prepared to provide a 7- or 8-percent rate of growth of the money supply in the hope that that would bring short rates down to a level that seems to me to be reasonable in the current situation, and consistent with our long-term picture.

Let me go back to the original question now. My judgment is that probably we are going to need something like a 4½-percent real rate of interest; that is, 4½ percent more than the rate of inflation that people expect for a long time. It is going to be some time before anybody thinks that there is going to be any less than 5-percent inflation. So I am prepared to live with long-term rates in the percent ball park. That implies short-term rates of, say, 8 percent for the money market rates. And that is where I think we ought to go. So I would look for the kind of money supply which would be moving the short rates down toward 8 percent over the next few months. And that would be consistent with a reasonable projection over the long run.

Now, it is consistent with a reasonable projection, and meeting our capital needs over the long run, only if the fiscal policy comes out to provide enough savings to balance the investment that goes with, say, a 4½-percent rate. You cannot separate the things.

Representative BROWN. Now I think we are feeling around another area of agreement, because it seems to me that that is where we ought to be heading. I would like to raise a question that maybe we agree on something else that I misunderstood.

We talk about macroeconomics and microeconomics. I am inclined to think that microeconomics, as far as our future is concerned, relates only to the United States, and that the macro should relate to our position in the world, because you talk about demand, and indicate that our situation is the result not of excess demands. Perhaps you will come back at me with the idea that it really is a shortage or a supply problem. But it seems to me that the excessive demand for U.S. food products and the excessive demand for world oil products, as a result of worldwide expansion a few years ago, related in some instances to our price increases for oil, and to some extent it is causing our current food price situation. What I am saying is that even though our food production for the United States may be in balance, if we have worldwide shortages, the current drought situation could lead to a domestic shortage which could be exacerbated beyond belief. Our price for food will really go through the roof if we respond to that worldwide food shortage. If, on the other hand, as we heard a few days ago, that there may be crop surpluses, then we will have reduced pressure on American food production and we may not be in as bad a way on food prices even with the current drought situation.

Are you following my concern here?

The fact is that we cannot just depict some of these basic elements as domestic only, but rather as impacted by foreign demands and supplies over which we do not have quite as much knowledge or control.

Mr. DUESENBERRY. There is no question but what in all of the raw material there are essentially world markets. There may be various barriers in those markets. But still, oil, copper. and any of these markets are worldwide markets. We are substantially affected by what happens elsewhere. Part of our difficult, of course, is that even so, those are a very small fraction of the total output.

It is also true that the prices are very volatile, and when there is a surge of demand worldwide which drives up those prices, and drives them up by tremendous percentages, that then gets passed into the cost of living. We do not get an offset in some other prices; on the contrary, we add other prices, and our economy has an inflation bias from that source.

I do not know what we can do about it.

Representative BROWN. My time is up.

But let me ask you two other questions.

I am fascinated by two comments you made in your prepared statement. You say that, "We should have a mechanism for monitoring wage and price changes by big firms and big unions." Senator Proxmire the other day suggested that we needed an antitrust policy to pursue the question of prices, at least to take the edge off of it and be sure that at least prices were not being administered. I would agree with that in terms of the business cartels in this country. But I also note that you add big unions to the problem. I think that has to relate, or at least to an increasing degree has to relate, to our situation in world competition due to the fact that we are moving toward a freer trade, which makes the administration of prices by big business and big unions less possible. The administration of prices in the automobile industry used to mean that you did not have any choice but to buy in this country. Now you have a choice to buy somebody else's products, Germany or France, or someplace else, if you do not like either the price or the nature of the product. Then you go on to say in the next point:

> **Second, we should be looking at the cost and productivity problems of particular industries, especially the health and construction industries. The Govern-**

ment pays for a lot of the output of those industries, and should take some responsibility for them.

I do not know what the word "responsibility" means. What do you mean? Should we take responsibility to reduce our investments in those industries. It seems to me that in the construction industry that means cutting back on public works, which supports Senator Percy's position. If you are talking about our investment in the health industry, then you are talking about a rather sharp change in "social policy" and doing the wonderful things we do in those fields.

Mr. DUESENBERRY. I am not just talking about cutting back in the social field, but in the health field.

Representative BROWN. Controls in those fields.

Mr. DUESENBERRY. In the health field a very large proportion of the total hospital bills are paid by third parties. If I recall the breakdown, roughly one-third is Federal and one-third is private insurance, and one-third is paid by the patients themselves. I am not sure how accurate that is. But that is roughly the idea. There is very little consumer control of hospital costs, because the consumers for the most part are not paying directly, they are paying only through some very indirect way, through their insurance premium, or even through their wage settlement, because their employer is paying the premium. This has led to a good deal of escalation of the cost of hospitals. I think the first thing we must do is, when we move toward a different form of health insurance—and I hope we will move to some more general forms of health insurance—we must do it with insurance in a way so that there will be some restraint on the part of the users on hospital costs.

Representative BROWN. You do not want a totally federalized system?

Mr. DUESENBERRY. I do not particularly want a totally federalized system, now. But I do think we have to find a mechanism to give incentives to save money.

To say it very simply, the doctors can find a way to spend all the money. To take a biased point of view, I think what is true of hospitals is also true of universities, the professors can find a way to spend all the money that there is coming. The cost of professors is one of the fastest growing items in the cost of living.

Representative BROWN. Thank you.

Senator PROXMIRE. I want to apologize for rushing off. That is in the nature of how things operate.

In my amendment on the floor I offered to cut 3½ percent of the atomic weapons that are in the public works budget. There is $1½ billion of atomic weapons in the public works budget, and nobody knows about it. I have talked to a number of Senators, and not 1 in 10 realizes that we are voting a very large part of the defense budget in the public works budget. So I tried to dramatize it by offering an amendment to cut it 3½ percent, which is what the percentage was to the rest of the budget.

You gave as your opinion that if your present policies are continued the economy will slow to a point where we would have 7 percent unemployment, is that right?

Mr. HELLER. I hedged a bit, because it is terribly difficult to pin it down precisely. I say closer to 7 than to 6 percent.

Senator PROXMIRE. You also indicated that the growth might slow to about 1 percent over the next three quarters, meaning through the first quarter of next year, the calendar year.

Mr. HELLER. Yes.

Senator PROXMIRE. You also indicated that prices might go up to almost a double-digit level. That means about 9 percent.

Mr. HELLER. I feel the hardcore level that we could anticipate reaching, sometime during, as I stated to Senator Humphrey, a Minnesota winter—which gives me a little more leeway—would be the 8 to 9 percent level.

Senator PROXMIRE. What happens if we follow your prescription? You say this is what will happen if we follow the administration's program. Supposing we follow the Walter Heller program, the Heller-Duesenberry program, because they are quite similar, what then can we expect in terms of growth, and in terms of employment, and in terms of prices?

Mr. HELLER. I would first of all, line myself up with Jim Duesenberry in saying that we should aim for a moderate expansion, not a full-scale expansion in the next few quarters, about 2 percent on GNP, 2 to 2½, I would say, would strike a reasonable balance.

Senator PROXMIRE. What will that do to unemployment? Instead of going through 6 and 7 percent it would be what?

Mr. HELLER. That would hold unemployment to 6 percent or below.

Senator PROXMIRE. That is really discouraging. The prescription that you offer would still result in an increase of unemployment from the present 5.2 percent to around 6 percent or perhaps a little less; is that right?

Mr. HELLER. I think we are on a course where it is almost impossible to stop and turn the economy around, first of——

Senator PROXMIRE. Even with the best will in the world and the wisest policies?

Mr. HELLER [continuing]. All, to stop us from moving in that general order of magnitude, and second, in terms of striking a reasonable balance between our anti-inflationary objective, which we all want to pursue, and our humanitarian objectives on the unemployment and income side, especially in the lower-income groups, in striking that balance we do have to endure some higher unemployment than we would like for some time. But I am not prepared to endorse a policy that would try to push inflation back to 4 percent in, say a year, or 18 months at the cost of 8 percent or even higher unemployment. I think that is the kind of distinction that has to be made.

Senator PROXMIRE. How about prices? What happens to prices if we follow your course, with increased growth at a very moderate rate, with somewhat less unemployment? Would you say the price expectation would be the same, or would it be worse?

Mr. HELLER. Provided you put in such things as some selective approach to credit allocation, provided that you put in a meaningful wage-price monitoring system, I would assume that we could achieve a somewhat better record on the price front. But most of that projection for the next 6 or 8 months is preordained. I think we have to look beyond that period. There is a lag in policy impact. There is a lag in the economic reaction to policy actions——

Senator PROXMIRE. When you put that in, are you arguing that the price increase would be lesser in spite of the fact that you have a more expansive policy?

Mr. HELLER. I would say that if we are in a position to do things—and I really frankly, rather despair of the possibility of following the prescription, given the present disarray in the Government, but if we are in a position to put that in, we would begin to feel the effects within 6 months, and instead of having to settle for, say, 8 or 9 percent hardcore inflation, we probably could knock one point, perhaps two points, off of that hardcore inflation. That, I think would be highly worthwhile doing. It would not involve as much of a squeeze on those who are most vulnerable to a policy of unalloyed stagnation.

Senator PROXMIRE. This is a great improvement—if you could improve upon public policy—so much of this is beyond our reach and our control, but if you argue that we would have a policy that could make a difference of 1 or 2 percent, that would be, I think, a considerable achievement.

Let me just say that on the amendment that I just mentioned I lost 47 to 47, I am told by the staff. So if I had stayed on the floor and talked to maybe one or two more Senators I could have won on that. So this is what I think of you, I came back and the amendment failed because I think so highly of Duesenberry and Heller.

Mr. HELLER. But you have got enough grievances against us already, I hope you will not hold this against us forever.

Senator PROXMIRE. I hope you recall that you just cost $54 million by being so eloquent and so seductive.

Mr. HELLER. By the way, was there any appropriation for the Trident missile system involved in that atomic——

Senator PROXMIRE. That is right.

Mr. HELLER. Can't you go back and have a reconsideration?

Senator PROXMIRE. You do not put any emphasis at all on the notion that as incomes are sustained, as they would be under your proposal, because you would have less unemployment, and a greater growth in the economy, that this might result in people buying more gas, buying more air conditioners, and, therefore, using up more energy sources, and perhaps buying even more cars, and using up scarce steel, and more plastic products that are in short supply, you put no emphasis on that aspect of this modest increase in demand? At least you think that would be offset by the policies that you would——

Mr. HELLER. First of all, one would not be an economist if one did not admit that higher demand in part always tends to increase price pressures. What you have to talk about is, what is the relative distribution of those pressures under the circumstances that we see and under the circumstances that are developing? Now, I have suggested that I hope the committee in its study of inflation will try to match the purchasing power structure, the increases that would result from tax relief for the lower-income groups, with the structures of available capacity, and that we ought to get a nonemotional answer to that. I have not been in a position to do it. But I think it is something that ought to be done, so that we do not need to speculate quite as much.

Senator PROXMIRE. So what your policies have to do is overcome the inflationary impact of additional demand. And again, I would like you to specify concisely just what those policies are. I have missed it.

Mr. HELLER. My guess, just to finish off that point, is that the kind of tax relief I am talking about would involve very minimal drain to resources in shortage areas, especially with the shortages disappearing day by day, except for a few notable exceptions. But I am talking about a policy that would introduce—we are talking now about czardom, if a policy czar could today introduce some kind of a circuit-breaker wage-price monitoring policy with guidelines and some clout, with the powers of inquiry, publicity, suspension, and in some cases a complete rollback—I do not think that is a possibility——

Senator PROXMIRE. As a matter of fact, if we had a new President of the United States, which we may have in a few months, and he wished to do this—after all, a new President automatically gets a lot of public sympathy and support and cooperation—could he not do a great deal without any change in the law at all?

Mr. HELLER. Yes.

Senator PROXMIRE. After all, the actions that President Kennedy took in the steel crises, for instance, he took without any legislation. We do not have any on the books right now.

Mr. HELLER. First of all, the answer to that is absolutely right. I would hope that there would be an era of good feeling which he could capitalize on in order to introduce a new sense of détente within the economy, a new sense of cohesion, a new sense of sacrifice, rather than dog eat dog and every man get as much for himself as he can, which seems to be the philosophy of the present administration. That would be a consummation devoutly to be wished. But I would hope that the Congress would help to prepare the way for that. There is no reason that this committee and the other bodies in Congress, given the things that have happened through the Speakers' office, and so forth, in the House—I think we have taken at least the first small steps toward it. There is no reason that the way should not be prepared for that by the kind of analysis and policy positions taken by Congress.

Senator PROXMIRE. Now, we get away from the dog-eat-dog policy, or try to move to a policy of harmonizing diverse interest, and so forth. It seems to me the first action that must be taken is to do our best to persuade the administration to recognize that it must not be one sided in the people that they appoint to office—the No. 1 economic counselor, Kenneth Rush, the former head of Union Carbide, Roy Ash, the head of the Office of Management and Budget, the former head of Litton Industries, one of the greatest conglomerates in the country, and Mr. Simon was a top partner in the Salomon Bros., the biggest Wall Street bond house in the country. You can go right down the line. There are many others.

This is the question I want to ask you, now coming into the Government is Mr. Greenspan, a very attractive clarinet player, a man of great charm, erudition and grace, but a man who is a follower of Ayn Rand, a man who has made some statements that are, it seems to me, as insensitive to the needs of people who are in difficulties as anyone I have heard, a man who has made his fortune out of being hired by a hundred of the biggest corporations in the country, and who will return to that as soon as he leaves the office. I understand you think highly of Mr. Greenspan. Why should the Senate confirm a man with this kind of background if you feel that one of our problems is that this is an administration that is too insensitive and does not have the balance that would bring harmony into our economy?

Mr. HELLER. This raises a basic question of the philosophy of the relations between the Congress and the President; namely, does he have the right to choose the kinds of people who mirror his own philosophy. Start with that. I do not like, as you do not either, obviously, the sort of economic philosophy that Mr. Greenspan has. But I respect him, because, one, he is an honest man, he will call the shots as he sees them; and two, he is competent, he is respected both within the nonacademic and the academic spheres. I have seen him make excellent contributions, for example, in the Brookings Panel on Economic Activity. Three, he will depoliticize the Council of Economic Advisers, which is desperately needed after the recent administration by his predecessor. He will restore some of its position in Government, it seems to me, even though he is pursuing the wrong policies. But that is not the basic question—and you may totally disagree with this—that is not the question on which he should be judged. I think if he has got honesty, competence, and a professional approach to life, he deserves the fate that is in store for him as a member of the Nixon administration.

Senator PROXMIRE. The difficulty, you see, is the combination. I like Mr. Rush very much. He is an able man. He has the economic background that you should have in that position. He is a very decent, able, and intelligent kind of a person.

And I think very highly of the intelligence and the ability of William Simon, although I disagree strongly with him.

I am sure Mr. Ash is also an able man.

You put those fellows together and I think they have got the kind of ability, and in most cases the respect, they have got the intelligence, but it makes a fierce combination that we are approving—and the Senate does have the right to advise and consent, we are a partner in this thing. At some point should we not draw the line and try to make a fight to get some balance here?

Paul McCracken, after all, was a Nixon appointee, and while he is a man of conservative views, he also is a man of considerable sensitivity who recognizes that you cannot have a harmonious program unless you have some give. He has proposed, for example, that to the extent that we have restraint that we also should have some kind of an income support program for people with low incomes. This is realistic politically, and in terms of equity and justice would make sense. So it is not as if the President does not have options, he does, he has good options.

Mr. HELLER. He has options. But I think you have to assume—and we are not talking economics now, we are talking political economics or even politics—that if you turn down Mr. Greenspan he will appoint someone worse. You have to operate in a world of reality.

I agree with you entirely about the case of the President's cast of economic characters. This is very distressing to me. One of the reasons I am pessimistic about the economy is precisely because of the combination of disarray and the views held by the people who are advising the President and exerting policy influence. But I do not think that that can be stopped or changed by turning down Mr. Greenspan as Chairman of the Council of Economic Advisers.

Senator PROXMIRE. But you do feel that his policies are bad, they will be bad for the country, that they are going to help to aggrevate unemployment, and we are going to have a situation in which we have less equity and less justice in the system because of the policies that he is going to follow?

Mr. HELLER. Given his public pronouncements that we have to press the economy down very severely for a prolonged period of time in order to beat back inflation, and he pursues that philosophy, yes.

Senator PROXMIRE. Do you think there is any economic merit at all, either you or Mr. Duesenberry, in the Greenspan argument that if we do not go through the wringer to a considerable extent now we will have to go through it much worse later on?

And that he feels that restraint does not necessarily mean an increased unemployment above what there would be otherwise? Do you think that is just economicallv unsound?

Mr. Duesenberry.

Mr. DUESENBERRY. I think that is a matter of degree. I think it is true that we do need to have a period of low growth and to accept some rise in unemployment in order to avoid something worse later on, because I think that we will have real trouble later on if we do not decelerate instead of accelerating the rate of inflation.

Now, the whole question, I think, is how far one wants to go with that. When I said I was prepared to accept a 2-percent rate of growth for the next 12 months and a rise in unemployment in the neighborhood of 6 percent, that is not something that I like to say, but only because those concerns about the future make me feel it necessary.

Now, I do not think that there is a great deal of additional payoff in terms of restraining inflation, in going from 6 to 7 percent. There is a lot of payoff in going from 3½ to 4½ percent, and there is something in going from 4½ to 5½ percent, and there may be a little more in going to 6 percent. But I think that once you get to the situation where there are no real shortages in labor markets, and where employees do not feel they have to build up wages in order to keep their good people from leaving, or in order to recruit others, then you are not going to do much good by having a lot of people on the streets. So it is all a matter of degrees. I really have not followed Alan Greenspan's statements enough to really know just where he falls in the spectrum of degrees on this matter. I know there are some people——

Senator PROXMIRE. He said a couple of things that are very specific about this. He thinks that we ought to hold down present spending, and we ought to have a very, very limited increase next year. He says that is what we can do, next year we ought to hold it down. I think $325 billion next year, which would be an extraordinary improvement, in my view, and in the view of some, in the rate of increase. Of course, we can have a change in the tax structure too, but I doubt if he is going to recommend that, if they cut taxes it will not be payroll taxes, it will be taxes on investment income and so forth. This is the kind of policy that he is going to push very hard for. He is going to join Roy Ash, and Simon, and others who have this view.

Mr. DUESENBERRY. I would hate to see us go in for a really panicky restraint on the budget, even though I believe that we ought to be very cautious about budgetary expansion. It is just a question of degree. We certainly have to lean on the side of restraint much more now than at some time in the past. We should not go off the deep end on it.

Senator PROXMIRE. Mr. Heller, how would you assess the outlook for business fixed investment? Are there really strong investment plans as shown in the earlier surveys? In the state of the economy now are they really likely to hold up, given the financing problems and the weak consumer demand?

Mr. HELLER. As a matter of fact, there are some signs of weakness beginning to appear in that previously optimistic plant and equipment investment picture. When you look at the numbers for the first half of this year, and adjust them for inflation, the real physical increase in plant and equipment investment was not nearly as impressive as it looks on the surface. The projections are such that—I do not want to be misunderstood, I think that we are going to continue to find that this is the greatest area of strength in the economy. But if we have persistent sluggishness, and stagnation in the economy, I cannot see that the plant and equipment ebullience, even to the degrees that we have now, can be sustained. That is why I say, part of a Greenspan policy would be self-defeating, because in the longer run we need these vast quantities of investment—higher than we had in the past as Jim Duesenberry has mentioned and which he and Barry Bosworth are making some explicit projections on. And that simply does not thrive in an atmosphere of stagnation and sluggishness and low profits. It seems to me that this is one of the greatest dangers of pushing the policy of fiscal and monetary tightness too far, that we will chop off the increases in investment that we need to relieve shortages and meet future demands and the increases in investment that we need for modernization, and increases in productivity.

Senator PROXMIRE. Plus the increases that you need, which are enormously large. I did not realize how large they were until I had a chance to look at them. The increases that you need in plant investment simply to reduce the noise pollution, to reduce the decibels of noise from 90 to 85, is $31 billion over the next 3 years. The investment that is needed for air pollution reduction is $100 billion over the next 10 years. The investment that you need for water pollution abatement is $6 billion each year over the next 10 years. The investment that you need for OSHA is about 3 or 4 percent of total private investment. You add those up—all of which I am for, I voted for all of them, and would do so again, though none of them are going to contribute to productivity in the usual sense—you have, one, an inflationary factor; and two, an investment requirement factor that is very great. We wish you would advise us on that whole situation. Have we moved too fast? Could we have what Paul Samuelson calls for a cost-benefit analysis of these requirements with respect to inflation before we vote them? For instance, should we crank into our environmental legislation the recognition that when we require some of these actions that it is going to have an inflationary effect? Because obviously, the consumer is going to have to pay every nickel of this in higher prices, we ought to face it and admit it. I am going to vote for them anyway. But I think we ought to recognize that this is an inflationary action, and if we are going to do that, the timing is very important, the size of what we require, the length of time we require industry to do these things, and we have to recognize that there are going to be other ways, or some kind of tax incentives, or some kind of concessions to see that this is done as efficiently as possible.

Mr. HELLER. Let me just make a quick comment or two on this.

The Samuelson approach appeals to me sort of rationally, but not emotionally. Let me put it this way. In the best of all possible worlds, where the full weight of externalities in our systems are recognized in public and private policy, in other words, where the proenvironmental-improvement forces had as much clout as their economically rational case for the imporvement in the environment justifies, I would agree. But it seems to me that there are enough barriers, especially with the present administration, in the matter of environmental and safety improvement, and so forth, that if you threw in one more; namely, that if you had to be sure it did not contribute to inflation, it could slow the movement below its optimum. And is surely true in terms of my values in regarding the quality of life in this country. And consequently I would be very chary about doing so, because it is one more block in the path of things that I think we need to do for an improved quality of life.

Senator PROXMIRE. To get more investment, what do you think of the suggestion by the President of a 1½ percent savings of people's incomes, an investment, which is translated in a big way, would result in far more funds available for housing, according to Mr. Stein, and for other investment, and would ease to some extent the demand pressures?

Mr. HELLER. I am going to let Jim Duesenberry address himself to that. I think it is another cop-out kind of a thing from the President. In the economic sphere, it is sort of a hollow request. It is not going to get anywhere. But the question you are putting is, what if it were done? Well, again it depends on the whole complex of policies: Would this 1½ percent cutback in consumer spending simply result in a reduction in the total level of our activity in the economy, and not simply turn it over to investment, or would it actually be picked up from the investment side?

Senator PROXMIRE. Would it be a help, Mr. Duesenberry, to persuade people to cooperate better if we identified areas of inflationary private action and made specific appeals to people to modify their action to some extent? Our people are very patriotic people. They cooperated very well with an unpopular President in an energy crisis. Gasoline is in short supply. Utilities are having a hard time supplying the demand. Plastics are in short supply. Is there anything, other than the market mechanism to retard these things very much, that the President does not do, by way of an appeal, by way of identification, to encourage it, so that in these areas we hold down spending? Or is it something that we just have to——

Mr. DUESENBERRY. I think that the life of enthusiasm for that type of voluntary program is really very short. I think it is one thing, when one clearly has a gasoline shortage, to induce people to respond to the crisis and share the burden for a few months. But to have them change their habits and resist their impulses and undergo discomfort if they live somewhere they need an air-conditioner I think it is something which is not likely to be sustained for any very long period. I think we have had appeals of this sort before, and they usually peter out pretty quickly. I think we really feel the need for restraint on energy consumption. It would be appropriate to look to taxes on high horsepower automobiles, and taxes on central air-conditioning, which I think is a fairly high income kind of comfort, rather than to rest on those appeals.

Senator PROXMIRE. You mentioned, Mr. Heller, in your prepared statement at one point—it was a very controversial issue, and I want to deal with it now—the plight of the small saver, the man who puts his money in the savings and loan and gets a 5½-percent return, and in a commercial bank even less, at a time when the inflation rate is high. You talked about getting away from regulation Q, which is, of course, one of the difficulties that makes it impossible for the small saver to have effective competition for his funds. But you know what removal of regulation Q does to housing. Housing is a basket case. Housing has suffered an over 500,000 unit reduction over last year. That is 1 million jobs. Housing depends on savings and loans. There is no way that housing can proceed without regulation Q. I wish that there were. But we have the combination of much higher interest rates that are bringing money out, and we have the Citicorp proposal, which is apparently catching on in many other banks, and also many nonfinancial corporations are now beginning to think about that. We had testimony before our Banking Committee that as much as $10 billion would be absorbed by it. Mr. Bomar of the Federal Home Loan Bank Board, who said that there could be a very substantial disintermediation. And as you know, savings and loan organizations suffered a great deal this last month. So as a matter of practical policy, one, is there anything we can do with the small saver; and two, is there anything we can do—and this is most important—without further devastation for the industry which is suffering the most, and is so important for construction, where we have 10 percent unemployment?

Mr. HELLER. Again, this is an area of Jim Duesenberry's expertise. So I will confine myself to just a couple of comments.

With the careful phaseout—and I realize how the thrift institutions are over a barrel in terms of the rate at which they have loaned money in the past, and this is the main barrier to doing something about regulation Q—it would put them in a better position over the longer run to compete for housing money. And they also ought to be given, as both the old study under President Kennedy 10 years ago that was done—it is now 11 years—of financial institutions and financial reform suggested, and as the more recent commission also suggested, the Hunt commission, they ought to be given the opportunity to compete—and perhaps I will be thrown off the board of the National City Bank of Minneapolis for saying this—more vigorously with other banking institutions.

Senator PROXMIRE. When you do that it results in their putting some of the funds they now put into housing into small business and other areas. So what the Hunt commission suggests is that you have a tax incentive which would encourage banks to put more of their money into housing as a kind of a quid pro quo, so that as they get their portfolio above a certain percent, that in that way you could get a tremendous amount of leverage involved, they would enjoy the full effects of a tax credit. This should make substantially more housing money available from the banks. Do you think that has promise?

Mr. HELLER. I think you know from my testifying before this committee for many years that I am very skeptical of new tax shelters. The trouble with new tax shelters is that they too easily get converted into new tax escapes—call them loopholes, if you will.

Senator PROXMIRE. I could not agree with you more. But at the same time, as a practical, realistic effort to try to get money into housing, what do you do?

Mr. HELLER. That is what we say every time, and then we riddle the tax structure. So I am very reluctant on that point. But I would rather listen to Jim Duesenberry than talk on this subject.

Mr. DUESENBERRY. This whole problem really has long- and short-term aspects, and we will never get back to it if we do not start. Maybe we had better start with the long term and come back to the short term.

In the long run the basic logic here has to be that, first, we recognize that there are two separate problems. There is the problem of a mortgage market. There is the problem of the thrift institutions as such. I think in the long run the mortgage market has to become less dependent on the thrift institutions, and more dependent on direct access to the long-term market, and the thrift institutions themselves have to participate in a wider variety of business and in effect become a good deal more like the retail commercial banks, the suburban commercial banks, which participate fairly heavily in the mortgage market.

You might notice that insofar as thrift institutions are competing in the suburban market for consumer loans, that is not going to increase the total involvement of consumer loans by any very large amount, it is mostly going to mean that they are going to take business away from commercial banks or financial companies which are going to have to go someplace else, which means they will probably go into the mortgage market. There may have to be some shift in rates. It used to be that mortgage rates were above bond yields. For some time they have been below. I think if we are going to have long-term financing in the mortgage market we will have to shift back to where we were before. We have made a good deal of progress in getting the mortgage market into direct access with the long-term market. If mortgage rates were a little more competitive with long-term rates, then the GNMA guaranteed securities would carry a larger value of funds. So that I think the right estimate in the long run is to move toward a different liability structure for thrift institutions with more long terms and toward a different aspect structure with more short terms, because they have been in trouble in borrowing short and lending long, as that is a dangerous situation unless interest rates are very stable. At the same time we need to get the mortgage market more directly dependent on the general security market. And we have been moving in that direction.

Now, that all takes a long time. We have made quite a lot of progress. But it will take a long time to complete. The real problem is how we get from here to there without getting into a lot of trouble and starting right now.

And there, I think the first thing is to get some reduction in the short-term interest rates, because the Citicorp issue would not amount to anything if the prime rate were not 12 percent, they would not be offering a rate that looked so good.

So I think that is the first thing. And that means holding a policy which will justify that, but you also need some early turn in monetary policy.

I think it is possible to think about phasing out regulation Q for two reasons. One, the thrift institutions do have increasing earnings. The proportion of mortgages which are 8- or 9-percent mortgages in their portfolios is much higher than this used to be, and if you look at a chart of their gross earnings you will see them steadily rising as a percentage. So that it is possible for them fairly immediately, probably, to pay a bit more.

And second, it is clear from the Citi Corp issue and other kinds of issue proposals that the effect of regulation Q has been gradually leaking out. I may say that I was one of the first people to propose that we should engage in the operation of regulating the rates paid by the commercial banks and thrift institutions on savings accounts and to split the large CP's off so that they could be dealt with. Unlike many of my colleagues, I feel that it was not a mistake to try to give some temporary protection. But it is in the nature of these markets that the protection only lasts until people find out how to get around it and continue to compete for money. We saw in 1969 that there were some corporations which were beginning to think about selling small denomination securities directly to customers. I think in the end we are bound to see more than that.

So I think we have had all the benefits that we are going to get out of regulation Q, and we had better start facing the necessity for getting rid of it. I would suggest that we begin by having them immediately move their rates up just as far as the supervisors think they possibly can, and perhaps being a little less cautious than the supervisors usually are in these matters. And secondly, that what is really required is to get those short-term interest rates down fairly soon.

Senator PROXMIRE. Thank you, gentlemen, very much. The time is just about up. I do want to ask one question and then make one comment and get your reactions.

The question is on indexing, indexing by permitting wages to rise, and rents to rise, and interest to rise, or whatever kind of income to rise, in accordance with the consumer price index, so that you adapt to an inflation by removing the pain from it. Some say this could be horrendous. But it has eminent intellectual support from the great economist in the University of Chicago, Professor Friedman. We are already proceeding along that line to some extent in wage contracts. As you know, we have 5 million wage earners who have part of their income indexed. We have it in social security, so that we already have it to some extent. What happens if we extend this? Much of it is being extended by government policy. There have been proposals that we should do this in almost every area. What is your reaction? It is almost 1 o'clock. And apologies for holding you so long.

Mr. HELLER. Unaccustomed as I am to disagreeing with Milton Friedman, I find myself in disagreement on his proposal for a full-scale indexing program. I have written about this. I would be happy to submit it for the record.[1]

Senator PROXMIRE. All right.

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[1] See Mr. Heller's article, beginning on p. 196.

Mr. HELLER. I feel that there are limited exceptions that make sense, indexing under present circumstances.

Senator PROXMIRE. How about the Canadian plan, where you at least index the income tax, so that if prices go up you allow more for dependents? For instance, instead of $750 you increase it as the cost of living increases.

Mr. HELLER. I am in favor of discretionary adjustments in relationship to the particular nature of inflation, as my tax cut proposal would suggest. But if we do it automatically we take out one of the automatic blocks to inflation and throw a greater burden on Congress to take discretionary action, to increase taxes. I am a little loath, given the record of the Congress, the White House, and the country on tax increases, I am a little loath to remove this automatic barrier to the growth of inflationary excesses of demand. I think occasional adjustments have to be made by the Congress in a discretionary way, but I do not want to put it on an automatic conveyor belt.

Finally, just on the general subject, I do believe there is some very real substance in the proposition that if you take all the pain out of inflation, and all the risk, so to speak, out of inflation, as you would with a comprehensive indexing system, you remove one of the few remaining barriers to this acceleration of inflation that Jim Duesenberry has spoken about. But beyond that I will simply submit my article on the subject.

Senator PROXMIRE. I appreciate it very much.

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

[From the Wall Street Journal, June 20, 1974]

HAS THE TIME COME FOR INDEXING?

(By Walter W. Heller)

In a world caught in the toils of unrelenting inflation, it is small wonder that "indexing" or "indexation" is gaining attention and adherents.

The idea of using a general price index to translate fluctuating money values of payments like wages and interest and of assets like bonds and savings into stable real value is not new, of course. A century ago, the English economist Jevons was searching for just such a stable standard of values. And in recent years, Belgium, Israel and Finland have indexed wages, pensions, rents and a wide range of financial transactions.

Even in the United States, we practice indexing in a limited way. Cost-of-living adjustments provide some insurance against inflation for 32 million Social Security and civil service beneficiaries and 13 million recipients of food stamps. And the wages of about 10% of the labor force are at least partly hedged against inflation by cost-of-living escalators.

What is new is not indexing as such, but the proposal that it be applied across the board. Struck by Brazil's heady economic experience, Milton Friedman urges us to "express all transactions that have a time duration in terms that eliminate the effect of inflation." This, it is claimed, would automatically take both the sting and the honey out of inflation and clear the path for monetary and fiscal measures to bring it under control.

Brazil's widespread use of indexing, or what it calls "monetary correction" has coincided with a marked slowdown in inflation and a strong speed-up in growth. The annual rate of inflation was brought down from about 90% in 1964 to 15% in 1973 (though world-wide inflationary pressures have again pushed it up to over 35% in the early months of 1974). Meanwhile, real growth has averaged better than 10% a year since 1968.

THE BRAZILIAN EXPERIENCE

But has indexing really been the hero of the piece? Does the Brazilian experience apply to conditions in the U.S.? For much of the following analysis I am indebted to Professor Albert Fishlow at the University of California.

After the military takeover in 1964, Brazil applied indexing with a vengeance in an effort to cope with rampant inflation and to get financial markets back on their feet:

Indexes measuring inflation rates of the recent past are used to translate money values into real values for payments of rent, interest and taxes as well as for assets like bonds, savings accounts and both the fixed and working capital of business.

Wage increases are determined by applying an index of expected future price and productivity increases to a base consisting of the average real wages paid in the preceding 24 months.

Profits are determined on the basis of real gains after monetary correction, while the level of exemptions and the range of tax brackets under the personal income tax are redefined each year in accordance with price level changes.

The foreign exchange rate was put on a crawling peg, a system of regular minidevaluations geared to the differential rate of Brazilian inflation.

The measure of inflation generally used for the correction process is the wholesale commodity price index (except in the case of rentals, where the minimum wage is used as the indexing standard). Apart from wages, where the index is applied in an arbitrary way, the system is far from automatic. To implement changes in economic policy, the authorities have adjusted tax privileges, loan repayment terms and real estate rate levels from time to time.

Wage indexing, as used in Brazil, was not a device to help labor keep pace with inflation. In fact, the wage formula, especially during the early years, had a built-in bias toward a reduction of real wages, partly because the correction for future inflation (and productivity advances) substantially undershot the mark and partly because rampant inflation eroded and calculated wage base. As a result, real minimum wages declined some 16% in the first phase of the program up to 1967. In the following five years, average wage gains covered only half to two-thirds of productivity advances. Only in 1972 and 1973 did rough parity prevail.

No one disputes that the Brazilian economy has made impressive strides in the decade since indexation was introduced. But the closer one looks, the clearer it becomes that indexing—in the usually accepted sense of impartial and automatic adjustments to general price movements—made only a marginal contribution to that success. Several facts lead inescapably to this conclusion.

First, the decisive role in reducing Brazil's inflation was played not by indexing but by (a) fiscal discipline that reduced the cash deficit from more than 4% of total output in 1963 to a small surplus in 1973; (b) price and wage controls; (c) the large productivity dividends produced by high rates of growth, and (d) greater international openness and the resulting competitive pressures on the domestic economy.

Second, Brazil's in-name-only indexation for wages was actually a formula for unwinding inflation at the expense of labor. The substantial decline in real wages, especially in the lower income groups, bears witness to this.

Third, from the foregoing it is clear that the important parts of the program bearing the label "monetary correction" did not serve the cause of equity under conditions of rapid price rise—which presumably is the name of the game in indexing—but precisely the opposite.

Fourth, far from being an automatic correction based on overall price movements and thereby serving as a neutral "rule" to supplant governmental authority in allocating resources and distributing income. Brazilian indexing has been highly discretionary. To think otherwise does not do credit to the ingenuity and innovativeness of Brazilian policymakers. It fails to convey the degree to which rapid growth and disinflation were a product of conscious intervention in the economy.

Fifth, as recognized by such respected Brazilian authorities as Minister of Finance Mario Enrique Simonson, indexing eliminates the usual frictions in the inflationary process and thus may become a "feedback factor" in the rate of price increases. The 1974 jump in Brazil's inflation rate stemming from the global rise in food and energy prices seems to illustrate this point. The country's nimble policymakers already are investigating new ways of blocking this transmission effect.

Although indexing played a minor direct role in Brazil's successes on the growth and inflation fronts, it did help set the stage. By restoring and guaranteeing positive real rates of interest to savers, it helped revive capital markets and created the conditions in which new financial institutions could work, thus enabling the market to allocate resources more efficiently. Also, with the help of a broad range of export subsidies and incentives, the crawling-peg exchange rate facilitated a truly impressive growth in Brazil's exports. These consequences were important for Brazil's economic advance. But they are largely irrelevant to the U.S. economy blessed with strong financial institutions and foreign trade.

Indeed, the adjustment of interest rates to inflation via the marketplace, as in the U.S., affords an interest contrast with adjustments by indexing. What is the greater wisdom? To escalate long-term interest rates via indexing in response to the 1973–74 food and fuel price explosion? Or temporarily to offer a negative return on long-term money as our sophisticated capital markets are doing? These markets seem to be telling us that we should not build today's inflation into tomorrow's expectations on an exactly proportionate basis (nor, for that matter, should we ignore projected earnings in the productive sector).

COST-PUSH PRESSURE

An automatic across-the-board indexing system would have promptly translated skyrocketing commodity prices not only into higher interest rates but into higher wages. Thus, it would have put relentless cost-push pressure on the general price level. Under the present system, one has at least a fighting chance to avoid converting the 1973-74 "soft core" inflation—food, fuel, industrial materials and post-Phase 4 pop-up inflation—into a "hard core" price-wage spiral reaching well into the future.

Because of its uneven impacts, then, our existing system throws sand into the gears of inflation. Indexing would oil the gears and speed the process of inflation.

Under the present circumstances, a good case can be made for using cost-of-living escalators in wage bargains instead of building the present rate of inflation into those contracts. Labor is thus protected against high rates of inflation, while the public is assured that wages won't be pegged at levels that ignore declining rates of inflation.

But it should be recognized that if across-the-board indexing of wages were required, vexing questions would arise. Would the base, or take-off point, simply be the existing wage level, or would adjustments have to be made for previous wage erosion and wage inequities? Would some nationwide adjustment for productivity also have to be prescribed? And would that not call for price-monitoring?

Beyond this, could a cost-of-living index be tuned finely enough to maintain the even-handedness that is a major objective of indexing? It is probably beyond the capacity of an indexing system, for example, to adjust for the fact that inroads of zooming food and fuel prices have been more serious for modest and low incomes than for high incomes.

Or consider the difficulties in trying to index income tax liabilities as Brazil has done:

Suppose we adjusted personal exemptions and the width of the tax brackets by the cost-of-living index today. It would give too much relief to those for whom food and fuel absorb only a small percentage of income and vice versa.

A tax fix via indexing cuts tax liabilities for those hurt by inflation but imposes no penalties on those, like debtors, who are helped by it.

Indexing reduces the automatic stabilizing force that a progressive income tax exerts by taking more money out of an inflationary economy. In this sense it demands more of discretionary fiscal policy.

Indexing would also throw a heavier burden on conventional fiscal, monetary and wage-price policies because it is such an efficient "conductor" of the inflationary impact of outside shocks like the quadrupling of Arab oil prices. Such policies are having a hard enough time trying to curb existing inflation without making them compensate for indexation as well.

SOME ATTRACTIONS

This is not to say that indexation has no role to play in the U.S. economy. As the Social Security and food stamp examples illustrate, it has definite attractions as a means of buffering the incomes of groups who have no built-in protection against inflation. Cost-of-living escalators for wages can also play a useful role in an economy where inflationary forces are ebbing. And the federal government might want to issue an indexed security itself and remove legal barriers to private indexing arrangements in financial transactions. Having "purchasing power bonds" as an option would enable the system to respond more efficiently to differential expectations of future inflation among investors and thereby reduce nominal interest rates.

But even with the best of intentions and the most perfect of applications, indexing cannot fairly lay claim to being neutral, automatic or highly equitable. It does not do away with either market power or political power. But it does do away with some of the inhibitions against inflation and some of the frictions that serve as circuit breakers to slow it down.

In short, carefully targeted indexing in small doses can promote equity without worsening inflation. But in large doses, it is more likely to be an opiate than a cure for inflation.

Dr. Heller, president of the American Economic Association, is Regents' Professor of Economics at the University of Minnesota and former chairman of the Council of Economic Advisers under Presidents Kennedy and Johnson. He is also a member of the Journal's Board of Contributors, four distinguished professors who contribute periodic articles reflecting a broad range of views.

Senator PROXMIRE. Mr. Duesenberry.

Mr. DUESENBERRY. Let me note first, that Milton Friedman did not propose indexing in order to make us happy living with inflation, but because he thought that so many people had such a vested interest in the existence of inflation that indexing would help them to live with a reduction in the rate of inflation.

Second, as to indexing, as to the tax cut, I do not see why we should take all the pleasure out of a Congressman's life. There is some advantage, I think, in having taxes which automatically tend to go up, which then permits the Congress to reduce them when needed, and it is easier to reduce them than interest.

Finally, it is a delusion to think that you can really make inflation go away by indexing. On the other hand, indexing tends to accelerate the rate of inflation by speeding up the process of passthrough of everything, and when inflation gets to very high rates, we then find that we get all the kinds of inequities, the same old problems, out of differences in indexing. It turns out that a fellow's wages are indexed on the CPI, but what he buys is on the wholesale price index, and they do not move exactly the same. And there have been a number of countries which have been indexed, and after a few years of indexing it has turned out that they had the same old social conflicts, now over the nature of the index which was used in that process. I have an English friend who once went to a former English colony to quell the riot by fixing up the cost of living index. So I think that you do not really make the problem go away.

Senator PROXMIRE. I think that is right. I think that is the essence of it. It is astonishing that it comes from Milton Friedman, who is, of course, a free-market man, because if there is any way, it seems to me, that the Federal Government is going to have to decide everything, and is going to be a real big brother, we have to arbitrate who gets what and how. The way it has been practiced in Brazil it is extraordinarily discriminatory against labor in favor of the investor. The pressure on Congress in adjusting that index would be, I think, immense. And if you just get a political decision, it might be highly inequitable.

Let me conclude by saying that I do think that while I have great respect for the capacity of both of you men, I do think you are a little pessimistic. I think that it is possible with a new President for us to put together a program which will do something big about this inflation. I think as you say, Mr. Heller, this is the time. People are outraged by the inflation, and it is a bigger issue than Watergate, it is a bigger issue in our country. It is going to get worse. As inflation gets worse the concern will get greater. I think it is the time that we can say no to pressure groups that we could not say no to before. It is time that we can take antitrust action that we could not take in the past. It is time to roll back prices. Any President who can do that now would be a hero. It is a time when I think everybody is going to have to recognize that this simply must be solved, because if we do not solve it, we are, as Arthur Burns has said, putting our free society into considerable jeopardy.

Mr. HELLER. I hope, Senator, that the study you make, and the actions you take in Congress, will pave the way for this kind of action, because a President Ford, with the kind of pressures that you have so elegantly delineated, is not going to carry out the kind of a policy that you suggest without pressure from the Congress and the people. The only way for the pressure to come from the people is for it to be mobilized and focused and crystalized by the Congress, and ready for action when the new President comes in. The Joint Economic Committee plays a crucial role in that process.

Senator PROXMIRE. I appreciate that. And I think that is very good advice.

Thank you, gentlemen, very much.

The committee will stand in recess until 10 o'clock tomorrow morning, when we will hear from Secretary of the Treasury Simon.

[Whereupon, at 1 p.m., the committee recessed, to reconvene at 10 a.m., Friday, August 2, 1974.]

EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

FRIDAY, AUGUST 2, 1974

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire, Sparkman, Humphrey, Javits, and Percy; and Representative Reuss.

Also present: John R. Stark, executive director; John R. Karlik and Courtenay M. Slater, senior economists; Richard F. Kaufman, general counsel; William A. Cox, Lucy A. Falcone, Robert D. Hamrin, Sarah Jackson, Jerry J. Jasinowski, L. Douglas Lee, and Larry Yuspeh, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

Opening Statement of Senator Proxmire

Senator Proxmire. The committee will come to order. This morning we are very pleased to have before the committee the Secretary of the Treasury, Mr. William E. Simon, a man of extraordinary ability and competence.

I am always glad to see you, Mr. Simon, because you do not hesitate to speak out and say what you think. You do not give us the same homogenized position that we so often get from the administration and the executive branch.

There are several areas that I would like to explore with you today.

First, in the President's speech last week he proposed what frankly I called a do-nothing policy, a do-nothing economic policy. He has proposed no change in tax policy, no real change in my view, in spending policy, no wage-price policy, no change in monetary policy, nothing to help the housing industry, nothing to prevent the threatened resurgence of food inflation.

The chief economic adviser of the administration, Kenneth Rush, appeared before us, as did Herbert Stein, the Chairman of the Council of Economic Advisers. And they gave us the same story, in my view; that is, pretty much of a do-nothing policy.

We want to know first, if you are in substantial agreement with this lack of policy. And I might say that doing nothing might be the right policy under some circumstances, but I doubt very much if it is the right policy today.

Second, you have been considerably more optimistic about the possibility of cutting the Federal budget than other members of this administration. I understand that you have proposed a $20 billion cut which takes first prize in the fight against inflation by cutting the budget. That $20 billion at first glance may not seem to be extraordinary—but actually it would permit a 6-percent increase in spending last year.

When Kenneth Rush testified on Monday, he said that it would be very difficult to cut more than $5 billion. In fact, Mr. Rush has been quoted in the press as saying, "A whacking of the budget by $10 or $20 billion could lead to recession which would lead to deeper deficits." Walter Heller indicated yesterday that he felt that even another $3 billion in fiscal restraint would be too much. I want to know from you what specific cuts we could make to substantially reduce the budget but avoid the possibility of recession.

I am also interested to know how you arrived at the $20-billion figure. I know that you are opposed to using the full employment budget as a guide to fiscal policy but what do you use instead? How did you determine that $285 billion would be the appropriate level of government spending for fiscal year 1975?

Third, it is interesting that you as Secretary of the Treasury should propose spending cuts and offer at the same time a far gentler and more passive tax policy, since you are the principal tax man of the administration.

Does the Treasury have any studies underway which might result in proposals for tax changes this year? I understand that you have mentioned the need for additional incentives to business investment which might be provided through the tax system. Is it feasible to think about cutting taxes for anyone and still balance the budget?

Mr. Simon, we are delighted to see you this morning to discuss these and other questions. You have just returned, I know, from an extensive trip to the Middle East, and certainly the international oil situation is another key economic question on which we are anxious to be briefed.

Before I call on Senator Percy I might note that we have scheduled the head of the Bureau of Labor Statistics, Mr. Shiskin, to come before us at 11:30 to brief the Subcommittee on Priorities and Economy in Government on the latest unemployment figures that are just out this morning, so that we hope we can wind up this part of the hearing by 11:30, if possible.

Senator Percy.

Senator Percy. Secretary Simon, I would just like to express appreciation to you for the fairly tough positions that you have taken that I think are in the national interest.

First, you have faced up to the fact that we can cut expenditures, that there is fat in this budget. All programs are desirable probably, but there are some that are essential and crucial and have higher priority than others. We simply have to lop off those that cannot be justified in the light of present inflationary pressures caused by Federal spending.

Certainly you have been the strongest voice in that regard. We want you to know that you have got some supporters here in the Congress.

I have suggested many specific cuts that I think could be made, and also revenues that can be added. But we are grateful for the leadership that you have provided.

Second, in recent days I think you have once again talked with a clear voice, and talked, I think, in the longrun interest of the consumer, by simply saying that it is unrealistic for Governors and State commissions to hold down utility rates unnaturally and keep them artificially low. It is not possible, in my judgment, to attract capital to expand those facilities to meet growing demands and future needs if we have these rates at unrealistically low levels. It may be politically popular now to try to hold the rates down, but it is going to be disastrous when we have blackouts and we cannot get energy and when a factory might be closed and we cannot keep people on the job.

I hope that we can not only support a 7-percent investment tax credit for utilities to put them on a parity with private industry—and they are competing against private industry for capital—but I also think that when we are on the verge of a telephone strike, once again we will recognize, if we have that strike—and I hope it can be averted—the necessity of telephones. Telephone facilities all over the country also need expansion as we have growing, future needs. We should like very much to have your views as to whether the 7-percent investment tax credit should be applicable also not only to public utilities but also other types of utilities such as telephone companies.

We welcome you very much, and appreciate the candor with which you have always testified before this committee.

Senator PROXMIRE. Mr. Secretary, will you go right ahead, sir. You have a detailed prepared statement, if you wish to abbreviate it in any way the entire prepared statement will be printed in full in the record at the end of your oral statement.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY, ACCOMPANIED BY EDGAR R. FIEDLER, ASSISTANT SECRETARY FOR ECONOMIC POLICY

Secretary SIMON. Thank you, Mr. Vice Chairman. I will try to abbreviate it as best I can.

Before I start, I was catching up on some of my reading material after I came home last Saturday, I noted your many statements, Mr. Vice Chairman, in the Congressional Record. I have not read them all, but I have read this first one: "What Is Right With the Federal Government and the U.S. Economy."

And I just want to tell you, from an American citizen's point of view, as well as a government official, that I think that this is what has been sorely needed in the country. We need more voices like yours to say what is good and great about this country instead of constantly denigrating it, recognizing that a big country with a diversified economy like ours has always had problems, and is always going to have problems. But, we are always going to have people that are working very hard and are determined to solve them. It does not serve any useful purpose just to be a constant cynic, because cynics never build anything, they just destroy things.

Senator PROXMIRE. I want to thank you very much for that, Mr. Secretary. When I made my speech on what is right with the economy I thought it might be news, because nobody is talking about that, but nobody paid any attention to it. I think there are many good things about the economy. But we do not put it into perspective. We have some tremendously serious problems. But I do not think we are going to be in a position to cope with those problems unless we recognize that we have an enormous amount of strength to work with us, a whale of a lot going for us. We have made great progress. As you say, this constant denigration of the economy from every side is likely to destroy the basis of confidence on which we have to build a constructive policy.

Secretary SIMON. I agree, Mr. Vice Chairman. Again, having been on a rather prolonged 18-day trip through the Middle East and through the European centers, and in conversations with all the finance ministers, I think that they take a much different view of the strength of the economy, its inherent strength. Of course, we have problems. We have an inflation rate that is intolerable to us, it is unheard of. But we are going to solve that.

On that, sir, I would like to start. I thank you.

Your midyear reviews provide a valuable opportunity to examine current economic developments and to make plans for the future.

In this statement, I plan to comment briefly on both domestic and international aspects of our current situation. There is, however, no need for me to cover in detail our recent and prospective economic performance or our basic economic policies. These have been carefully and thoroughly described within the past week by the President and other administration spokesmen.

Nevertheless, I do want to say a few more words about the intolerably rapid rate of inflation we are now experiencing. Domestically this has become the dominant, overriding—almost overwhelming—fact of economic life. Americans are experiencing their first sustained siege of rapid peacetime inflation. It is a new and most unwelcome experience. They do not understand where double-digit inflation came from and they lack confidence that their government will be able to get the situation under control.

How did we get here? I will not try to retrace all the causes of the current inflation, or try to fix the blame one place or another. Without too much risk of oversimplification, I think it is fair to say that the price explosion of 1973–74 is primarily attributable to (a) a series of severe temporary shocks that originated mostly outside the U.S. economic system and (b) almost a decade of excessively stimulative fiscal and monetary policies.

The outside shocks are, by now, familiar to all of us: The worldwide agricultural crop failures of 1972, enormous pressures on the prices of internationally traded raw materials, two devaluations of the dollar, and the Arab oil embargo. In addition, the end of the controls program is now operating as an additional temporary force to raise some prices and wages faster than otherwise would have been the case.

But all these special factors, as important as they have been, are of a temporary, one-shot nature. Had our general economic policies not been too stimulative, the outside shocks would have had only a one-time effect. Once they had worked their way through the system, the inflation would have settled down again to a tolerable rate.

But our general economic policies have, in fact, been far too stimulative for a long period of time. Let me give you two examples of how policy changed in the mid-1960's. First, on the fiscal side: From 1955 to 1965 Federal expenditures rose at roughly a 6-percent annual rate. From 1965 to 1974, however, Federal expenditures surged to a 10-percent annual rate of growth, Second, monetary policy also broke out of a previously established pattern. From 1955 to 1965 the money supply grew at a 2½-percent rate. Since then, the growth rate has more than doubled to a 6-percent annual pace. It is no accident that during the earlier period we had a rather stable performance, but since 1965 we have had the worst peacetime inflation in our history.

What has and is happening, then, is that the excessive budget deficits and the excessive growth of money and credit in recent years prevented the "temporary" price pressures from running their course and fading away. Instead, much of the inflation from the outside shocks is or soon will be deeply embedded in our entire system. It is or soon will be embedded into the pattern of wage settlements and into the structure of interest rates, It is or soon will be embedded into the economic expectations of consumers, of workers, of investors, of businessmen—everybody.

And because this inflation is becoming so deeply embedded, squeezing it out of the system will be a long, tough process. It is a most difficult challenge for economic policy.

In my opinion, the correct course of action is to apply the necessary fiscal and monetary discipline persistently and consistently to keep the economy operating within the limits of its capacity to produce. The economy can be prosperous and it must continue to grow, but we must not let it continue to run away with itself. Demand will have to be held slightly below total potential output. Sales can show a healthy growth, but that growth will have to be constrained so that if businessmen try to raise prices too fast, competitive pressures will prevent them from doing so. Employment can grow, too, but our labor markets must not be too tight so that the joint worker-management process of wage determination can result in a gradual deceleration of the upward trend of pay scales.

Let me emphasize that this fight against inflation will take time, years of it. There are no shortcuts, no acceptable quick solutions. Frequent and abrupt changes in policy are the worst policy of all. To cure the price disease, we must be prepared to stay the long course and take an even strain on economic policy year after year. This is the only way to get the job done.

The President has put forward a coordinated program for dealing with inflation. The first requirement is to relieve those pressures of excessive demand in the economy that have caused the acceleration of advances in the price level. The second part of the program has to do with measures to relieve the casualties and inequities of inflation.

There are many who question the effectiveness of restrictive fiscal policy to counter these fundamental inflationary pressures. In my view, however, the evidence of experience is clear that fiscal restraint applied consistently and in tandem with monetary restraint can bring inflation under control.

I have attached to my prepared statement a chart[1]—a very instructive chart, I believe—that shows the broad relationship between the

[1] See chart, p. 220.

budget and inflation. As seen on the chart, the actual budget position does not correlate closely with the rate of inflation.

This is where the full employment budget proves itself to be a useful guide to economic policy; the full employment calculation adjusts the budget data to remove the impact of the economy on the budget, and thereby brings out the impact of the budget on the economy. And when the full employment budget position is compared to the rate of inflation, a fairly high degree of correlation shows up. The relationship is less than perfect, but in the broad sweep of things it is clear that sustained budget surpluses are associated with below-average inflation, and sustained budget deficits are associated with above-average inflation.

There are 2 years during the 26-year span covered by the chart in which the inflation is far higher than can be accounted for by fiscal policy. These years are 1950–51 and 1973–74, which were the two occasions when commodity inflation—food and industrial raw materials—had an extraordinarily large, one-time impact on the general price level. Aside from those two occasions, the relationship strongly supports the general motion that budget deficits are inflationary and budget surpluses are not inflationary.

I do not want to suggest that countering inflation is so simple that all we have to worry about is our budget position. Quite the contrary. We all know that "money matters" and that we have to be concerned with monetary policy. Arthur Burns has already testified that a 6-percent growth in money is too high for price stability over the longer term. He has also stated that monetary policy will be conducted so as to avoid a credit "crunch."

In this regard, we should remember that a strong, steady fiscal policy is especially important when, as at present, demands for financing capital formation and housing are heavy relative to the flow of national savings. I believe the normal target for the budget should be a surplus equal to 1–2 percent of Federal outlays. With such a surplus, which would add roughly 2 percent to the national savings stream, credit requirements would be in approximate balance with this flow of savings, and the needed steadier course for monetary policy would then be less endangered by the risks of floundering credit and capital markets.

Any well-conceived anti-inflation program must also have regard for the casualties of inflation and for those whose earnings may be interrupted for a time by a program of disinflation. Without getting into detail, let me say that I believe we can gradually reduce inflation without suffering massive unemployment. For a time, we will have to live with slightly more unemployment than we would like, but it will not have to be a large amount. To deal with this contingency, the President has proposed improvements in our system of unemployment compensation, and I again urge congressional passage.

Strains in the financial markets have had particularly adverse effects on housing, and in May the President put forward a $10 billion program to augment the supply of mortgage funds. These financial strains together with higher prices of primary energy have—because of the slow pace of the regulatory process—produced dangerously low earnings for many companies in regulated industries.

While these are largely State and local regulatory bodies which must act, the administration is examining what might be done to speed up the needed changes. These illustrate the kinds of economic adjustments that must be accommodated in order to facilitate the disinflationary process.

SUMMING UP

To bring our price disease under control, we will have to keep our general economic policies under firm control. There is no acceptable alternative. We can and will pursue complementary policies—maximizing agricultural production, reorganizing inefficient Government regulatory practices, and others. But the key is to keep demands in the economy within the limits of its productive capacity through balanced fiscal and monetary restraint.

If we do not do so, we will continue to have the cruel, indiscriminate, insidious tax of inflation. Inflation hurts everybody—people on every rung of the income ladder, corporations, financial institutions, State and local governments—everybody. Most of all, it hurts the poor. And if we do not have the self-discipline to keep Federal spending in line with tax revenues, what happens is that the deficit is closed by the harsh and uneven tax of inflation, rather than by more equitable routes of achieving balance between outlays and revenues.

Before closing this discussion of our domestic economic situation, I want to say a few words about profits. To curb inflation, our policy in the short run must be to restrain demand. In the long run, however, we must make every effort to expand our productive capacity. To this end adequate profit incentives are crucially important.

In the last year or two, there has been much talk about an excessive increase in corporate profits. I am afraid, however, that these increases in profits have not been put into proper perspective. In particular, there has been inadequate recognition of the impact of inflation on this measurement of profits.

For example, nonfinancial corporations reported profits after taxes in 1973 of $55 billion as compared to $38.2 billion in 1965, an apparent 44-percent increase. But when depreciation is calculated on a basis that provides a more realistic accounting for the current value of the capital used in production and when the effect of inflation on inventory values is eliminated, after-tax profits actually declined by 25 percent, from $35.3 billion in 1965 to $26.5 billion in 1973. One major factor behind this decline is the fact that taxes were paid on these fictitious elements of profits, which resulted in a rise in the effective tax rate on true profits from about 44 percent in 1965 to 60 percent in 1973. On this basis, furthermore, after dividend payments, the retained earnings available for reinvestment, which were $18.4 billion in 1965, were only $2.8 billion in 1973.

Thus, a more realistic calculation shows that the sharp rise in profits was an optical illusion caused by inflation. And this helps to explain why the ability of business to increase its productive capacity is in jeopardy and why our financial markets are so congested.

In this context, it is not surprising that basic industries such as steel, coal, natural gas, and aluminum are experiencing shortages in productive capacity. Increased productivity and decreased Government spending are the two essential lines of attack against inflation. Both the administration and the Congress must reassess past legislation that stimulates consumption and inhibits saving and investment. No nation can neglect investment in favor of consumption for very long and still prosper. I am quite concerned that since 1960, plant and equipment spending in the United States was only 15 percent of total output, whereas France invested 18 percent, Germany 20 percent, and Japan 27 percent. And furthermore, for gross domestic investment—which includes inventories, housing, and public investment—the proportions for 1973 are: United States, 17 percent; France, 26 percent; Germany, 25 percent; and Japan, 37 percent.

Senator PROXMIRE. Mr. Secretary, I hesitate to interrupt you, but we have a situation at this point—I want you to continue your statement before the rest of us question, but Senator Percy has to catch a plane and has to leave within a very short time, so if the other committee members do not object, I am going to ask unanimous consent for him to ask questions here, and then later you can finish your statement.

Secretary SIMON. Fine, Mr. Vice Chairman.

Senator PERCY. I thank my distinguished colleague very much.

I would like, Secretary Simon, to have your comments on a question I posed in the opening statement on your concern as to where we are going to get the capital for our utilities in the future. The needs are horrendous. We are going to need about $5½ trillion of new capital investment for all plant and equipment expansion in the next 12 years. The utilities will be competing in the private market. What has to be done to insure that they get that capital in order to supply energy, power, and all the other services, if we expect them to supply them?

Secretary SIMON. I share your concern, Senator Percy, on the capital needs of the future. It is not very simple to change the policy of Government for many years from one that promotes consumption and penalizes savings and investments. And these must be reversed, as I testified before your subcommittee several weeks ago at great length.

We did a study in the Treasury Department on the subject of public utilities, which was completed about 3 or 4 weeks ago on the critical problems stemming from the increase in their feedstock petroleum, and the problem of getting sufficient rate increases to meet this additional cost. And we certainly favor the increase of the investment tax credit from 4 percent to 7 percent.

The fact is that this is a regulated public utility when in fact, their profits are being regulated at levels that are too low to allow them to increase the needed plant capacity in the future—I do not have the amounts, they are looking it up for me down in the Treasury now on the components of recent utility construction in this country. And as you said in the outset, our shortrun objectives in keeping the prices ridiculously low on the consumption of electricity in this country are going, in the intermediate term, not even the long term, to come back and affect us in brownouts and blackouts, and the lack of this commodity that is so critical to us.

Senator PERCY. I have just two other areas that I would very much appreciate your comments on.

We have discussed in this committee a number of times the possibility of reducing the deficit in the fiscal 1975 budget by some $10 billion. You have indicated that you feel that there should be budget cuts. And others have commented on this. But can we expect a fiscal 1975 budget to be resubmitted by the administration to the Congress with specific cuts outlined for our consideration? If you do not agree with us, let us counter with another proposal. But we should agree on an objective to bring the 1975 budget reasonably in balance, because we were very close on the 1974 budget, with only a $3½ billion deficit. I think it would be disastrous for us to go deeper into the red.

Secretary SIMON. I would like to answer that and at the same time answer the vice chairman's questions about my proposed $20 billion recommendation.

My position on the budget and the damage that our fiscal and monetary policies have done to this economy are well known to the American people now. Unfortunately, when I was testifying before many committees back in the House and the Senate, going back to the credit crunch in particular of 1966, when I spoke of many of these policies. it was like this dialog in the country today. It reminds me of the dialog that I heard in my last assignment with the Government during the energy crisis. People said, why didn't you tell us? Nobody was prepared for this. As everybody knows, there was adequate warning.

And there has been adequate warning on this financial mess that we find ourselves in and the inflation problem that we find ourselves in today. We must reverse the excesses of the past.

So my stance has been well known. And perhaps I have been a bit stronger than the other members of the team that I participate in. And that is what a team is for.

The press very often says that it is a difference in degree. When your direction is all the same, it seems that there is acrimony and arguments over the matter of degree. When intelligent men get together and discuss something as serious as the problems of our economy policy in today's environment, there are going to be differences of opinion indeed. You heard the differences of opinion when the economists testified before this committee. Well, I would have preferred—my direction would be to move toward balance in 1975, recognizing that it would require legislation to move in this direction.

In discussions on what we would like to do and what indeed is practical to accomplish in the administration, the President decided two very important things. One, that the nearly $7 billion in spending that is being discussed. and probably voted on the Hill right at this point, if it reaches the White House, he will veto it. And this is $7 billion over and above the $305 billion that he had budgeted for 1975.

We also decided that we would move the budget from the $305 billion down to the $300 billion level of expenditures, which I think is a great step in the right direction, when one looks back only 4 months ago. I was pretty well out alone on the end of this limb in the recognition and, I think. acceptance. of the damage that Government overspending has done in the last 10 years, and the damage it has done to our economy.

So I am satisfied that the direction we are moving, moving toward a balance in 1976, is the proper fiscal policy to adopt right now.

If you wish to ask me, well, what would you think about moving to exact balance in 1975? I would say if that is practical we should sit together and perhaps work together on that.

Senator PERCY. Can we expect a resubmittal of the revised 1975 budget, though, for consideration?

Secretary SIMON. I doubt a resubmittal, Senator Percy. I would say that you can expect specific actions to be taken in this area and that area.

Now, relative to my suggestions on $20 billion, during the course of the economic teams meeting with the President over the last 3 months, or 4 months, and me being on this cut-the-budget effort, he requested me to draw up a discussion paper for our next meeting. And I drew up a discussion paper saying where we had been and where we are and the danger of where we might be going, and taking a look at the budget and the components of the budget, and where the recent growth had indeed occurred. And 65 percent of that growth, from 1972 to 1975, had been in the area of general welfare, if you will. So let us take a look and where these increases have occurred, have they been overlapping increases, what have we paid for? What are some of the problems, the financial problems that we are facing in the future in the area of social security that will require a funding of $2¼ trillion moving into the early 1980's? So my suggestion that this represents a real danger to our financial system. Well, I think it is time that we sit down and have a dialog. This confidential memo was prepared for the economic group meeting with the President. I also discussed with him at that time specifics in the space program and the highway trust programs, as well as several other items that did not appear in this memorandum. I was quite surprised to see it appear in the newspaper, because in no way, shape, or form were they recommendations of specific cuts of $20 billion.

There were areas for us to sit down and say, this is something that I would like some more economic studies done on immediately, because this is an area that will show us great concern. It is the President's obvious choice—and he makes each choice personally—as to the specifics of where the budget should be cut. And we have got discussion.

Senator PERCY. Thank you, Mr. Secretary.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Thank you very much, Senator Percy.

Mr. Secretary, why don't you go right ahead and complete your statement. Then we will question you.

Secretary SIMON. Thank you, Mr. Vice Chairman.

We have now had more than a half year's experience with the increased oil prices announced late last year. The international economy has been profoundly changed. Fortunately, the most exaggerated fears of some have not proved justified. But we are confronted by difficult problems, related both to petroleum developments and to worldwide inflation, which together have led to a widespread slowdown in economic growth this year.

As in the United States, people everywhere are suffering the wrenching pains of inflation. Few countries have escaped double-digit rates of price increase and almost all are experiencing inflation rates considered intolerable by past standards.

Inflation is a common problem around the world in part because of the strong forces that carry price pressures across national boundaries. Fundamentally, this reflects our growing interdependence—the fact that the links among nations have become stronger as international trade has grown more rapidly than domestic trade. To illustrate the importance of the international transmission of inflation, I would cite recent forecasts of the Organization for Economic Cooperation and Development that increases in the price of imported oil will directly add some 1½ percentage points to the rate of inflation in OECD member countries this year, and increases in the prices of imports of other primary products another percentage point. These figures do not allow for secondary effects of the import price rises on domestic prices, and thus understate the total price effect. Another striking measure of the price increases affecting international trade is that in the first half of 1974 the average value of OECD imports, swollen by the oil price increases, rose by 65 percent and the average value of exports by 32 percent.

I found in my recent travels abroad that others view the inflationary problems we are experiencing in this country somewhat differently than we do. In fact, others look at our record with a certain envy. While this does not make our inflation easier to bear or to deal with, the fact is that we are doing better than many other countries. Consumer prices have been rising at rates of about 12 percent in the United States, but this compares with figures of some 30 percent for Japan and 15 to 20 percent for Italy, the United Kingdom, and France. In Germany, on the other hand, where strong policies of demand restraint have been pursued for an extended time, prices are rising at a rate of less than 8 percent.

Recognition of the common danger of inflation has in recent months brought about a more realistic view of the prospects for growth. At the turn of the year, against the background of an oil embargo, some thought the oil consuming nations might be thrown into chaos, and the specter of a 1930's depression was raised. Today, the embargo is lifted and energy shortages are no longer a severe restraint on growth. While the industrial world is still experiencing a slowdown, there is wide agreement that the slowdown is essential if we are to control the forces of inflation. There is a healthy recognition that the inflationary costs of excessive expansion would be unacceptable. While we cannot turn our backs on the possible future need for stimulative policies, it is understood that nothing could more severely threaten the fabric of our societies than to hit the throttle at a time when we should have our foot firmly on the brake.

The increase in oil prices brought with it the danger of an escalation of trade restrictions. There was concern that importing nations, seeing their own trade balances deteriorate because of increased oil imports, might impose restrictive trade measures which would simply shift more of the deficit elsewhere, and the cumulative effect could be excessive domestic deflation. This must, of course, be watched. However, OECD member countries agreed in May to a declaration of intent to avoid recourse to restrictive measures.

In June the IMF Committee of Twenty agreed to a similar pledge for adherence by the broader membership of the International Monetary Fund. The United States strongly supported both these moves, and we are confident they will reinforce the commitment of the world trading community to a liberal trading order. It is critical that the Congress help us maintain the momentum toward expanding world trade by prompt and affirmative action on the Trade Reform Act, so that the "Tokyo Round" of multilateral trade negotiations can move forward toward reducing trade barriers and building better arrangements for managing international trade relations.

When this Committee met in February, concern had already been expressed about the problems of financing oil surpluses and deficits and the ability of private financial markets to handle the anticipated vast flows of funds. More recently, difficulties of a few banks heavily involved in international transactions have magnified expressions of concern.

We recognize that the private markets face a serious challenge. But we should not exaggerate the difficulty. Let us not make allegations unsupported by facts. An individual bank, through imprudence or other management problems particular to the firm, can certainly get into trouble. But that does not imply any impending failure of financial markets generally or of the monetary system.

Certainly there will be strains in the face of the major challenges posed for the markets. In my talks with the Finance Ministers of other countries, we have frankly recognized this prospect. And we are confident that we can develop mechanisms to deal with these strains.

I do not, however, classify as real the problem of potentially massive shifts of funds—the worry that oil moneys will be capriciously shifted from one market to another thereby disrupting the foreign exchange and financial markets. In part, this is because investments by the oil producing countries will be in instruments of varying degrees of liquidity, some of which—probably a growing proportion—could not be liquidated without losses that would make such shifts unattractive.

Senator PROXMIRE. Mr. Secretary, this is an excellent prepared statement. Is it possible for you to summarize your prepared statement? Because we do have a number of members here. But if you feel you would like to read the entire prepared statement, go ahead.

Secretary SIMON. Why don't I just recommend it for your bedside reading, Mr. Vice Chairman.

Let me just read the last two paragraphs, and then I will end it up, Mr. Vice Chairman.

It would be a disservice to underestimate the tenacity with which we shall have to attack our present problems. I am confident, though, that we are on the right track, that the policies being followed nationally and internationally are the policies which will in time bring solutions to our problems. Inflation will abate. We will avoid the extremes of depression and finanical collapse. We will find a new equilibrium in the commodity markets.

To achieve these goals here in the United States, the most important single action we can take is to regain control of Federal spending. To this end, close, cooperative, and bipartisan action will be required. This committee could make a significant contribution by encouraging a prompt activation of the new and stronger procedures for budget control provided in the Congressional Budget Act of 1974. Without determined action by both the administration and the Congress, the rise in Federal outlays this year and next could be so large as to impose sustained rapid inflation on the American people. To prevent that result is our most important duty as public officials.

Thank you.

Senator PROXMIRE. Thank you, Mr. Secretary.
[The prepared statement of Secretary Simon follows:]

PREPARED STATEMENT OF HON. WILLIAM E. SIMON

Mr. Vice Chairman and Members of the Joint Economic Committee, your Mid-Year Reviews provide a valuable opportunity to examine current economic development and to make plans for the future. It is a pleasure to be here today and to participate in these deliberations.

In this statement, I plan to comment briefly on both domestic and international aspects of our current situation. There is, however, no need for me to cover in detail our recent and prospective economic performance or our basic economic policies. These have been carefully and thoroughly described within the past week by the President and other Administration spokesmen.

Nevertheless, I do want to say a few more words about the intolerably rapid rate of inflation we are now experiencing. Domestically this has become the dominant, overriding—almost overwhelming—fact of economic life. Americans are experiencing their first sustained siege of rapid peacetime inflation. It is a new and most unwelcome experience. They do not understand where double-digit inflation came from and they lack confidence that their government will be able to get the situation under control.

How did we get here? I will not try to retrace all the causes of the current inflation, or try to fix the blame one place or another. Without too much risk of oversimplification, I think it is fair to say that the price explosion of 1973–74 is primarily attributable to (a) a series of severe temporary shocks that originated mostly outside the U.S. economic system and (b) almost a decade of excessively stimulative fiscal and monetary policies.

The outside shocks are, by now, familiar to all of us: the world-wide agricultural crop failures of 1972, enormous pressures on the prices of internationally traded raw materials, two devaluations of the dollar, and the Arab oil embargo. In addition, the end of the controls program is now operating as an additional temporary force to raise some prices and wages faster than otherwise would have been the case.

But all these special factors, as important as they have been, are of a temporary, one-shot nature. Had our general economic policies not been too stimulative, the outside shocks would have had only a one-time effect. Once they had worked their way through the system, the inflation would have settled down again to a tolerable rate.

But our general economic policies have, in fact, been far too stimulative for a long period of time. Let me give you two examples of how policy changed in the mid-1960's. First, on the fiscal side: from 1955 to 1965 Federal expenditures rose at roughly a 6 percent annual rate. From 1965 to 1974, however, Federal expenditures surged to a 10 percent annual rate of growth. Second, monetary policy also broke out of a previously established pattern. From 1955 to 1965 the money supply grew at a 2½ percent rate. Since then, the growth rate has more than doubled to a 6 percent annual pace. It is no accident that during the earlier period we had a rather stable price performance, but since 1965 we have had the worst peacetime inflation in our history.

What has and is happening, then, is that the excessive budget deficits and the excessive growth of money and credit in recent years prevented the "temporary" price pressures from running their course and fading away. Instead, much of the inflation from the outside shocks is or soon will be deeply embedded in our entire system. It is or soon will be embedded into the pattern of wage settlements and into the structure of interest rates. It is or soon will be embedded into the economic expectations of consumers, of workers, of investors, of businessmen—everybody.

And because this inflation is becoming so deeply embedded, squeezing it out of the system will be a long, tough process. It is a most difficult challenge for economic policy.

In my opinion the correct course of action is to apply the necessary fiscal and monetary discipline persistently and consistently to keep the economy operating within the limits of its capacity to produce. The economy can be prosperous and it must continue to grow, but we must not let it continue to run away with itself. Demand will have to be held slightly below total potential output. Sales can show a healthy growth, but that growth will have to be constrained so that if businessmen try to raise prices too fast, competitive pressures will prevent them from doing so. Employment can grow, too, but our labor markets must not be too tight so that the joint worker-management process of wage determination can result in a gradual deceleration of the upward trend of pay scales.

Let me emphasize that this fight against inflation will take time, years of it. There are no shortcuts, no acceptable quick solutions. Frequent and abrupt changes in policy are the worst policy of all. To cure the price disease, we must be prepared to stay the long course and take an even strain on economic policy year after year. This is the only way to get the job done.

The President has put forward a coordinated program for dealing with inflation. The first requirement is to relieve those pressures of excessive demand in the economy that have caused the acceleration of advances in the price level. The second part of the program has to do with measures to relieve the casualties and inequities of inflation.

There are many who question the effectiveness of restrictive fiscal policy to counter these fundamental inflationary pressures. In my view, however, the evidence of experience is clear that fiscal restraint applied consistently and in tandem with monetary restraint can bring inflation under control.

I have attached to my statement a chart—a very instructive chart, I believe—that shows the broad relationship between the budget and inflation. As seen on the chart, the actual budget position does not correlate closely with the rate of inflation. This is where the full-employment budget proves itself to be a useful guide to economic policy: the full-employment calculation adjusts the budget data to remove the impact of the economy on the budget, and thereby brings out the impact of the budget on the economy. And when the full-employment budget position is compared to the rate of inflation, a fairly high degree of correlation shows up. The relationship is less than perfect, but in the broad sweep of things it is clear that sustained budget surpluses are associated with below-average inflation, and sustained budget deficits are associated with above-average inflation.

There are two years during the 26-year span covered by the chart in which the inflation is far higher than can be accounted for by fiscal policy. These years are 1950–51 and 1973–74, which were the two occasions when commodity inflation (food and industrial raw materials) had an extraordinarily large, one-time impact on the general price level. Aside from those two occasions, the relationship strongly supports the general notion that budget deficits are inflationary and budget surpluses are not inflationary.

I do not want to suggest that countering inflation is so simple that all we have to worry about is our budget position. Quite the contrary. We all know that "money matters" and that we have to be concerned with monetary policy. Arthur Burns has already testified that a 6 percent growth in money is too high for price stability over the longer term. He has also stated that monetary policy will be conducted so as to avoid a credit "crunch".

In this regard, we should remember that a strong, steady fiscal policy is especially important when, as at present, demands for financing capital formation and housing are heavy relative to the flow of national savings. I believe the normal target for the budget should be a surplus equal to 1–2 percent of Federal outlays. With such a surplus, which would add roughly 2 percent to the national savings stream, credit requirements would be in approximate balance with this flow of savings, and the needed steadier course for monetary policy would then be less endangered by the risks of floundering credit and capital markets.

Any well-conceived anti-inflation program must also have regard for the casualties of inflation and for those whose earnings may be interrupted for a time by a program of disinflation. Without getting into detail, let me say that I believe we can gradually reduce inflation without suffering massive unemployment. For a time, we will have to live with slightly more unemployment than we would like, but it will not have to be a large amount. To deal with this contingency, the President has proposed improvements in our system of unemployment compensation, and I again urge Congressional passage.

Strains in the financial markets have had particularly adverse effects on housing, and in May the President put forward a $10 billion program to augment the supply of mortgage funds. These financial strains together with higher prices of primary energy have—because of the slow pace of the regulatory process—produced dangerously low earnings for many companies in regulated industries. While these are largely state and local regulatory bodies which must act, the Administration is examining what might be done to speed up the needed changes. These illustrate the kinds of economic adjustments that must be accommodated in order to facilitate the disinflationary process.

SUMMING UP

To bring our price disease under control, we will have to keep our general economic policies under firm control. There is no acceptable alternative. We can and will pursue complementary policies—maximizing agricultural production, reorganizing inefficient government regulatory practices, and others. But the key is to keep demands in the economy within the limits of its productive capacity through balanced fiscal and monetary restraint.

If we do not do so, we will continue to have the cruel, indiscriminate, insidious tax of inflation. Inflation hurts everybody—people on every rung of the income ladder, corporations, financial institutions, state and local governments—everybody. Most of all, it hurts the poor. And if we do not have the self discipline to keep Federal spending in line with tax revenues, what happens is that the deficit is closed by the harsh and uneven tax of inflation, rather than by more equitable routes of achieving balance between outlays and revenues.

PROFITS

Before closing this discussion of our domestic economic situation, I want to say a few words about profits. To curb inflation, our policy in the short run must be to restrain demand. In the long run, however, we must make every effort to expand our productive capacity. To this end adequate profit incentives are crucially important.

In the last year or two, there has been much talk about an excessive increase in corporate profits. I am afraid, however, that these increases in profits have not been put into proper perspective. In particular, there has been inadequate recognition of the impact of inflation on this measurement of profits.

For example, nonfinancial corporations reported profits after taxes in 1973 of $55 billion as compared to $38.2 billion in 1965, an apparent 44 percent increase. But when depreciation is calculated on a basis that provides a more realistic accounting for the current value of the capital used in production and when the effect of inflation on inventory values is eliminated, after-tax profits actually declined by 25 percent, from $35.3 billion in 1965 to $26.5 billion in 1973. One major factor behind this decline is the fact that taxes were paid on these ficticious elements of profits, which resulted in a rise in the effective tax rate on true profits from about 44 percent in 1965 to 60 percent in 1973. On this basis, furthermore, after dividend payments, the retained earnings available for reinvestment, which were $18 billion in 1965, were only $3 billion in 1973.

Thus, a more realistic calculation shows that the sharp rise in profits was an optical illusion caused by inflation. And this helps to explain why the ability of business to increase its productive capacity is in jeopardy and why our financial markets are so congested.

In this context, it is not surprising that basic industries such as steel, coal, natural gas and aluminum are experiencing shortages in productive capacity. Increased productivity and decreased government spending are the two essential lines of attack against inflation. Both the Administration and the Congress must reassess past legislation that stimulates consumption and inhibits saving and investment. No nation can neglect investment in favor of consumption for very long and still prosper. I am quite concerned that since 1960, plant and equipment spending in the United States was only 15 percent of total output, whereas France invested 18 percent, Germany 20 percent and Japan 27 percent. And furthermore, for gross domestic investment (which includes inventories, housing and public investment), the proportions for 1973 are: United States 17 percent, France 26 percent, Germany 25 percent and Japan 37 percent.

THE INTERNATIONAL ECONOMY

We have now had more than a half year's experience with the increased oil prices announced late last year. The international economy has been profoundly changed. Fortunately the most exaggerated fears of some have not proved justified. But we are confronted by difficult problems, related both to petroleum developments and to worldwide inflation, which together have led to a widespread slowdown in economic growth this year.

As in the United States, people everywhere are suffering the wrenching pains of inflation. Few countries have escaped double-digit rates of price increase and almost all are experiencing inflation rates considered intolerable by past standards.

Inflation is a common problem around the world in part because of the strong forces that carry price pressures across national boundaries. Fundamentally, this reflects our growing interdependence—the fact that the links among nations have become stronger as international trade has grown more rapidly than domestic trade. To illustrate the importance of the international transmission of inflation, I would cite recent forecasts of the Organization for Economic Cooperation and Development that increases in the price of imported oil will directly add some 1½ percentage points to the rate of inflation in OECD member countries this year, and increases in the prices of imports of other primary products another percentage point. These figures do not allow for secondary effects of the import price rises on domestic prices, and thus understate the total price effect. Another striking measure of the price increases affecting international trade is that in the first half of 1974 the average value of OECD imports, swollen by the oil price increases, rose by 65 percent and the average value of exports by 32 percent.

I found in my recent travels abroad that others view the inflationary problems we are experiencing in this country somewhat differently than we do. In fact, others look at our record with a certain envy. While this does not make our inflation easier to bear or to deal with, the fact is that we are doing better than many other countries. Consumer prices have been rising at rates of about 12 percent in the United States, but this compares with figures of some 30 percent for Japan and 15 to 20 percent for Italy, the United Kingdom and France. In Germany, on the other hand, where strong policies of demand restraint have been pursued for an extended time, prices are rising at a rate of less than 8 percent.

Recognition of the common danger of inflation has in recent months brought about a more realistic view of the prospects for growth. At the turn of the year, against the background of an oil embargo, some thought the oil consuming nations might be thrown into chaos, and the spectre of a 1930's depression was raised. Today, the embargo is lifted and energy shortages are no longer a severe restraint on growth. While the industrial world is still experiencing a slowdown, there is wide agreement that the slowdown is essential if we are to control the forces of inflation. There is a healthy recognition that the inflationary costs of excessive expansion would be unacceptable. While we cannot turn our backs on the possible future need for stimulative policies, it is understood that nothing could more severely threaten the fabric of our societies than to hit the throttle at a time when we should have our foot firmly on the brake.

The increase in oil prices brought with it the danger of an escalation of trade restrictions. There was concern that importing nations, seeing their own trade balances deteriorate because of increased oil imports, might impose restrictive trade measures which would simply shift more of the deficit elsewhere, and the cumulative effect could be excessive domestic deflation. This must, of course, be watched. However, OECD member countries agreed in May to a declaration of intent to avoid recourse to restrictive measures. In June the IMF Committee of Twenty agreed to a similar pledge for adherence by the broader membership of the International Monetary Fund. The United States strongly supported both these moves, and we are confident they will reinforce the commitment of the world trading community to a liberal trading order. It is critical that the Congress help us maintain the momentum toward expanding world trade by prompt and affirmative action on the Trade Reform Act, so that the "Tokyo Round" of multilateral trade negotiations can move forward toward reducing trade barriers and building better arrangements for managing international trade relations.

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Certainly there will be strains in the face of the major challenges posed for the markets. In my talks with the Finance Ministers of other countries, we have frankly recognized this prospect. And we are confident taht we can develop mechanisms to deal with these strains.

I do not, however, classify as real the problem of potentially massive shifts of funds—the worry that oil monies will be capriciously shifted from one market to another thereby disrupting the foreign exchange and financial markets. In part this is because investments by the oil producing countries will be in instruments of varying degrees of liquidity, some of which—probably a growing proportion—could not be liquidated without losses that would make such shifts unattractive. Beyond this, massive shifts of funds would cause pressures on exchange rates, also quickly making such transfers unprofitable. I can assure you my experience has been that the financial authorities of the Arab countries who will be managing oil revenues are indeed conservative and responsible and will not be found taking illogical actions.

The private financial markets are in fact making substantial progress in adapting to the problems of oil financing. In the first instance, bankers have initiated discussion of the problems, such as rapidly growing liabilities relative to their capital base, excessive divergency in the maturity preference of lenders and borrowers, and too much concentration on particular lenders and borrowers.

And they are adapting their own practices. In a market saturated by offers of short-term funds, banks are insisting on paying lower rates for monies in maturities they don't need. We are seeing banks acting as brokers, arranging direct placements. These are necessary, encouraging responses.

The lenders, too, are adapting. They are looking for other places to put money: government securities; advance payments for imports; phased loans to governments; real estate; and equity of large corporations. These shifts of funds into non-banking channels will ease the pressures on the banks.

In these circumstances bankers must continue to look for new techniques, new channels of moving funds to those who need them. Some traditional practices may have to be re-examined. Management must above all be prudent and careful. But there is no reason why the banking system cannot continue to handle a very large share of these funds while the remainder move through other channels.

I am asked what the role of governments and central banks is in this situation. Certainly they must maintain a proper economic environment, by containing inflation and following suitable policies. But that is not their only duty. I do not believe that the private sector alone should carry the responsibility. Governments and central banks as bank supervisors and suppliers of liquidity—their traditional role in developed financial systems—have a clear reponsibility to assure the soundness of the system as a whole. I am referring to problems of liquidity, however, not solvency. It is not the role of the public authorities to underwrite management of an individual institution or to assume the risks of its stockholders.

There will also be occasions when direct government-to-government handling of funds will be the most efficient method. Over the years, the Treasury Department has issued special securities to various countries, including particularly large amounts to Germany. Inevitably, special responsibility must be assumed by governments of the oil exporting countries, and they are already beginning to provide direct loans and other types of financing for, and investments in, the economies of their oil customers. Iran alone has in recent weeks agreed to make substantial loans to France and the U.K. and made a substantial investment in the Krupp concern in Germany.

Government's most urgent task—one for which the private markets are largely inappropriate—is to organize assistance for the poorest countries most seriously affected by the oil price increases so that severe hardships are not wrought on their populations. The new Development Council recommended by the Committee of Twenty will urgently address this problem. Public responsibility has also been recognized in the establishment of a special oil facility in the International Monetary Fund to supplement private markets—a kind of "safety net" for countries able to afford its near-market terms but unable to obtain adequate financing through the private markets. We have also expanded our extensive network of inter-government swap agreements.

However, the objective of public policy should not be to take over the basic role the private markets have traditionally played in moving funds about the world. Rather governments should seek to strengthen that role, as the United States did early this year when we removed our capital controls.

We are fortunate to be able to approach the problems we face today within the framework of the monetary agreement reached at the Committee of Twenty Ministerial meeting in June. That agreement represented a landmark in our efforts to reform the international monetary system. Certainly much remains to be done, and further negotiations lie ahead. But the international community has responded in a constructive manner to the challenges it faces. One of the most important results of the C–20 work was that it demonstrated both our determination and ability to work cooperatively in dealing with our problems. This spirit is essential to the success of our future efforts. I have had useful discussions with my counterparts in other countries and am confident that a solid foundation exists for our continuing to work together.

I believe, too, that the flexible exchange rate arrangements presently in place have served us well in a particularly difficult period. Despite the great uncertainties we have been through, speculative pressures have not been excessive and exchange rates fluctuations have not been extreme. The dollar, following a rather large swing from the middle of last year to the first quarter of this year, has subsequently moved against the trade-weighted average of other currencies within a range of plus or minus 2 percent around the levels prevailing following the realignments of February 1973.

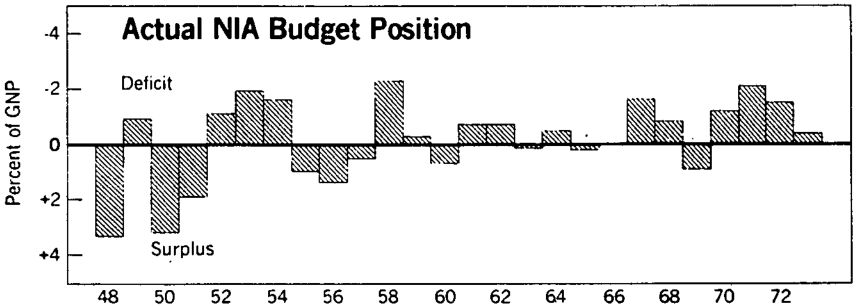
I had an opportunity on my trip last month to discuss the oil financing problems with Middle Eastern and European leaders. The authorities of the oil producing countries with whom I spoke displayed a keen awareness of their interest in and responsibility for assuring that their vastly increased oil revenues will be invested in a way that minimizes disruptions to world economic and financial relationships. I am glad to report that the atmosphere I encountered in Europe on the question of re-cycling oil revenues was one of concern but basically consistent with our own views. It was generally agreed that we should broaden our exchange of information and ideas on developments in the financial markets. We must have contingency plans, so that we are prepared to act, and to act quickly, in the event an emergency situation requires it.

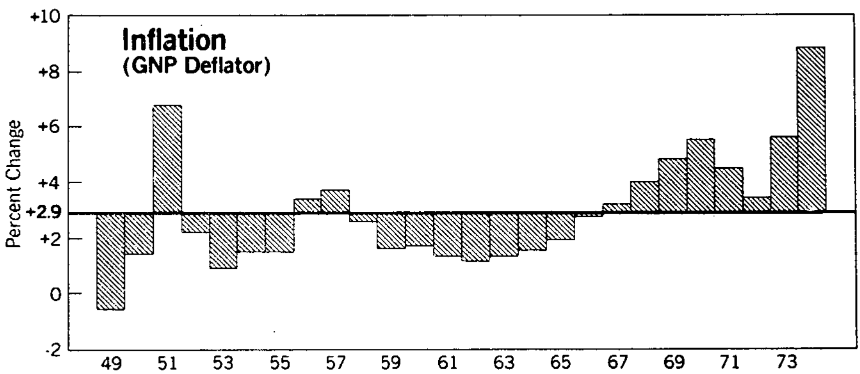
Mr. Chairman, a great deal of what I have spoken to you about today is related directly or indirectly to the question of oil prices. As you know, it is my conviction that we will see lower oil prices. I am convinced this is in the long-run interest of producers as well as consumers. I know of no single move more important to the elimination of world-wide inflation and the maintenance of international financial stability.

It would be a disservice to underestimate the tenacity with which we shall have to attack our present problems. I am confident, though, that we are on the right track, that the policies being followed nationally and internationally are the policies which will in time bring solutions to our problems. Inflation will abate. We will avoid the extremes of depression and financial collapse. We will find a new equilibrium in the commodity markets.

To achieve these goals here in the United States, the most important single action we can take is to regain control of Federal spending. To this end, close, cooperative, and bipartisan action will be required. This Committee could make a significant contribution by encouraging a prompt activation of the new and stronger procedures for budget control provided in the Congressional Budget Act of 1974. Without determined action by both the Administration and the Congress, the rise in Federal outlays this year and next could be so large as to impose sustained rapid inflation on the American people. To prevent that result is our most important duty as public officials.

THE BUDGET AND INFLATION





NOTES TO CHART

Panel 1.—The budget data shown here are the actual surpluses and deficits, on a national income accounts basis, for calendar years expressed as a percent of Gross National Product. Note that these data are plotted on an inverted basis in order to provide an easier visual comparison with the inflation rate.

Panel 2.—These budget data are the same as in Panel 1 except that the surpluses and deficits have been adjusted by the Federal Reserve Bank of St. Louis to a full-employment basis by standardizing the figures to a constant 4 percent unemployment rate. The bars are plotted—for the purpose of better displaying

Senator PROXMIRE. Mr. Secretary, your prepared statement certainly indicates your absolute dedication and determination, and I am sure you are sincere, to do your best within the administration to fight inflation. And yet, going through in your prepared statement, as in that of Mr. Rush and Mr. Stein, there does not seem to be a specific, definite, clear-cut concrete program to fight inflation. For example, there is nothing that I can see here to recommend changes in tax policy, wage-price controls—which I think most of us would reject, but nevertheless they are an option—antitrust, monetary policy. Nor do you propose how we can improve Government productivity, or productivity in the private sector, or what we should do to confront the great pressures from various pressure groups on both the Government and the private sector in increasing prices. I just do not get anything of that kind.

Then when we come to spending, you say that the $20 billion reduction which has been associated with you is not really a proposal, but simply a study paper indicating areas where spending reductions might be considered. It appears that you have come down on the same side as the other administrators in the administration who suggest that the goal might be $300 billion—in other words, a $5 billion cut—which would leave us with about an 11-percent increase in spending, much more than we had in the period of 1955 to 1965, and even more than we have had since 1965. And this at a time of inflation.

So I just do not see in your prepared statement any more than I saw in the preceding prepared statements any program to fight inflation effectively.

Secretary SIMON. Mr. Vice Chairman, actually, the key to fighting inflation is monetary and fiscal policy. You and I both know that there is no quick fix to the problems that face us in the country today. There are no magic wands that we can wave, no spectacular policies. I suggest that some of the spectacular things done in the past 10 years have resulted in some of the problems that we indeed are facing.

Now, this study, as you called it—I was careful to call it a discussion paper with the President rather than a study. In such a discussion paper, one would have brought up specifics in the budget that could be candidates for reduction subject to, obviously, his approval. Arthur Burns had his own specifics, as did Ken Rush. It was a very long, 2½-hour meeting.

The President, as you remember, asked for extension of the Cost of Living Council statutorily to provide a monitoring system for wages and prices in this country. He also asked for extension of controls in the health and construction area. Congress did not see fit to continue with this program.

He has also announced, as he did in his recent speech, the reaffirmation of his desire to put into place this monitoring system. We are going to go ahead and do it without statutory authority if need be.

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the relationship between the budget and inflation—as deviations from the average surplus for 1948–73 of 0.8 percent of GNP. (Panel 1 was not plotted this way because the average was virtually equal to zero.)

Panel 3.—Inflation is represented here by percent changes in the GNP deflator from the previous year. In effect, therefore, the inflation measure is charted with a 6-month lag compared to the budget data in Panels 1 and 2. The bars are plotted as deviations from the 1949–74 average price increase of 2.9 percent.

Source of data: U.S. Department of Commerce.

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So I think we have a very real policy, a policy that will deal with the problem, recognizing that it is going to take time. But we have never allowed in our country the time to have fiscal policy——

Senator PROXMIRE. Mr. Secretary, I would agree that the President is anxious to do what he can to stop inflation. But yesterday we had the testimony of Mr. Walter Heller. I asked him, What could be done without any statutory action? I pointed out that President Kennedy had acted with respect to rolling back steel prices without any legislation, without any changes in the law that the administration has proposed. There is no reason why the President could not use jawboning to call attention to price increases that were not justified. He has not done that in any case that I know. There is no reason why he could not take other action that would bring pressure to bear on unjustified increases. We have great procurement power in this administration. We have stockpiles. We have other authority which the President can use. The President is in the position of being the only official and the only person in our society who can do that.

Secretary SIMON. We have been selling our stockpiles in the last year and a half, agricultural as well as the internationally traded raw materials. Of course, we have been getting legislation to do this, and we have been doing it as the legislation permitted.

Now, as far as rollbacks in prices, there again, as you well know, that really does not do very much to fight inflation, which in the long run is what we are actually interested in doing.

Without a statutory base as far as the ability to say, "Yes, you have to do this by law," I have found that labor and management since I have been in government are very responsive as far as their willingness to cooperate, and recognize that explosive wage demands and prices certainly do not benefit anyone. And we have seen a great deal of success as a result of John Dunlop's efforts in the Cost of Living Council, as evidenced by the very moderate wage increases of the last couple of years.

Senator PROXMIRE. We have had moderate wage increases, but we have had scandalous price increases, accompanied with enormous increases in profits. This is true in industry after industry, it is true in oil, steel, chemicals, machinery, and in other sectors. The expectation is that the wholesale price index will break all records in July over June. So it seems to me we are confronted with a very serious crisis.

Let me get to the areas of spending, which I think are unfortunately vague at this point. You have only had one specific recommendation with respect to spending in your prepared statement, and it would recommend an increase in spending; that is, you recommend—and I would approve it—that we ought to expand unemployment compensation. That, of course, means that we have to spend more. Interest on the national debt is something that we obviously cannot reduce. Would you recommend a reduction in military spending?

Secretary SIMON. I have been quite convinced over the past 2 years that our defense budget, being over 30 percent under what it was at that period, is only sufficient to maintain the peace in this troubled world. The President's desire to make sure that we never become a secondary power is consistent with our defense spending.

Senator PROXMIRE. So you would not recommend a reduction in military spending?

Secretary SIMON. Other than just the efficiency cuts that Secretary Schlesinger, having been in the OMB, is very good at, you would not touch——

Senator PROXMIRE. He is not recommending much of it. Secretary Schlesinger is sticking by his budget. He appeared before this committee earlier this year, and he did not relent at all.

How about foreign aid, would you recommend a cut there?

Secretary SIMON. It all depends, you just cannot take the broad category of foreign aid. There are certain responsibilities that we have as the leading country in the world. We cannot have a stop-and-go-again program of foreign aid. We diminished our contribution to world aid and held down our contribution to the multilateral lending institutions.

Senator PROXMIRE. I think you can make a case, I agree with that, I think we ought to provide more generously in the multilateral area, but I think there are other areas in which we can cut sharply. The President has asked for one of the biggest foreign aid increases that any President has asked for, very big increases, as you know, for this year, including military assistance.

How about public works?

Secretary SIMON. There are areas of public works—once again that is a broad category. It depends on what specifically you are speaking of.

Senator PROXMIRE. Would you recommend that we cut the overall public works budget? We have acted on that in the Senate, but it has to go to the conference.

Secretary SIMON. A broad cut in the area of public works is like saying, let us cut 3 percent across-the-board, or 5 percent in every area, it takes the good with the bad along with it. I would rather attempt to work with the agencies on some of the programs, whether it be in the welfare budget or overlap.

Senator PROXMIRE. I take it this is your comment with respect to social security, highways, HUD, HEW, veterans—can you specify any place where we can make a reduction?

Secretary SIMON. The point is, Mr. Vice Chairman, when you are attempting to cut $5 or $6 billion out of a $305 billion budget there are no massive recommendations to make, because that is such a small percentage of the overall budget that you could indeed take a small percentage out of many different areas.

Senator PROXMIRE. This is exactly what I am trying to find out. You say you would not take that kind of a cut out of the military, as I understand it, you might take it out of foreign aid. But you are not very specific in that area. I think that almost any of these programs could live with a 3-percent cut. I just asked the people of my State—and it is a fairly typical State—how they felt about a $10 billion cut in Federal spending. Their response was 89 percent "yes," and 9 percent "no." That is 10 to 1, I do not think you can find any proposition on which you can get the people of Wisconsin to agree 10 to 1 on. This is just an overwhelming feeling on their part.

Fortunately that view is being accepted by the Congress. The Senate for the last 3 or 4 days has cast a series of remarkable votes, in my view, against the Appropriations Committee, against the recommendations of the Appropriations Committee, on appropriations bill after appropriations bill, it was very close to or under the budget estimate.

Let me point out that the House has recommended 10 appropriation bills which are a billion dollars under the budget. Just yesterday the

House Appropriations Committee recommended a $3 billion cut in the President's military budget. I think that if we get specific recommendations from people like you in the administration, who clearly are in favor of holding down spending, that it is possible for us to achieve the kind of reduction we should have. But if a man like you, with your reputation for a restrained fiscal policy, is going to come before this committee with a kind of vague, indefinite notion that we ought to lean a little bit here and there and maybe we can pick something up and reduce spending here and there, I just think that there is no hope.

Secretary SIMON. I try not to be vague, Mr. Vice Chairman. You know that. This is the President's decision and prerogative to make the decisions on the specifics of a tax cut. In our discussions together he has asked for further conversations on the specifics. And when he does add specifics I will be able to come out and tell you exactly what the administration favors. But to give my personal judgment——

Senator PROXMIRE. I know you are in a difficult position. My time is up. But let me say we have had all the very top economic advisers come before us, and they do not give us any specific program for reductions, they just do not, Rush, Stein, Simon, it is all the same as the President's speech in California. It is just a vague, general notion that somehow we are going to have a goal of $300 billion, but no notion of how to get that. In the meantime, we have this inflation.

Senator Javits.

Senator JAVITS. Thank you, Mr. Vice Chairman.

Mr. Secretary, we welcome you here, and hope very much that you are not only giving us official administration policy, but your views as well as the Secretary of the Treasury. This is a time when I think that kind of individual leadership is also being encouraged, because our country is in grave trouble, especially on the immobilization of its policy and new initiative. I would greatly concur with Senator Proxmire, we are terribly short on initiative.

For example, you have just said that the administration still wants a monitoring agency for prices and wages and salaries. Now, there is legislation on that. I introduced a bill for a review board, with many members joining in. What about the President sending a message up here asking for it, uncomplicated, now, by wage and price controls—which obviously nobody wants—that is not necessarily the right decision, but no—why don't you urge the President to send us a message saying, I need a monitory agency, and this is the one I want?

Secretary SIMON. Senator Javits, that was in his recent speech. I will do exactly that.

Senator JAVITS. I thank you very much. I think that is making progress.

Secretary SIMON. I think the most important thing, in response to your first question when you talk about new initiative, I think the greatest impetus we have is the desire once and for all to have some fiscal discipline in the Government. I see this new initiative coming not only from the Congress, but in the executive branch. I think that is more than just a first step. And that encourages me.

On the other hand, I hear a lot of talk about cutting spending. When it finally comes to actions, some of the actions are exactly in the opposite direction. This is where we have to resist these movements.

Senator JAVITS. My own belief on that, if I may say a word about it, is that Senator Proxmire is 100 percent right. I would like to get at it through the ideas suggested by Senator Muskie, which track the new budget committee concept.

Let us take a look at income, because inflation will also materially add to the income of the United States. Let us take a look at the global effect of these appropriations. Then let us cut them either across the board or selectively. I am ready to go with either, provided that we look at the whole thing together. I would hope very much that support may be gathered here, including the support of Senator Proxmire, who is a very valuable advocate on this matter, so that we do that this session on this budget. No matter what the other decisions of the Senate are—and we will have them, apparently—this deserves high priority attention. I hope it will have it. In other words, if the 3 percent, 5 percent, chipping away of individual appropriations does not go—and I do not think that is fair to individual items, because it does not yield to the global necessity of inflation and total government cost. But if we tackle it all together in one resolution, we setting the national prorities, and we making the cuts according to the way we choose to make them, I am thoroughly with it. I believe in that way we can be specific, if the administration cannot, and we will make the $10 billion cut. I certainly pledge myself to it. I am not known to be a budget cutter.

The second point I would like to ask you about, if I may, is the question of how to gear up productivity. Your whole statement is resonant with that. Why does not the administration go for the recreation of labor-management-public productivity councils as we did in World War II, to which labor—I will say this to you advisedly—is perfectly willing to lend itself and cooperate? At least such committees could deal with absenteeism, which is rampant and bad, with quality depreciation, which is rampant and bad, with alcoholism, which is a very serious problem, let alone the drug problem, with all these little efficiencies would go into the total productivity picture, giving enormous leverage, in addition to the remaining of the American industrial plant, et cetera, which will be facilitated by that kind of collective, patriotic approach to the productivity of a country. I cannot for the life of me see why we have not done that. It worked in World War II. Labor, I am convinced, is ready to cooperate. What is holding us up?

Secretary SIMON. We have a Productivity Commission that is considering part of what you said, Senator Javits, the quality of work and the entire area of productivity in this country.

Relative to the question the vice chairman asked a little while ago with respect to what we are doing about the tax changes that we needed, this has been confused. and I have been misquoted on occasions when I talk about longer run versus shorter run policy. Obviously, to increase productivity and capacity in some of our basic industries—steel, aluminum, et cetera—we have proven methods of investment tax credit and accelerated depreciation that we know have worked; we have the proof. We are doing the work in the Treasury Department now. And that is very tedious work. Whether it should be done by specific industry or whether it should be done on an overall basis has to be determined. This. of course, is going to help. This will go along with the comprehensive package, because we recognize that if we give tax breaks to business in this country, we also have to look at helping the poor and the middle income as well. Then, of course, if we are going to do this as far as the revenue side is concerned, we also have to look at increasing revenues as well. So this is the work that is going on in the Treasury right now.

But Senator, to answer you question on this type of commission as we had in World War II, that has not to be best of my knowledge been discussed. We have many committees, such as the Labor-Management Committee and the Productivity Commission, that deal with facets of this, but no one center that deals with the overall.

Senator JAVITS. It is not one center I am talking about, it is 5,000. That is the number of these committees we had in World War II. And it worked.

I would like to point out to you that you are establishing this Productivity Commission. It is ridiculous that as the key way to beat inflation, the administration itself only asked for $10 billion, and then we contributed to that abysmal performance by cutting down to $1½ billion. I never heard of anything so unthinkable and shameful in terms of recognizing a problem, and then almost willfully, by design, destroying it. So I hope very much, Mr. Secretary, that you will discuss this with the President. I will be happy to make available to you $5 million. Big deal. We are talking about $300 billion. You can set up these committees and tell the country like you wanted to tell Senator Proxmire—the country wants to know, Mr. President; what do you want us to do? We do not like inflation either. Well, let us tell them. We are telling them nothing. We are going to economize on fiscal policy and money, all these esoteric things that do not tell them to do anything except save 1½ cents. And they laugh.

Mr. Vice Chairman, I would like to make another request. I do not know of a single witness in the Government more important than Secretary Simon. We have another witness. With all respect to him, he is not nearly as important as this. And I make this request, that in accommodating our next witness. that Secretary Simon be recalled at the earliest possible moment, including this afternoon, so that we may set a record in this country as to what can or cannot be done in the international financial establishment.

Senator PROXMIRE. Mr. Shiskin is here. and we do not know how long he will take. Every member here will be entitled to ask questions as fully as he wishes.

I agree that not only is the Secretary of the Treasury important, he is also a very wise and intelligent and helpful person. I think we should question him to what length the members wish.

Senator JAVITS. I think my time is up.

But I have one other question. You speak philosophically of the inflation in your prepared statement. The things I would like to ask you is this: Is it realistic to expect in all fairness that you are going to be able to reduce prices, or is it not more realistic to say to the country, "Look, these prices are where they are, we are going to do our utmost if you help us to hold them there, and then we are going to give the economy an opportunity to catch up"? Sure, it is all going to be on a higher level, the factory worker instead of earning 12 is going to earn 17, and we will equalize it out giving ourselves a chance to do it. But let us not kid ourselves that we are going to be able to reduce prices materially, rather than just making these general statements which avoid the key issue.

Secretary SIMON. I really, there again, do not mean to be general or avoid any key issues, Senator Javits. I think you and I are really saying the same thing. When I say it is going to take a long time to cure this problem, I am talking about when our capacity and productivity exceeds our demand, it is only then that one can see relief from prices. The best we can hope for right now is just to maintain this present price level and avoid further increases. I agree with you.

Senator JAVITS. Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Senator Sparkman.

Senator SPARKMAN. Mr. Vice Chairman, I have enjoyed very much the presentation of Secretary Simon.

I think we all have a feeling of futility in dealing with this matter of inflation. I think that is certainly true throughout the country. For a long time it has been apparent that the No. 1 problem confronting the people in this country is inflation. I think that we all feel that there has not been much headway made, and not much promise of headway. I think it is fine to talk about things that are going to happen, and what is planned, and so forth. But I think the people of the country want something that they can sink their teeth into. Perhaps, if I may use that wornout expression, they will see the light at the end of the tunnel. Up to the present time it is one of great doubt and disappointment.

The statement was made a while ago that the President wanted the Cost of Living Council extended. Now that was handled by our committee, Senate Banking. I know of no particular effort that the President made with our committee to handle any extension. As a matter of fact, I think you will recall that the Republicans on the committee very strongly supported the continuance of it. Furthermore, when Mr. Dunlop was before us, he merely asked that we extend it in the field of public health. The vice chairman will remember that.

Frankly, I think we made a mistake in doing away with the Cost of Living Council. I supported it at that time, but I think we should have held to it in a broader field, not just in the field of public health.

Here is something I have wondered about. For years the Chairman of the Federal Reserve Board, Arthur Burns, has recommended the establishment of a Wage and Price Review Board—I believe that is what he calls it. I am sure the vice chairman has heard him say that a dozen times before our committee and in this committee, too. I do not understand why something like that has not been done. I wonder if you could comment on it, give us your thought on that.

Secretary SIMON. Yes. Senator, I would be glad to.

The President asked in May, not for the ability to have wage and price controls. as we had since 1971, but a continuation of the Cost of Living Council on a monitoring basis, which really is the same thing that you just described, I believe, in a different name. He did ask for specific controls. in the areas of health, as you said, and also in construction. I think it is a good idea to have a board that monitors wages and prices regardless of what the name is. So we can, as Senator Javits said, get everyone together, and make this a national effort.

It is our No. 1 problem. Let us bring the American people in, and explain what the problem is, and how, as you said, there is a feeling of futility. I would agree with that and add that there is a feeling of helplessness. There are people who expect a spectacular, a happening. They want to be able to say, yes, this is what is going to happen, they are going to roll things back and do something that you and I know would actually be counterproductive.

We are doing a lot about inflation. But the problem is that it cannot be solved quickly, because the excesses of the last 10 years in particular just cannot be wrung out of this economy in a short period of time.

But I agree that it takes public cooperation, and I am getting that message from everyone on the panel this morning. And I knew it already. The Government is working and is trying—we all have to work together, the Congress, the Executive and the American people, to solve this.

Senator SPARKMAN. The President did not include in his speech the other day a recommendation that the Cost of Living Council be reestablished, did he?

Secretary SIMON. I am trying to find the exact terms. Yes, he talked about this monitoring agency.

Senator SPARKMAN. I heard the speech. I do not recall that that was in there. As I said a few minutes ago, I think we should have continued the Cost of Living Council, or that we ought to establish something along the line that Mr. Burns has suggested to watch these things, and to let the public know what the facts are, not controls. I do not think the country would want to have controls.

Let me ask you this. With reference to reducing the expenditures, or the budget, a tighter fiscal management, we are always getting those suggestions. But the budget has already been sent to Congress by the President, at the first of the year, and the Congress has been operating on the basis of that budget. I believe—I am sure that Senator Proxmire can tell me this—are not the appropriations running at a lower level than the amount requested in the President's budget?

Senator PROXMIRE. They are, indeed. As I say, the House has reported out 10 appropriation measures, they are a billion dollars under the President's estimate. That does not include the defense appropriations of $3 billion of obligation authority and $10.8 billion in outlay, and does not include foreign aid, which is always cut by the Congress, very sharply. So we are going to be well under the President's budget, there is no question about it. We are $27 billion under President Nixon's request in the 5 years he has been President.

Senator SPARKMAN. So I do not see how we are going to get any place.

Secretary SIMON. I think that is a healthy development, Mr. Vice Chairman.

Senator SPARKMAN. As a matter of fact, is it not true that every year for the past quarter of a century Congress has appropriated less money than the President asked?

Senator PROXMIRE. Every President. There has not been a year when that was not true.

Senator SPARKMAN. Yet it always seems that the criticism comes that Congress is a big spender, when as a matter of fact, we have appropriated regularly less than the President asked for, whoever the President was.

Secretary SIMON. Senator, if I could interrupt for a second, let me say that I have never myself believed that I should sit downtown and point my finger up here and say, it is those fellows up there that are doing all this spending. I think we both ought to look in the mirror. It is both of us who spend money, and we ought to work together to stop spending so much and start matching expenditures and revenues in this country.

Senator SPARKMAN. I agree with you completely. I think Congress has done a very fine job this year in setting up this new budgetary control machinery.

Secretary SIMON. I do, too.

Senator SPARKMAN. I have hopes that that will do a lot of the things that you are recommending with reference to tighter fiscal policy.

That is all the time I will take, Mr. Vice Chairman.

Senator PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Mr. Vice Chairman.

And welcome back, Mr. Secretary.

The administration wants to cut the budget $5 billion. And as far as I am concerned, if they will give me a list of what they want to cut, I will come up with an extra billion. It is no problem. I think that excessive spending and borrowing by the Federal Government is part of the problem.

I just want to make the point, however, that one should not get obsessed with this. I point out, for instance, that in the last year, in the last 12 months, the publicly-held Federal debt has gone up by $3 billion. That is about $3 billion too much, as far as I am concerned. But while that has been going up, the amount of commercial and industrial loans outstanding has increased by $26 billion, many times that much.

Now, commercial and industrial loans that end up bidding up the price of real estate, or the price of inventories, or the price of supplies, or surges around commodities, seem to me to be quite as inflationary, or a little more so, as increases in the Federal debt and overspending on the Federal side.

So should we not take into account that old maxim in the Bible about straining at gnats and swallowing camels? Ought we not to pay some attention to the excessive and in some cases unnecessary spending on the private side?

Secretary SIMON. I agree with you, Congressman. In my prepared statement I point out, let us not be lulled into complacency in thinking that it is just the fiscal side that contributes to the inflation. It is a major contributor. But you should also pay attention to monetary policy. Mr. Burns in his questions and answers the other day evidenced great concern at the surge in business demand in the civilian sector this past year. It has been highly exorbitant and he is extremely concerned.

When we look at the presence, as I call it, of the Federal Government in our capital markets, where the U.S. Government and federally sponsored agencies, in fiscal year 1973, accounted for upwards of 62 percent of the funds raised in the securities market—that is too great a presence. Who becomes the disadvantaged? Are we pushing traditional borrowers from the capital markets into the commercial banking system and into other areas to pay higher rates than they ordinarily would if we did not have this major presence in that market? I think that is bad.

Representative REUSS. Perhaps you would urge the President to direct the Fed to use the power which Congress gave it in the Credit Allocation Act of 1969 to stop sitting passively by and try to see that credit is allocated away from inflationary uses and toward uses that fight inflation, such as productive new investments, such as homebuilding, and the many things that we need.

But I am delighted to have your view on that.

Let me turn to our observations about oil. You said today, as you have been saying since January, that oil prices are too high and ought to come down. I have been sharing that sentiment ever since you expressed it.

Secretary SIMON. In fact, you ought to tell me how to get them down.

Representative REUSS. The unfortunate part is, they are going to go up. The recent incident in Kuwait is just another chapter in the sad story.

In view of the unwillingness of the Saudis to step up production dramatically, and in view of their unwillingness to break with the rest of OPEC and bring prices down unilaterally, and indeed in view of the spending table of Aramco, which will raise the net cost of Saudi oil to consumers, what ground is there for believing that the price of oil will be lower? What is our strategy?

Secretary SIMON. No. 1, prices have come down from the extraordinary highs during the embargo. We had spot prices at that point that were upwards of $25 a barrel.

Representative REUSS. Surely. But it is still $11 a barrel.

Secretary SIMON. Our landed cost today is close to $11 a barrel here in the United States, where the posted price, remembering that 67 percent of the world oil is controlled——

Representative REUSS. Much too high for you or me and the American people.

Secretary SIMON. The whole world. The damage it is doing to the world——

Senator PROXMIRE. May I just interrupt to say that there is a rollcall on the floor of the Senate, and I am going over, and other members can go as they wish. Congressman Reuss can chair, and we will come back.

Representative REUSS [presiding]. I would be delighted.

Please continue, Mr. Secretary.

Secretary SIMON. Right now in the world petroleum market there is a surplus that approximate $2\frac{1}{2}$ million barrels a day. This is putting some pressures on the prices, as evidenced by the recent Kuwaiti auction, where they went below the 93 percent posted price. Saudi Arabia has announced that it is going to conduct an auction during the month of August. One might assume, with the storage tanks full around the world, that the auction bid will be below the prices, the 93 or 94 percent of posted price. But it is going to take a long time before we will have a two-tier system of pricing, when the independents can come into the market, and some majors will purchase their market oil at $2 below the posted price or whatever the bid price is. One can only make his judgments as to whether the market price will force a reduction in the posted price, which would certainly be to the benefit of the whole world, or whether the market price would not need to creep up. With the surplus I happen to believe that the pressures are going to continue unless production is cut in those countries.

Now, I attempted in my conversations with all of the oil ministers that I spoke with in the Mideast to show them how it is in their best interest, both from a responsibility point of view, and most importantly, in their economic self-interest, and the assurance of a long-term market for their commodities, to have a lower price of oil. Obviously, I am not going to have instant agreement on this subject. But I do have agreement with Saudi Arabia on this. But remember Saudi Arabia is just one of many nations that must live and exist, along with the other members of the Persian Gulf.

Representative REUSS. As a practical matter, they are not likely to defy Iran, are they, if Iran does not take the same view of their self-interest?

Secretary SIMON. I do not think it is a matter of defiance.

Representative REUSS. Jumping ship in OPEC would not be well received.

Secretary SIMON. I do not see them jumping ship, if you will, in OPEC. But they have announced this auction, which is an extraordinary measure.

Representative REUSS. On the present oil prices, I am persuaded by what you had to say about the relative unlikelihood of massive shifts of funds by the oil producing states. It is something that we have to watch. But it would so tend to bring down the temple upon themselves that, I think, that those who see a catastrophe around the corner in that respect are unduly pessimistic.

Secretary SIMON. Congressman, I could not agree with you. Being the expert in this area, you know that people act in their own economic self-interest. In the long run and the short run, clearly it would not be in their best interest to bring about exchange rate changes and instability in the international financial markets.

Representative REUSS. What I do see, however, is a problem which has, I think, not been sufficiently brought to the attention of the American people, and which has been accentuated by the announcement yesterday that our perspective deficit due to oil is going to be $25 billion rather than $20 billion, without getting into guesstimates. What is happening is that the oil producing countries are building up tremendous reserves, while we and the other industrialized western countries are building up tremendous debts. We have to pay interest on those debts. This is not one of those we-owe-it-to-ourselves deals. We owe and will owe more and more, and will have to pay interest on more and more, to foreigners. This means the transfer of real wealth made by the sweat of our brow.

It is a real case, as opposed to a phony or rhetorical case, of shifting intolerable burden, not to our grandchildren, but to ourselves, in a very few years. It seems to me a great problem, soluble, in my judgment, only during the periods when we are building up our own independence by heroic allocation and rationing.

What has happened to those rationing stamps?

Secretary SIMON. They are still in storage. I have not seen them, just as I have not seen the gold in Fort Knox.

Representative REUSS. Nor have I. I am delighted to hear what you just said. Hang onto those rationing stamps, because in my judgment, the American people have not been adequately told by you or me or anybody else what all of this transfer of wealth is going to mean. One has only to go out on the highway to see the traffic whisk by, if one is going 55 miles an hour, to realize that we are being very profligate right now, and that the profligacy is not going to be worked out in an intramural manner as far as getting into debt is concerned, but through the ultimate transfer of real wealth. There are other ways of doing it—total inflation, which is an unacceptable method—repudiation, which is an unacceptable method. Do you agree with me that this is an insufficiently examined part of the picture?

Secretary SIMON. Yes, I do. Of course, it has been a relatively short period of time, Congressman Reuss. I have not read it yet, but the OECD has a recent world economic forecast that deals with this. I hope we both have an opportunity in the near future to read this. But they suggest that some of the OPEC countries by 1980 will be in current external deficit. One thing that I learned when I was over there, is that, in my judgment, everyone has misgaged the extent of the internal demand for expenditures in these countries, looking ahead to the next 5 years. I think that is going to surprise people. I share your credo completely. But the problem today is not the reflow and the instability in the financial markets, although there will be strains that we can deal with through the special mechanisms that we have already set up and will set up to meet the particular strains. Our problems come right back to these oil prices, and the damage that they are doing short run and long run to the world economy.

Representative REUSS. Let me turn to another problem. In your prepared statement you say:

> Governments and central banks as bank supervisors and suppliers of liquidity—their traditional role in developed financial systems—have a clear responsibility to assure the soundness of the system as a whole. I am referring to problems of liquidity, however, not solvency. It is not the role of the public authorities to underwrite management of an individual institution or to assume the risks of its stockholders.

I think that is an excellent statement. I agree with it. However, what about the Franklin National? Was not our friend the public authority underwriting management of an individual institution and assuming the risks therewith?

Secretary SIMON. The Franklin National Bank actually illustrates exactly what I was pointing out in my prepared statement, though perhaps inadequately. They had a problem of liquidity. The money that was lent to them by the Federal Reserve Board was all collateralized by the bank, and continues to be. That deals with a temporary hopefully, liquidity problem as they worked out their longer run policies to bring stability back into the institution. Their temporary liquidity problem was brought about through mismanagement in the foreign exchange area of the bank.

Representative REUSS. Their liquidity problem was their inability to pay off the holders of their short-term commercial paper to banks and corporations when it became due because their loans were sticky.

Secretary SIMON. When large losses are taken, like the disclosure of the foreign exchange houses in this bank, it leads to great concern and worry as to, well if that has happened over there, what are their problems as well. Let us take a look at their investment portfolio, and what is the value of their market portfolio, how large are bad loan reserves, and begin to look at the individual components. During this period there is always a danger that there will be a decrease in deposits in the bank, an inability to raise additional funds in the CD or commercial paper market. This is the Fed's role as lender of last resort, but not in the case of a solvency problem. That was illustrated by the Comptroller of the Currency's, I think, tremendous expertise in solving the San Diego bank problem over the weekend with minor ripples in the banking system.

Representative REUSS. Mr. Vice Chairman, I have ended my questions.

Senator PROXMIRE [presiding]. I would like to say, Mr. Secretary, that perhaps the economic news of the day is being made on the floor of the Senate. We will know in a minute. Senator Robert Byrd, who is chairman of the Transportation Subcommittee, recommended to the full committee a transportation budget that was below the budget estimate. I think it is below the House. I am not sure about that aspect of it. As chairman of the subcommittee that handled that budget, he has just proposed on the floor of the Senate that this bill be cut by an additional 3½ percent. Of course, as chairman of that subcommittee, his recommendation carries great weight, and I think it has an excellent chance of passing.

I am chairman of the HUD Appropriations Subcommittee, which handles the money for Veterans, Space, the National Science Foundation, and so forth. We recommended to the committee yesterday that we cut that budget below the administration request by $150 million. They approved that. It is below the House substantially also. I am going to recommend that that budget be cut on the floor of the Senate by at least 3 percent, or perhaps more. So I think that this sentiment, that you are a champion of, within the administration, needs to catch fire. I think that we are going to get some results.

Secretary SIMON. Mr. Vice Chairman, I will do nothing but applaud your efforts, I think it is wonderful.

Senator PROXMIRE. Of course, we have not gotten to the big budget yet.

I would like to carry on a little bit in this area where you are so expert and have had so much experience with respect to oil.

On Monday, Kenneth Rush admitted that he had met with officials of the Gulf Oil Co. in San Clemente on July 15 to discuss recent demands upon Gulf by Kuwait to increase the price of crude oil. Gulf has refused to resist the price increase and has agreed to pay it. Are you aware that this meeting took place, and do you believe that the Kuwait price hikes caused severe repercussions among other producing nations?

Secretary SIMON. In the OPEC agreement, it is agreed, I believe, that when one nation, or oil company, agrees to a contract price, the other countries in OPEC cannot negotiate at a lower level. But that does not preclude, as I commented at some length while you were gone——

Senator PROXMIRE. Does that mean a new round of price hikes by the OPEC nations?

Secretary SIMON. No, this was for 3 months—this contract runs through September, Mr. Vice Chairman.

Senator PROXMIRE. What specific plans do we have to resist this kind of increase in the future?

Secretary SIMON. Well, by resisting, are you suggesting that we should order the oil companies not to negotiate at anything above a certain level?

Senator PROXMIRE. As I said, you are the expert in this area. But it seems to me that the Arab Governments have pulled off a real rip off of the American consumers and the consumers throughout the world, and it is having an appalling influence on the economies of the underdeveloped countries, as you recognize, and a very serious influence on the economies of countries from Europe to Japan, and is having a tragic effect in this country. It just seems to me that rather than rhetoric, there does not seem to be a program to cope with it. It may be that there is nothing that we can do, that we are helpless. But it is hard for me to accept that. If anybody in the administration is qualified to tell the answer to that, it is you.

Secretary SIMON. Mr. Vice Chairman, I wish I had the easy answer for returning oil prices to a level at which the economies of the world can agree and prosper. Part of my trip in the Mideast was spent discussing this very subject with the oil and financial ministers, and how it clearly was in their economic best interest to have a lower price of oil.

Senator PROXMIRE. Supposing they conspire to increase the price again, is there nothing we can do except talk about how we can be self-sufficient in 1980 or 1985?

Secretary SIMON. The increase that has already occurred has resulted in a surplus of 2½ million barrels a day today in the world. Assuming production remains where it is, it is putting pressure on the world price of oil right now. But I do not look for any significant decline.

Senator PROXMIRE. Is it not true that all the major producing nations with the exception of Saudi Arabia put a lid on the production of oil, thus tending to restrain supplies, which indicates that we may be in for another of those external shocks?

Secretary SIMON. Saudi Arabia is raising its production as rapidly—well, they own 25 percent of the world's oil, and they are on their way to higher rates now.

Senator PROXMIRE. Is it not true that Iran in just the past 2 or 3 years decided to cut their production, and that the Shah of Iran has stated that the price will rise to $22 per barrel?

Secretary SIMON. I do not share the Shah's opinion on the subject.

Senator PROXMIRE. You and the Shah have had a few differences, I know.

Secretary SIMON. Well, the first differences, I guess, were well known, Mr. Vice Chairman, coming on what we were importing, which, of course, is a statistical fact, according to the Customs Bureau. And the second so-called mixup was a misquote.

Senator PROXMIRE. Has the Treasury done any analysis of how the new round of oil price increases might affect our economy and the consumer? If not, will you instruct your staff to make that kind of a study and provide this committee with the results?

Secretary SIMON. Yes, we certainly will, Mr. Vice Chairman. When I was recently in Kuwait discussing the problems of oil prices in the world economies, and the maximization of profitability of a cartel, and what is the long-term price, or near the long-term price that was in the best interests of the producing nations, they evidenced great interest in this economic study. We had two of our petroleum economists in Saudi Arabia at the time, and at the Kuwait's request, we flew them over to present our views on why the present world price of oil would not serve them in their best long-term interest.

Senator PROXMIRE. Do you think, then, that our Government has done everything it can do to encourage the major oil companies to resist demands for price increases from foreign governments?

Secretary SIMON. Yes.

Senator PROXMIRE. Do you believe that our Government should play any other role in this area other than simply acquiescing in the price increases?

Secretary SIMON. I do not like to say we are acquiescing, because it is a terribly difficult problem. I continue to meet, as does Secretary Kissinger and many other senior members of this administration, with the officials of Aramco, and with the officials of the oil companies, attempting to deal with this problem. They have a supply of oil. If they decide that they are not going to pay the price that is demanded for that oil, they are not going to get that oil, and the consumers will be penalized. It is a matter of today paying an exorbitant, unconscionable price for that oil, or not having it.

Senator PROXMIRE. When will your study be finished and available? Can you give us an estimate?

Secretary SIMON. The one you just asked for?

Senator PROXMIRE. On the effect of the increase in the price of oil on the economy and the consumer.

Secretary SIMON. This level.

Secretary PROXMIRE. Will you get that for us? How long would that take you to put it together?

Secretary SIMON. Will a month be all right, Mr. Vice Chairman?

Senator PROXMIRE. The sooner, the better. If that is the best we can do, we will accept that, of course.

Senator Humphrey.

Senator HUMPHREY. Mr. Secretary, it is good to see you again. Just a couple of quick points. I have actively supported the Cost of Living Council's continuation as a monitoring agency. I regret to say that I did not see too much active support from the administration. I joined with Senator Muskie, and I think the record ought to be clear, we put up a hard battle for it.

I want the vice chairman and you to know that at this very hour I have a task force consisting of eight people and the Committee on Foreign Relations staff people, along with my own special assistant in foreign aid, working on the foreign aid budget. It will be cut. I have been a very active supporter of foreign assistance, as you know. I handled the legislation last year, when we passed the first foreign aid bill in 3 years. This year I predict that we will reduce the budget request of the administration on foreign aid by $1 to $1½ billion. So that we will be making substantial budget reductions. This is not an irresponsible reduction. I am a supporter of foreign assistance. We now have this task force now at work on it, so that it is not a meat-ax approach, but rather a systematic balance.

I would think that we could reduce the military budget by about $4 billion, $3½ to $4 billion, or maybe more. The vice chairman has possibly more accurate or firm views on this. But I think it ought to be reduced by about that amount.

Both the vice chairman and I just came back from a vote in the Senate to reduce the transportation budget by another 3 percent. I voted to reduce the public works budget by 5 percent. So we are exercising fiscal responsibility, as you have indicated we should, and as the administration has requested that we do.

These are just a few of the areas where I think we are moving in the right direction.

But I want to come down to something more basic and fundamental. In your prepared statement, you have used the full employment budget to show the relationship between the budget and inflation. I tend to note that in the administration's proposals about controlling inflation that they focus in on the Federal budget, because it is the easy one to talk about, and everybody gets excited about the Federal budget. It does not require any self-sacrifice particularly; it is a way of sort of targeting in on Congress and bureaucracy and Government as such. I happen to believe that the Federal budget is only a part of the problem, and maybe not the most significant part. You even have a chart in your prepared statement that shows this relationship between budget and inflation. Then you say in your prepared statement: "The relationship is less than perfect, but in the broad sweep of things it is clear that sustained budget surpluses are associated with below-average inflation, and sustained budget deficits are associated with above-average inflation."

Yet, if you examine your chart, it shows that we have had full-employment surpluses since the beginning of 1973. Interestingly enough, Mr. Secretary, you did not even have 1973 on your chart for the full-employment basis on the national incomes account budget position. Yet, over the same period since 1973 to now we have had the worst inflation that we have had in over 20 years. In other words, the current inflation has not apparently been caused by excessive Federal spending.

Secretary SIMON. 1973 is there, it is the last little bump, it is just not printed down below on the chart. The deficit is above the line and the surplus below.

Senator HUMPHREY. Yes; but on a full employment basis, there was a budget surplus.

Secretary SIMON. No; there was a deficit.

Senator HUMPHREY. Our staff tells me to the contrary.

Mr. FIEDLER. There are notes to the chart in the prepared statement which explain several points. First of all, this is labeled the budget on a national income accounts basis, and second, it is for calendar years that we have plotted these figures, not for fiscal years. So they should not be compared with the regular unified budget on a fiscal year budget.

Senator HUMPHREY. It is our view that on a calendar year there is a substantial surplus.

By the way, your chart is misleading, you have got that heavy line there not above the zero point but below the zero point.

Mr. FIEDLER. That is correct.

Senator HUMPHREY. Why do you have that?

Mr. FIEDLER. We have done the same thing on both the budget position and the inflation chart in order to bring out the relationship between the two. It is an unconventional presentation.

Senator HUMPHREY. It is mighty confusing. Ordinarily, you have a line at the neutral point, the zero point, that is up and below. But this kind of statistical gymnastics does not sell too well with me.

Mr. FIEDLER. There is no way to avoid statistical gymnastics, because it is a very complex problem. As explained in the notes to the chart, we did it just to bring out the relationship that we are making of the general correlation between the two series, the second and third panels. We do not pretend that the relationship is perfect, and you can find even greater discrepancy in the general correlation if you go back to the Korean war period, the early fifties.

Finally, we certainly pointed out very strongly that the special factors of the worldwide food grain-crop disaster of 1972, dollar devaluations, and the oil embargo, certainly do not mean that fiscal policy alone accounts for the enormous rise in inflation in 1973–74.

Senator HUMPHREY. You see, I do not say these things. I do not have to think that fiscal policy alone is the major factor. You people keep talking about that—that is our oldtime religion—you keep pounding away at that like it is some kind of a Dead Sea scroll we discovered around here. All I am saying is that in fiscal 1973, it is the observation of the staff of the Joint Economic Committee and the Senator who is now speaking to you, that there was a surplus and not a deficit. If you want to argue the case, we will do it by letter and by document.

Mr. FIEDLER. We will check those figures.

Senator HUMPHREY. I think when you check them, you will find out. I am simply saying what Mr. Simon says. I think that the prepared statement speaks for itself. It says:

> The relationship is less than perfect, but in the broad sweep of things, it is clear that sustained budget surpluses are associated with below-average inflation.

Now, we have had in the full-employment budget—which is your concoction, not mine, that came in with this administration—you have had sustained full-employment budget surpluses in 1973 and 1974, is that right?

Mr. FIEDLER. Calculated on the conventional full-employment basis, that is correct.

Senator HUMPHREY. Then, if that is the case, how can you say that budget surpluses, sustained budget surpluses, are associated with below average inflation when you have had the worst inflation that you have had since I do not know when?

Mr. FIEDLER. The sustained budget surpluses came in the early 1960's and early 1950's when we did have below-average inflation.

Senator HUMPHREY. Let us get up to date. I have studied history, too. But the most important history is contemporary history. What is going on now? Are you going to try to tell me that sustained budget surpluses in 1973 and 1974 have contributed to lower inflation?

Mr. FIEDLER. They will if they are maintained, Senator.

Senator HUMPHREY. Well, we have had 2 years of it.

Mr. FIEDLER. But that is not sustained. as we are using the term here.

Senator HUMPHREY. You do not think that it would have any effect?

Mr. FIELDER. Pardon me.

Senator HUMPHREY. Does it have any effect?

Mr. FIEDLER. Of course. But the deficits which run from the middle 1960's on created a momentum of inflation that is still very much with us.

Senator HUMPHREY. Well, we will argue the point, but I think you are dead wrong.

My judgment, sir, which I expressed yesterday to Mr. Heller and Mr. Duesenberry, who were here, is that this Government has no national economic policy, nor do we have a mechanism of bringing one about. We go at it piecemeal. The current religion is: Reduce the budget. We are all joining together to go down and kneeling at the altar of budget frugality. That is supposed to give us salvation. Quite frankly, I think our sins are so manifold that this little prayer alone won't do the job.

We voted a budget ceiling in the Senate, a spending ceiling. We voted it overwhelmingly. The administration tells the folks to save 15 cents out of every dollar, or whatever the figure is, when the folks do not even have the dollar. There are all kinds of little hit-and-miss statements and policies being made. But is there anyplace where we ever bring together the policymakers of this Government to decide what ought to be the national economic policy? First of all, we have no national plan, none whatsoever. We rely on God, good weather, and luck. We have a budget that is a fiscal budget. The only people that plan are the highway department and the Defense Department, and that is why they get the money. There is no other planning. We do not have any plans for anything else. We have no national food policy. Finally, because of the threat of the Arabs, we are starting to work on a national energy policy. We do not have a national health policy; it is up or down, in and out, and hit or miss. No educational policy. We do it each year. The Government has no plan.

Now, when you come to the control of inflation, or designing a national economic policy, we have got the Federal Reserve Board going off over here, and the Congress going off over here, and the administration in recess.

Frankly, I do not think anybody knows what is going on. I think the greatest contributing factor to inflation today is the lack of a sustained position and leadership. This promotes panic buying and all kinds of decisions that are made sporadically without any continuity, or any sense of balance.

How does the administration work out an economic policy? How often do we have relationships between what is said in the Treasury Department and what is said by Mr. Stein and what is said by Mr. Burns, all these doctors that we have? Are they all writing separate prescriptions, or do they have some kind of a group clinic here?

Secretary SIMON. Senator Humphrey, that is exactly what the President has proposed, a defined position of leadership in economic policy. We have mechanisms, the quadriad, Federal Reserve, the CEA, the OMB, and the Treasury Department, that deal with economic policies both in the short run and the long run. If anything, we have an excess of planning capacity and planning ability down here to deal with the many problems that face us in our country today, such as the action which recently removed the set-aside of upward of 60 million acres to bring on more supplies.

Senator HUMPHREY. Mr. Secretary, I want to take sharp exception. When we opened up those acreages, we forgot to tell the fertilizer people. When we opened up those acres, they were going to get more production. We forgot to tell the railroads.

By the way, the Department of Agriculture was as far off their mark as a blind marksman. They were way off. They were off on food prices; they predicted 3 percent, and they went up 20 percent. They predicted a crop reduction this year which has no relationship to fact because it depended on weather, and anybody with the brains of a March hare knows you cannot depend on good weather. You have got to have an element for error there, and there is none.

Mr. Stein comes in and predicts inflation will be 7 percent. He admits now he was wrong. Last year he did exactly the same thing, and I bet him the best dinner in town, with dancing girls and sweet music and French wine. We had it, Mrs. Stein and Mrs. Humphrey, we went out and had dinner.

Mr. FIEDLER. Where did you find the dancing girls?

Senator HUMPHREY. Mrs. Humphrey dances well.

My point is, to be more serious about it, we do not have the plan. We planned to produce, but we did not plan to move. We planned to produce, but we forgot the inputs of fertilizer and credit and moving stock, railroad hopper cars and trucks, Mr. Secretary.

Secretary SIMON. I think, Senator Humphrey, that there is reason for great humility among the forecasters. The people are put in a position where they must forecast to set an economic policy. It not only goes for Government economists and the planners for economic policy, but the private economists as well. I do not know anyone who forecast what occurred in 1973. Certainly one could not have forecast a quadrupling of the price of oil, the bad weather that occurred that gave us the problem in the agricultural area. Obviously, there is a lack of fertilizer in this country. We have had many hearings over the past year on the railroad problem. So that speaks for itself. But we do have planning, and we do have capable people who are attempting to deal with the tremendous problems that face our country today. I am not happy with our incidence of success up to this point. But we have a policy that if followed for a sustained period of time, I am confident, will attack and lick this terrible problem of inflation, Senator.

Senator HUMPHREY. Mr. Secretary, I happen to be one of your admirers. as you know. I have said so publicly. I have said the same thing of Mr. Burns. I think Mr. Dean is a very able man. The point is that I do not see the kind of machinery in the economy and the Federal Reserve and the executive branch in what I called the National Economic Planning Council in some form really to lay out a program that we can listen to. that we can abide by. We are sort of running it on the line to see whether or not we can make a play. There is no game plan here.

Secretary SIMON. Of course. we work with the Fed, there is no day goes by that I do not work with Mr. Burns or other Board members in the Fed. I would hope that the new budget process that has been put in place in the Congress will give us this vehicle to work together on the fiscal side, because it is going to have to encompass fiscal planning and future economic outlays. I think that is a good idea.

Senator HUMPHREY. But there are other factors, the national income policy, the wage and price guidelines, the allocation of credit, the whole subject matter of the Federal Reserve Board with its monetary policy and rate of money growth, and credit terms. All of these things are interrelated.

I want you to know that next week Senator Roth and I are going to introduce legislation to set up a national commission on economic policy directed toward this problem of inflation, made up of 17 members. The Secretary of the Treasury, the Chairman of the Council of Economic Advisers, the Chairman of the Federal Reserve Board, will represent the executive branch, and four Members of Congress appointed by the bipartisan leadership of both houses will represent the Congress. Then we would have 10 members that would be appointed by the President in consultation with congressional leaders, and no more than five public members can belong to the same political party. I do not know whether that will do the job. But I tell you this, there is one thing I have learned in government, if you do not have people working together, they are working at cross purposes. You cannot just work by the telephone, you have got to meet in concert, and in a cooperative effort.

One other thing—I know my time is up—one thing I have not heard anything about here is recession. This morning in the reports out from the Department of Labor I see that unemployment is up another 0.1 of 1 percent, up to 5.2——

Senator PROXMIRE. If you will yield, there is a rollcall. I will vote and come back. Please continue, Senator Humphrey.

Senator HUMPHREY [continuing]. Or 5.3. There are 100,000 more workers. Inflation is tough. But when your unemployed, it is a catastrophe.

Again our economic policy must not only be directed toward controlling inflation, but also increasing productivity. I go back to what Senator Javits had to say, and I join him in this effort, of getting people to work, getting this economy out of the swamp.

The stock market indicates a lack of confidence. There is a rising level of unemployment. There are indications in the automobile industry and other sections of the economy that we are in a soft position and in recession.

I know the inflation message gets across. But when you are one of those unemployed—and that is 5 million plus—it is not inflation that is your problem, it is poverty. It is being out of a job.

What medicine do you have, Mr. Simon, that on the one hand will not bring about increased inflation, but will hold the price structure somewhere near where it is, and get this economy moving?

Secretary SIMON. I have made my comment that as far as the fiscal and monetary policies, if kept in place for a long enough period of time, will wring out this inflation problem. The President has submitted an unemployment compensation proposal to the Congress for their enactment, and this will deal with the specifics of unemployment. You recognize that during a period of slower growth when we are reducing demand in our economy so that our capacity to produce and demand is brought into better equilibrium, that there will be a small rise in unemployment. This should be dealt with specifically by legislation for the unemployment.

Senator HUMPHREY. What bothers me is the emphasis on unemployment compensation. Why do we not have an emphasis upon a work program? I would rather pay a man $150 a week to work than 75 percent a week to sit on his behind. Why do we not have a much greater public service employment program? We are just dillydallying around with that. Every time we come up with something now we figure out how we are going to get extended unemployment compensation. I want to give them a chance to do something. There are cities to be built, and there is work to be done in this country. I am an old workman. I grew up in the middle west. I do not believe in sitting around on your buttocks, I believe in getting people to work. Why do we not do something more about that?

Secretary SIMON. Well, my experience with public service employment—these discussions are still going on, and no decision has been finally made by the President in this instance—is that it has not been that productive an effort.

Senator HUMPHREY. Then we ought to find a different kind of program. There are things to do in this country. There are parks to be built, and cities to be cleaned up. This city of Washington could use about 2,000 people cleaning up the mess around this town instead of paying people to be idle.

I am a compassionate man. I have never been accused of not being willing to help people. But I think we do not help people by just leaving them sit. I believe that we need a work program, we need a hell of a public works project that we can put people to work on. I urge the administration to come forth with this.

Finally, what about fuel allocation, Mr. Secretary? I understand that in a telegram to Chairman Jackson of the Interior Committee, you indicated that you were not for the extension of the emergency petroleum allocation program; is that correct?

Secretary SIMON. We believe that the allocation program at this point in time, with a 2½ million barrel a day surplus in the world, has created distortions and inequities as any allocation program would. It has been handled in the way that we handled it in the Oil Policy Committee before all these problems started. We were actually dealing then with a really slight, 2 to 3 percent, short, fall.

On Senator Jackson's comments: Well, if the embargo was reimposed et cetera, we would not be proceeding with deallocation. We have discussed deallocating residual fuel oil already, and we favor a simple amendment to extend the allocation authority to June, and this we have recommended.

Senator HUMPHREY. Might I suggest that if that allocation program comes off, the fuel prices will go up, because the only controls we have are in that allocation program on old oil. If that old oil price goes up to the world price, gasoline will be 65 cents a gallon as sure as you and I are looking at each other. The American market will soon reach the market price, and crude will soon reach the price of the Arab market. When translated to an inflation factor in our economy, that will be horrendous. I just cannot believe that we can get away from some type of allocation authority such as we had without disastrous results. I am surprised, frankly, Secretary Simon, that you would recommend that we not have it. Because to me there are two factors that have caused inflation above all, food scarcity and the Arab oil embargo. Now they have got their prices up, which is helping these American oil companies make exorbitant profits, shameful profits. If we let the price of old oil in America go up from that $5.25, or whatever it is a barrel, up to that $10 figure which is the world market—or better than that, $11—I think you would have to agree with me that you are going to see unbelievable increases in prices, fuel oil, distillates, and gasoline.

Secretary SIMON. I have never advocated the removal at this time of the old oil price. I have been quite specific about that, because obviously there is no economic reason at this particular time for the world price being set, not by the forces of supply and demand, but by producers who control 67 percent of the world's supply. We do have another tier now, as you know, for stripper wells, and reserves above, to kill the incentive for additional production. That is fine. It is getting its desired results, with 34 more wells, more finds, this year than last year. That is good. Because that ultimately is what is going to bring the price down. Obviously, we need one market price for this commodity ultimately. But I am suggesting that now is not the proper time.

Senator HUMPHREY. But if you repeal the Emergency Petroleum Allocation Act or do not extend it, you then repeal the authority which permits us to exercise the controls.

Secretary SIMON. We have agreed, Senator Humphrey, to the 4-month extension that Senator Jackson——

Senator HUMPHREY. Four months. Then what happens after 4 months?

Secretary SIMON. I think that is a long time off. We are talking about a year from now. I do not know what the world price of oil will be a year from now.

Senator HUMPHREY. Do you have any indications it will be less?

Secretary SIMON. I have a personal judgment that the world price of oil will decline in the year ahead, not significantly, but decline due to the surplus that exists today. I hope that production will continue at these levels, or slightly higher, that this surplus will continue to put the pressure on prices.

I would also hope that we will have the ability, as per my recent trip to the Mideast, to continue to have this dialog with the oil producers, that it is in their best interest, in their own economic self-interest, to have a lower price of oil.

Senator HUMPHREY. Let me just say that I hope your efforts will be successful. I know that they have been very sincere and arduous. But I have not seen any lessening of desire on the part of the producers who keep that price up. I noticed the other day that the gasoline companies, the oil companies, are cutting back on production. That is the announcement. But they have not cut back the price. All that need practice stuff that I hear about just does not work. When you get too many eggs from the chickens, the prices goes down. When we get too many gallons from Exxon, the price of gasoline goes up.

Secretary SIMON. What they do, and do every year, is what we call turning the crank in the refinery to shift the production to fuel oil for the winter.

Senator HUMPHREY. Except that we have got a surplus this year.

Secretary SIMON. We have a reduction in demand, and that is good.

Senator HUMPHREY. Total consumption went down.

Mr. FIEDLER. May I correct the record on one point that we covered when Senator Humphrey and I were discussing the chart in the prepared statement.

In panel 2 of the chart on the budget position is a surplus of 0.3 percent of GNP in 1973. Not a deficit. I just wanted to correct the record now so we would not have to later.

Senator PROXMIRE. Whatever the effect of fiscal policy on inflation—many people think it has a decisive effect—the Senate did agree to reduce the transportation appropriation bill. It was already about 5 percent below the budget estimate. They reduced it another 3 percent below the budget estimate. So that it is 8 percent below what the President requested. That motion passed 58 to 15, 4 to 1. So I think this is the beginning of an extraordinary reaction on the part of the Congress to inflation, which I think is right. It is certainly very promising from our point of view, Mr. Secretary.

I would just like to ask a couple of more questions. Unfortunately, Senator Javits had to go to vote, but he will be back. I apologize to Mr. Shiskin, because he has been very patient. But I do have some questions, too, in the absence of Senator Javits.

Mr. Secretary, the first question I want to ask you relates to the capability of President Nixon in his present posture to act effectively as the President of the United States, particularly with respect to economic policy. Yesterday, President Nixon canceled a meeting with the economic advisers in order to devote his time to listening to Watergate tapes before turning them over to the court. Regardless of Mr. Nixon's guilt or innocence, it seems to me he is going to have great difficulty devoting the time required to stay on top of economic problems. What is even more important, as the weeks go by, and the President is tried in the Senate, if he is—it seems likely that he will be—he will be under constant fire, his veracity will be challenged, the capability of controlling his subordinates, and his relationship to the agencies of our Government, whether it is legal and proper. It seems to me that under these circumstances that the country is ill served to have a President who is in the very serious straits of President Nixon and whose credibility is so strongly challenged, to have a President under these circumstances to try to run our very complex and difficult economic policy. What is your response to that?

Secretary SIMON. Mr. Vice Chairman, I think in this respect this country is blessed with having a President whom I will describe as the strongest man that I have ever met. On Tuesday of this week I met with the President. We had a 15-minute meeting scheduled to deal with my Mideast trip. That meeting lasted for over 1½ hours, at which time we had one of the most spirited and wide-ranging discussions I ever had with the President—I have met with him at least weekly since last November at the beginning of the energy problem—dealing with areas of foreign policy, foreign economics, domestic problems, and especially our terrible inflation problem. Our President has complete focus on all of the problems, domestic as well as international, that face our country today. He is not unique in the fact that he is being attacked today. Many Presidents in our history have been under constant attack on this issue or that issue.

Senator PROXMIRE. This is entirely different than that, Mr. Secretary. We have only had one other President who was impeached. Our economy was far simpler then. These questions are so complicated.

Above and beyond the time the President must take out in order to make the impeachment fight—he should devote his time to that—above and beyond that, it is his credibility factor. It is not your faith in him—you have great faith in him, and millions of Americans do. But the fact is that a very large proportion of Americans do not have. As this particular kind of a trial goes on, in which the issue is the honesty and integrity of the President of the United States, it seems to me that under these circumstances the country would be well served, and the world economy would be well served, if the President would step aside under the 25th amendment and permit Vice President Ford temporarily—only temporarily, depending, of course, on the outcome of this whole process—to serve as Acting President.

Secretary SIMON. I spoke, Mr. Vice Chairman, to many of the world leaders and finance ministers in all of the countries that I visited recently. I made 14 stops in 16 days. I did not hear one person make even the vaguest hint of that suggestion. I can assure you that this current problem that our President is having, however severe, is not distracting him from his duties as the Chief Executive Officer of this country. I find him completely focusing in on these problems and wrestling with them just as hard as all of his economic advisers are.

Senator PROXMIRE. Mr. Secretary, I would expect you as a loyal member of the administration to make a reply of that kind. But I do hope that you will talk to the President—as you say, he is a strong man, there is no question about that, he is an extraordinarily intelligent man, and I have been impressed with his understanding of the details of economic policy, although he has to consider many other things. But I think I have already made clear that I am talking about something quite different than that. I hope he will give it the most careful consideration. Because it is a matter that goes beyond the capability of this President. It goes to the belief that people will have under these circumstances.

During the televised Judiciary Committee hearings, I think you could sense in the country—I sent questionnaires out in my State, and I got a profound reaction to the President's position. I think that this is going to intensify what is going to happen in the House, and very probably will happen in the Senate. So I think this is what the President should be made aware of.

I would like to ask you about something else. You talked about the necessity of high profits to provide funds, investment funds, so that industry can invest more heavily. According to the New York Times, on July 14 capital spending for this year is estimated at $112 billion, an increase of about 12 percent. After inflation, it would be about a 4- or 5-percent increase. When we get a breakdown as to where this increase is occurring, it is encouraging, it indicates that we are getting a great increase in productive facilities and the capability of increasing production where we need it—in steel, for example, an increase of 32.6 percent, nonferrous metals, 31 percent; machinery, 21.3 percent; paper, 38 percent; chemicals, 22 percent; petroleum, 41 percent; and railroads, 29.8 percent. McGraw-Hill says this year that 53 percent of investment will go for actual increasing capacity, and that physical capacity will be increased by about 6 percent for the year. Under these circumstances, why is this not enough to indicate that we are getting on top of inflation from the supply side, and getting into a position where perhaps we do not need to reduce taxes or provide other investment incentives in order to get more funds into the productive side of the economy?

Secretary SIMON. This is an encouraging development, Mr. Vice Chairman, there is no doubt about that. But it must go on for a sustained period of time in order for the capacity in many of these industries that you mentioned to meet the demands that we presently have, not only the demand that we presently have, but the demand that is going to continue to grow in the future. So this is encouraging.

Senator PROXMIRE. You see, in your discussion of profits one of the things that troubled me was that it did not seem to take cognizance of the study that was recently revealed that effective corporate tax rates have dropped from 43 percent to something like 35.6 percent over the past 5 years, because of the corporations being able to take advantage of tax shelters. Moreover, the corporations paid this 35.6 percent rate in inflated dollars, too. The law said they should pay 48 percent on this profit. So it appears that they are getting a mighty good break already, particularly in view of the enormous profits that have been reported in industry after industry in this quarter already, the past quarters.

Secretary SIMON. They are enormous profits. But the figures are stated in my testimony. I want to leave with you for the record a new study that was just completed last night on the so-called phantom profits and investment in industry. The other side of the equation is the accounting practices and inflation factor that works on the opposite side.

[The study follows:]

PHANTOM PROFITS AND INVESTMENT

(By H. I. Liebling and J. Jackson, Office of the Secretary of the Treasury, Office of Financial Analysis)

Review of

ECONOMIC AND FINANCIAL DEVELOPMENTS

August 2, 1974

PHANTOM PROFITS AND INVESTMENT

Due to inflation, the adequacy of corporate earnings to finance working and fixed capital has diminished significantly over the past decade. By 1973, that adequacy had diminished precipitously, and worsened further in early 1974.

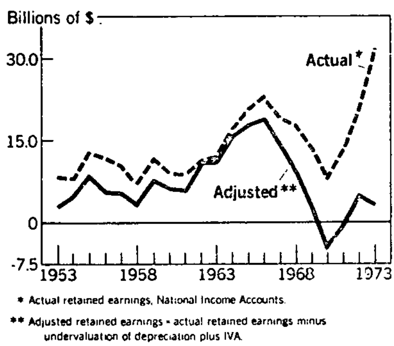
This growing inadequacy has become a major factor contributing to a shortfall in capital spending; to major shortages in materials and in finished goods-producing industries, thereby adding to the current accelerated inflation rate; and to the heavy current pressures in capital markets.

Since 1965, it has been the inflation that has caused a large discrepancy between the historic and replacement costs of physical assets by business, which lies at the root of the problem of profits adequacy. The discrepancy caused by inflation has resulted in a serious overstatement of corporate profits in recent years.

Chart I:

RETAINED EARNINGS: ACTUAL AND ADJUSTED FOR REPLACEMENT COST

(Non-Financial Corporations)



* Actual retained earnings, National Income Accounts.

** Adjusted retained earnings - actual retained earnings minus undervaluation of depreciation plus IVA.

In 1973, profits after taxes for nonfinancial corporations were estimated at $55 billion, which appears relatively large. However, if replacement costs for inventory and depreciation were charged, profits after taxes would be reduced to $26.5 billion. And, if dividends are then deducted as necessary payment to obtain capital from investors, retained earnings can be shown to have been only $2.3 billion. This represents a deep plunge from the 1965 level of $18.4 billion, as shown by the chart on this page; these data are also shown in

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the following, for selected years (while the complete historical record since 1953 is shown in Table 1, attached):

Non-financial Corporate Earnings (Bil. dol.)

	1955	1965	1973
Profits after tax, reported	22.2	38.2	55.0
Profits after tax, adjusted*	18.0	35.3	26.5
Retained earnings*	8.6	18.4	2.8

* Adjusted for replacement costs of physical assets

Superficially, many national accounts measures of earnings appear to have ballooned since 1965. This contrasts with "adjusted" earnings shown below (and the declining share of them to corporate GNP, not shown):

Non-financial Corporate Earnings (Bil. dol.)

	After Tax Profits	Gross Cash Flow*	Net Cash Flow** "Historical"	Net Cash Flow** "Replacement"
1955	22.2	39.3	29.9	25.7
1965	38.2	73.6	56.7	53.8
1968	38.3	83.7	62.8	54.6
1973	55.0	123.1	99.4	70.9

* After tax profits plus "historical" depreciation.

** Retained earnings plus "historical" depreciation (Col.3) or "replacement" cost of inventories and fixed assets (Col.4).

But, the pace of inflation makes these figures much less meaningful than they have been. As prices rise significantly, the replacement cost of physical assets -- indeed, of all assets -- increases. Accordingly, those generally used Commerce Department measures of corporate earnings or cash flow -- because they reflect historical rather than the current or replacement cost of depreciation or of inventories -- are overstated. They are deficient, if intended as a measure of funds available to keep the capital stock intact, let alone as being a guide for the available finance of capital stock expansion.

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As the inflation accelerated in the U.S., the greater has been the overstatement of corporate earnings because of the substantial understatement of the cost of replacing physical assets. The increasing magnitude of this negative factor on profits is shown in the chart on this page. (Note negative scale.)

Entering into the steep decline in "adjusted" retained earnings are corrections for the overstatement of corporate earnings made by:

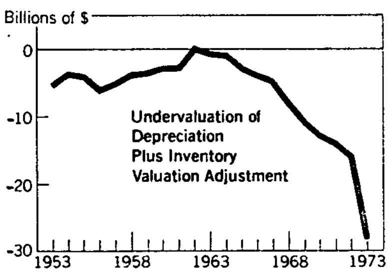
- The inventory valuation adjustment (IVA) in the national accounts, which attempts to correct corporate profits for changes in the replacement or current cost of inventory. This is required because most U.S. companies are on a "first-in first-out" or historical cost basis.

- Repricing of depreciation charges at replacement value. (However, statistical problems are involved in this measurement. Should the replacement cost be applied on a "straight-line," "double-declining balance," or some other type of depreciation method? Also, what service life might be assigned to physical assets -- Bulletin F, or what some have claimed as "more realistic" shorter lives?)

Chart II:

THE LOSS OF PURCHASING POWER OF RETAINED EARNINGS

(Non-Financial Corporations)



Alternative methods of depreciation have been calculated by the Department of Commerce. However, many authorities, including George Terborgh, are agreed that 85% of Bulletin F lives, as depreciated by the "double-declining balance" method, might be a good and realistic approximation of actual depreciation. This *Review* uses that procedure.

The decline in "adjusted" retained earnings noted above -- steep as it has been -- appears more grim when it is recognized that the adjustments noted above apply only to the replacement value of physical assets, not to funds that might finance expansion of capital. For that expansion, the 1973 level of retained earnings is surely very small as a source of finance. Moreover, the overstatement of earnings became even more dramatic during the first part of 1974, as the inflation accelerated. Some rough estimates indicate the overstatement of retained earnings grew from $28.5 billion in 1973 to perhaps twice that rate in the first half of 1974.

But, the capital stock of the U.S. surely needs to grow. The internal sources of corporate funds clearly are insufficient to provide for expansion in the "net" capital stock.

All of this would indicate that corporations will need to rely very heavily on external means of financing -- in other words, having recourse to the capital markets for means of financing of capital expansion programs. Those markets already have been under pressure. Indeed, some expansion plans have recently been deferred because of high interest rates. In view of this Nation's present pattern of savings and consumption, there is little indication that such pressure will ease soon -- even under conditions of lower-than-expected economic growth in 1974 (assuming little change in overall capital spending plans).

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Table 1

PROFITS AND RETAINED EARNINGS OF

NON-FINANCIAL CORPORATIONS

(Billions of Dollars)

	PROFITS AFTER TAXES	ADJUSTED PROFITS AFTER TAXES*	ADJUSTED RETAINED EARNINGS*
1953	16.4	10.9	2.9
1954	16.3	12.6	4.4
1955	22.2	18.0	8.6
1956	22.1	16.0	5.8
1957	20.9	15.6	5.2
1958	17.5	13.5	3.3
1959	22.5	18.8	7.9
1960	20.6	17.7	6.1
1961	20.5	17.5	5.9
1962	23.9	23.8	11.0
1963	26.2	25.3	11.0
1964	31.4	30.3	15.4
1965	38.2	35.3	18.4
1966	41.2	37.1	18.9
1967	37.8	33.0	14.2
1968	38.3	30.1	9.3
1969	34.3	23.4	2.7
1970	28.2	15.5	-4.5
1971	33.4	19.5	-0.7
1972	43.0	27.5	5.3
1973	55.0	26.5	2.8

* Adjusted for replacement costs of physical assets other than residential properties.

Senator PROXMIRE. Were you not surprised when you had to revise your estimate of corporation tax receipts down?

Secretary SIMON. Well, surprised, no. One could expect that our revenue estimates would be lower, would slow down in our economy. But revenue estimates are the trickiest form of estimate in the Treasury Department. It is very difficult to gage accurately what our revenues are going to be. I think that our unit does a very good job looking over a long period of time. Obviously they are going to make errors in forecasting.

Senator PROXMIRE. I understand you have not revised the figures for past years very sharply, and that there was surprise that the effective rate had dropped as much as it had. Are you making any analysis of the reason for this?

Secretary SIMON. On the revenues the Treasury received?

Senator PROXMIRE. That is right, corporate tax receipts.

Mr. FIEDLER. I think the discussion is about the changes in the national incomes account numbers for corporate profits and taxes.

Senator PROXMIRE. That is right.

Mr. FIEDLER. Those are not our Treasury Department estimates, they are Commerce Department estimates. In view of past history of these revisions, it did not surprise me, Senator. That is to say, we have seen many times in history when changes have been made in corporate profits and in taxes, I think, of this magnitude, although I have not looked at it deeply. But every July there is a revision of this sort.

Senator PROXMIRE. This seems to be a very large revision.

Mr. FIEDLER. Yes. But this is the history of the corporate profit series.

Senator PROXMIRE. My time is up.

Senator Javits.

Senator JAVITS. Mr. Vice Chairman, I shall take less than 10 minutes.

I would like to enter a note of information, Mr. Secretary, about public service employment. We now have provided roughly for 100,000 jobs. The proposals being made to the Labor Committee, of which I am the ranking member, would provide for 500,000 jobs if there is a 6 percent unemployment. That would mean the expenditure of roughly $4 billion if there is a 6 percent unemployment trip. That is by sections or so-called labor markets. I would like to inform you—and I hope you will examine this carefully—that the record has been extraordinarily good, in that it is a 2-year span when people are put to work. Our figures show that over 70 percent of those who have gone through the program have gotten regular jobs at the end.

That seems to suddenly be an adequate figure to quiet the fears that they would somehow currently remain on the Government payroll as make-work operations. We are very encouraged, and it should make a very strong case before the Labor Committee for this approach as being a very critical resource in the event that we have serious unemployment.

I give you that for information. You really didn't say you were against it.

Secretary SIMON. I am aware of your recommendation. I have already spoken to the President about it. Frankly, I am intrigued with the idea of recognizing that when we put in fiscal restraint in the economy there will be an increment in unemployment, and it must be dealt with specifically. The President has his unemployment compensation program. But I like your idea, frankly, the trigger mechanism that would be brought into place, because there again forecasting is a dangerous business. This would help to deal with it.

Senator JAVITS. You could allocate quotas and people to begin to plan. This would give them a chance to build up to it.

Secretary SIMON. I will have further conversation with the President on this, Senator Javits.

Senator JAVITS. Thank you very much.

I would like to move now, if I may—and I might say, Mr. Seccretary, as always you are refreshingly frank. More than that, you are not a pro, in the sense that you have a feeling or opinion as an American or an important financial leader. I think what you have developed today respecting the general effort to keep the price structure where it is—actually we want to cut back on oil, we hope for food drops, and consumers' disciplines, which seemed to have worked in the meat field. But as to the price structure generally, can give the people some feeling as to the general objective, sit on it and let the economy gradually adjust itself?

I think that has been very important. I thank you for being so forthcoming.

I would like to ask you about the international thing which is so serious, in two areas.

One, the grave peril which confronts us because of the shaken faith in instruments of credit which has contributed so very heavily to very high interest rates. The people being hit the most by that are the utilities. I know as a liberal—and I am, and I am very proud of it—the theory is that liberals are against the utilities, quote, unquote.

But I think we are harping back to a totally different day, the days before regulation, et cetera. Right now the grave danger is that they are responsible for roughly 40 percent of the capital equipment in the country, and an indispensable ingredient to the expansion of production. We have got to see that they don't fall on their faces, unless we want to take them over, and I doubt very much that we do.

Do you think the time has come to consider some special financial mechanism like an FHC, in view of the jam in which they don't have the capital markets to enable them to borrow money at rates which will allow them to defer sensational rate aberrations which can't be acted on in time to do them that much good, and that is the reason for your market crunch? The question: Should the Government do anything about that very serious situation in the way that I have suggested, some technique, or something like that?

Secretary SIMON. A Government guarantee to give them the ability to finance again attacks the result of the problems and doesn't do anything for the causes.

I think that we have made our recommendations on the utilities. We will favor the investment tax credit increase from 4 percent to 7 percent for the utilities. We also are going to work with the rate commissions for the utilities to require this immediate attention to restore their profitability, because if their reasonable profitability is restored, they will have ready access to the capital markets, because as you know, people who buy utilities common stocks, preferred or the bonds, recognize that they are going to get a constant rate of interest, constant dividends from these stocks, and this is presently not guaranteed, if you will, because the costs have exploded. I think a perfect example of that is, we had a utility financed yesterday for 5 years at 11 percent in the marketplace. This was a good utility. Think of what happens to some of the lesser utilities. They obviously cannot finance at all. I think we have to address this most urgently with a proliferation of Government guarantees in the marketplace that we have seen over the last 7 or 8 years, as was my pet peeve before I arrived in Washington in the Treasury Department.

I can say that I had this pet peeve in a somewhat unselfish fashion because my firm underwrote and managed the great majority of all of these issues, and we indeed made a lot of money out of it. But I just think it is the wrong way to go financially.

Senator JAVITS. I certainly thank you for that, for stating what is the policy now. At least we have a fixed point with which to deal. If that doesn't work—and that is what you are trying now—is there anything the Congress can do to help?

Secretary SIMON. Of course, change the investment tax credit.

Senator JAVITS. That is urgently needed in your opinion?

Secretary SIMON. It is needed more for the intermediate and long term as far as additional plan expenditures and increases are concerned. Yes, it most certainly is.

Senator PROXMIRE. Will the Senator yield on that?

Senator JAVITS. Surely.

Senator PROXMIRE. I think that is a very interesting suggestion. It has a lot of merit, I have always supported the investment credit. But I think Mr. Burns was right. He said, if you are going to provide that kind of relief for business, you ought to balance it with an increase in the corporation income tax. If you are going to lose revenue by increasing the credit, that you will have to have an increase in corporation income tax escalated from 48 percent to 50 percent.

Secretary SIMON. When we talk about what is ample, the utilities industry is the only industry in the United States that doesn't get the 7-percent investment credit.

Senator PROXMIRE. I am sorry, I am talking about the overall. He suggested an increase from 7 percent to 10 percent overall to be balanced with an increase in the corporation income tax from 48 to 50 percent, and no less in revenue, but an increase in incentive.

Secretary SIMON. I heard that suggestion yesterday, and I talked to the secretary of tax policy about this last evening. By the time I get back he is going to have a piece of paper on this; does this increase create an incentive or does it take away more money than it gives?

Senator JAVITS. The only other question that I have to ask you is about this effort to recycle these sums which are going into countries which have low input into the consumption of the world, and therefore cannot pay it back on a current basis.

In that regard you have just been abroad on a very interesting trip. Your report generally is optimistic on that score. But is there some contemplation of bringing into this effort a multilateral approach, for example, for the OECD countries collectively to offer the Arabs some kind of a recycle mechanism, or some other way of approaching it other than strictly on a U.S. basis, as we understand the Saudis, contemplating the purchase of U.S. Government securities?

Secretary SIMON. We talked at some length while you were voting, Senator Javits, Congressman Reuss and I, about the problems. There are two problems. One is the reflow, and the second one is oil prices.

I have never been a pessimist on the subject of reflows of these funds on the international markets, as some people have. Now, this isn't suggesting a laissez-faire philosophy, which would say, don't worry the marketplace will take care of itself. There are going to be strains, and these strains are going to have to be dealt with in a multilateral way through the efforts of governments. We should have guidelines from the Federal Reserve and the central banks of other countries. We will soon have the special facilities in the International Monetary Fund. Various organizations are studying exactly what you suggested, reflows to the less-developed countries, and specifically the size of reflow that is required for this period of time.

We are also seeing that the Arab producing nations recognize their responsibilities in this area. The Kuwaitis, as an example, have increased their Kuwaiti fund from $600 million to $3.2 or $3.3 billion, and announced simultaneously that this is not only for the lesser developed Arab nations, but for other lesser developed countries on a bilateral basis.

The producers are lending money, not only to the $3 billion special fund in the IMF, but also on a special basis direcctly to individual countries. There have been loans to the United Kingdom, a $5 billion deal between Iran and France involving a substantial advance, and there is another oil producer now talking to Italy. So, the reflows of that money are being undertaken on a government-to-government basis.

The markets are also performing their intermediary function. Initially when a conservative group of investors—which they are, not only conservative, but responsible—receive this great largesse, the first reaction is to put the money into the commercial banking system. Obviously, commercial banks are not going to accept these deposits at the interbank level, just as an illustration, unless they can invest them at a higher price simultaneously matching, to the best of their ability, assets and liabilities to avoid the borrowing-short-and-lending-long syndrome that has gotten institutions in trouble in the past. Well, when more money flows into the institutions, they pay below the interbank rate, 2, 3 or 4 percent below the rate. Then they decline to accept these funds, which moves them into the intermediate and longer term area, not only in the United States, but in other countries of the world in many forms.

Also it has been greatly misjudged in my opinion, having just been over there, what the internal demands for funds in these countries is going to be, in particcular Saudi Arabia. Their budget for expenditures this year is close to $13 billion, which is a little over half of the revenues, which is an extraordinary explosion. One might say, they do not have the ability to spend that much money. But they are going to make commitments and let the contracts, and it will be spent in a reasonable period of time. They have great desires for their country in the area of social programs, and airports and everything that the country needs, not to mention industrialization and diversification that they are moving full steam ahead on.

Senator JAVITS. One other question I would like to ask.

What progress are we making with the International Monetary Fund agreement that is so critical in this field of the jeopardy or credibility of instruments of credit and so so, including monetary?

Secretary SIMON. The International Monetary Fund finance ministers agreed to a broad list of reforms, including rules for floating exchange rates, and the setting up of these special facilities, et cetera, during our June meeting. We were prohibited from agreeing to a great deal more than that due to the terrible problem of inflation, and the oil prices worldwide. But we continue to work toward the permanent international monetary agreement that suits this new world.

Senator JAVITS. Is that on high priority?

Secretary SIMON. Yes, sir, it is.

Senator JAVITS. There was a little confrontation between you and Iran. I noticed you mentioned Iran. You have no inhibitions about getting Iran into the international stream, have you?

Secretary SIMON. No, sir. I was misquoted as far as that recent report is concerned.

Senator JAVITS. You feel no inhibitions as American Secretary of the Treasury in dealing with the Shah of Iran?

Secretary SIMON. I most certainly do not.

Senator JAVITS. Thank you very much.

Senator PROXMIRE. I am just about through.

I would just like to say in conclusion, Mr. Secretary, that I am sorry we don't have time to proceed, because I would like to ask you about antitrust, about the study that I have here that indicates that price fixing by private industry is costing us about 6 percent of the GNP, which means that the typical person, or the person with a $10,000 income, has to pay $600 out of that income because of fixed prices, because of the inadequate antitrust actions of various kinds. And out of a $20,000 income you have got to pay $1,200. A Senator who makes $42,500 a year shells out $2,500 a year out of his pocket because prices are being fixed.

In addition, there is one other area that I think we haven't touched on, and we should, it is a shame we haven't. That is the area of monetary policy and the effect on housing. Because this is the real basket case, and it is a tremendously difficult problem. I know that you have championed a constructive proposal, which has been criticized by Walter Heller just yesterday as providing just another tax shelter and tax privilege, and that is, in the Hunt committee report which you favor so strongly, you provide for a tax benefit to banks if they put more of their portfolios into housing. Perhaps in some other way we can modify monetary policy to meet that. But there was a discussion in the paper this morning about the possibility of having the Federal Reserve allocate credit particularly to housing.

Secretary SIMON. Yes, I was interested. I guess Andy Brimmer is the sole dissenter.

Senator PROXMIRE. He is the holdout, he is in favor of it. The rest of the Fed is not.

Secretary SIMON. I must admit that my sympathies and my financial experience dictate that I agree with the chairman on the function of our central bank, and that if we wish to deal with housing, we should deal with it specifically here in the Congress and not force our central banks to adjust monetary policies to social priorities.

Senator PROXMIRE. Again I want to thank you very much, Mr. Secretary. You are a brilliant man and a good witness, even though I disagree with you rather strongly in some areas.

The committee stands recessed until Tuesday, August 6, at 10 a.m., when we will hear from Arthur Burns.

[Whereupon, at 12:40 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, August 6, 1974.]

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

RESPONSE OF HON. WILLIAM E. SIMON TO AN ADDITIONAL WRITTEN QUESTION POSED BY SENATOR PROXMIRE

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., August 19, 1974.

Hon. WILLIAM E. SIMON,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: Senator Proxmire has asked me to forward the following question for your response to be included in the record of our recent hearings on the state of the economy at mid-year.

In your testimony before the Joint Economic Committee on August 2, you referred to 62 percent of the American capital market being preempted by demands of the Federal Government or government-sponsored agencies. Would you explain this more fully and specifically show (1) how the figure was derived; (2) for what period of time it is applicable; and (3) how this compares to the demands the Government has made on U.S. capital markets over the past ten years and is projected to make during the next two years.

Thanks very much for your cooperation.

Sincerely,

COURTENAY SLATER,
Senior Economist.

THE SECRETARY OF THE TREASURY,
Washington, D.C., September 20, 1974.

Mrs. COURTENAY SLATER,
Senior Economist to Hon. William Proxmire,
U.S. Senate, Washington, D.C.

DEAR MRS. SLATER: This is in reply to your letter of August 19, requesting an explanation of my reference to 62 percent of the American capital market being preempted by demands of the Federal Government or Government-sponsored agencies during my appearance before the Joint Economic Committee on August 2. Your letter asks specifically: (1) how the figure was derived; (2) for what period of time it is applicable; and (3) how this compares to the demands over the past 10 years and is projected to make during the next 2 years.

The figure was derived from flow of funds data published by the Board of Governors of the Federal Reserve System for fiscal year 1973, as follows:

	Billions
(1) U.S. Government securities	$21.6
(2) Federally sponsored agency securities	11.2
(3) Subtotal	32.8
(4) State and local government securities	9.6
(5) Corporate and foreign securities (excluding equities)	10.1
(6) Total securities (sum of lines 3, 4, and 5)	52.6
(7) U.S. Government and federally sponsored agency securities as a percent of total securities	62.4%

Subsequent to my August 2 appearance, the Board of Governors published revised figures for fiscal years 1971 through 1973 and preliminary figures for fiscal 1974. The enclosed table covering the 10 fiscal year period 1965–1974 is derived from the latest flow of funds data.

Based on the revised figures, the U.S. Government and Federally-sponsored agency share of the securities market in 1973 was 59 percent. In fiscal 1974, the U.S. Government and sponsored agency share fell to 43 percent. This decline is largely accounted for by the sharp reduction in U.S. Government borrowing in 1974.

The 1974 experience underscores the importance of a tight fiscal policy and the need for a balanced budget to reduce the heavy pressures which now exist in the financial markets.

The Board of Governors does not make flow of funds projections.

Sincerely yours,

WILLIAM E. SIMON.

Enclosure.

NET FUNDS RAISED IN THE SECURITIES MARKETS BY MAJOR SECTOR

[In billions of dollars]

Fiscal years	U.S. Government securities (1)	Federally sponsored agency securities (2)	Total (1)+(2) (3)	State and local government securities (4)	Corporate and foreign securities [1] (5)	Total securities (3)+(4)+(5) (6)	U.S. Government and federally sponsored agency securities as a percent of total securities (3)−(6) (7)
1965	3.8	1.5	5.4	6.9	5.1	17.7	30.4
1966	1.6	4.1	5.7	7.3	9.2	22.2	25.8
1967	1.8	.2	2.0	6.0	12.2	20.3	9.9
1968	20.5	3.3	23.8	7.2	15.1	46.1	51.6
1969	−.4	4.1	3.7	12.0	14.7	30.5	12.3
1970	4.2	10.8	14.9	9.7	14.8	39.4	37.9
1971	20.3	2.9	23.2	15.0	23.0	61.2	37.9
1972	20.7	7.5	28.2	15.6	15.8	59.6	47.3
1973	21.5	11.2	32.7	12.6	10.5	55.8	58.6
1974	4.1	18.0	22.1	16.1	13.6	51.8	42.7

[1] Excludes equity securities.

Source: FRB flow of funds—Office of the Secretary of the Treasury, Office of Debt Analysis.

EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

TUESDAY, AUGUST 6, 1974

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

The committee met, pursuant to recess, at 10:05 a.m., in room 318, Russell Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present Senators Proxmire, Sparkman, Humphrey, Javits, and Percy; and Representatives Moorhead and Brown.

Also present: John R. Stark, executive director; John R. Karlik and Courtenay M. Slater, senior economists; Richard F. Kaufman, general counsel; Lucy A. Falcone, Robert D. Hamrin, Jerry J. Jasinowski, Carl V. Sears, and Larry Yuspeh, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. Our witness this morning is Mr. Arthur Burns, Chairman of the Board of Governors of the Federal Reserve System.

Mr. Burns, you carry an especially heavy weight of responsibility at the present time. The country is faced with the most intractable inflation in many years—perhaps the most difficult inflationary problem we have ever faced in the history of this country, because the previous inflations, as you recall as an economic historian, were primarily associated with wars or the periods immediately after wars and were limited.

In addition, as we have learned from both official and private witnesses during the course of these hearings, the outlook for real growth and employment has worsened considerably. After falling about 4 percent in the first half of the year, real output is expected to grow only slowly, if at all during the second half. This implies that unemployment will continue to rise, perhaps substantially.

Frankly, as one who has been at all of these hearings and presided at all of them, I have been unhappy about the fact that there doesn't seem to be a comprehensive and effective program to deal with this problem. Even the critics of the administration, who have suggested alternatives concede that anything they offer is going to result in continued high inflation, and probably a continuation of a rise in unemployment.

So we seem to face a grim outlook.

Monetary policy has been conducted, in the view of most observers, by you with considerable force and effectiveness. But I think we all recognize that monetary policy is not enough. It is a strong, major weapon, but it can't do the job by itself, and if it tries to do the job by itself it works tremendous inequities. It is a policy which simply has to be supplemented by other policies.

We are delighted to have you here. Other members of the committee will come a little later. You may proceed in your own way. If you would like to abbreviate any part of your statement, it will be printed in full in the record.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, THE FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you, Mr. Vice Chairman. I am pleased to appear before this committee once again to present the views of the Board of Governors on the condition of the national economy.

Our country is now struggling with a very serious problem of inflation. In the past 12 months, the consumer price level has risen by 11 percent; wholesale prices have risen even faster. When prices rise with such speed, inflation comes to dominate nearly every aspect of economic life.

The current inflation is of worldwide scope and of virulent intensity. Among the principal industrial countries, consumer prices over the past year have risen anywhere from 7 to over 20 percent, while wholesale prices have advanced from 15 to over 40 percent. Inflation is also raging among the less developed countries, and apparently in socialist countries as well as in those practicing free enterprise.

A major cause of the stepped-up rate of inflation around the world was the coincidence of booming economic activity among major industrial nations during 1972 and 1973. With production rising rapidly, prices of labor, materials, and finished products were bid up everywhere. The pressures of demand were particularly acute for industrial materials; severe shortages developed and prices of these commodities skyrocketed.

The impact of worldwide inflation on our own price level was magnified by the decline since 1971 in the value of the dollar in foreign exchange markets. Higher prices of foreign currencies raised the dollar prices of imported goods, and these price increases were transmitted to domestic substitutes as well as to finished products based on imported materials. Moreover, as the dollar became cheaper for foreign buyers, our export trade increased rapidly and thus reinforced the pressure of demand on domestic resources.

Other special factors have also contributed to the higher rate of inflation since the beginning of last year. Disappointing harvests in 1972—both here and abroad—forced a sharp runup in food prices during 1973. And the manipulation of petroleum shipments and prices by oil-exporting countries has caused a spectacular advance since last fall in the prices of gasoline, heating oil, and other petroleum products.

More recently, the removal of direct controls over wages and prices has been followed by sharp upward adjustments in both labor and commodity markets.

The inflation that we have been experiencing has already caused injury to millions of people and its continuance threatens further and more serious damage to the national economy.

As a result of the inflation, consumer purchasing power is being eroded. During the past year, the take-home pay of the typical worker declined nearly 5 percent in real terms.

As a result of the inflation, the real value of the savings deposits, pensions, and life insurance policies of the American public has diminished.

As a result of the inflation, financial markets are experiencing strains and stresses. Interest rates have moved skyward. Some financial and industrial firms have found it more difficult to roll over their commercial paper or to raise needed funds through other channels. Savings flows to thrift institutions have diminished, and stock prices have plummeted.

As a result of the inflation, profits reported by corporations have risen sharply; but much of the reported profit is illusory because it fails to take into account the need to replace inventories, plant, and equipment at appreciably higher prices.

In short, as a result of the inflation, much of the planning that American business firms and households customarily do has been upset and become confused. The state of confidence has deteriorated and the driving force of economic expansion has been blunted.

It should not be surprising, therefore, that the physical performance of the economy has remained sluggish in recent months, despite the lifting of the oil embargo that depressed the economy last winter. Auto sales have recovered somewhat since March, but total retail sales—allowing for price advances—have continued to move sidewise. Residential building activity is in a slump. Although the volume of new housing starts rose a little in June, the average for the second quarter fell and the number of new building permits also declined. Actually, most major sectors of the economy recorded little or no change of activity in the second quarter, and early estimates suggest a slight further reduction of the real gross national product in that 3-month period.

Recent economic movements do not have, however, the characteristics of a cumulative decline in business activity. In a typical business recession, all—or nearly all—comprehensive indicators of economic activity move downward simultaneously. That is not the case presently. For example, the demand for labor has remained strong. Employment has continued to rise, and the unemployment rate appears to be about the same level now as it was in January.

In the industrial sector, production has recovered somewhat over recent months; factory shipments have continued their upward course; and new orders received by manufacturers of capital goods have risen further. Unfilled orders on the books of business firms, especially in the capital goods industries, are enormous and are still advancing, as shortages of critical materials and parts continue to hold back production schedules.

In addition to the business capital sector, our export markets are a source of continuing strength to the economy. Also, some businesses are adding significantly to their inventories, in order to replenish depleted stocks and bring them into better balance with sales. These sources of strength have kept up activity in the industrial sector and have prevented the downward tendencies in our economy from cumulating in the manner characteristic of economic recessions.

We should, however, act decisively to bring inflation under control before these remaining sources of strength are undermined. If interest rates continue to soar, if construction costs and equipment prices continue to rise at a feverish pace, if our export prices continue to mount, we may eventually find that incentives for business investment are being eaten away and that our export markets are shrinking.

Let me turn now to the condition of international financial markets and recent trends in our international trade and payments accounts.

Our foreign trade balance has moved into deficit this year, principally because of the huge increase in the bill for imported oil. The dollar value of our fuel imports rose from an annual rate of $8 billion in the second quarter of 1973 to a $28 billion rate in the second quarter of this year. The deterioration in the overall trade account was much less than this, however, since our exports over the past year have risen much more than imports outside the petroleum category.

Partly for these reasons, partly also because our money and capital markets have been attracting funds from oil-exporting nations, the high price of imported oil has not created a serious balance of payments problem for the United States. Uncertainties surrounding the effects of recent oil prices have given rise to large and rather unsettling swings in the value of the dollar relative to other currencies since last October, but on balance the dollar is stronger now than it was at that time. The value of the dollar in exchange markets began to recover last October, fell once again between this February and May, and since then has gathered some strength. At present, the average price of the dollar in exchange markets, although below the high point reached in January, is still about 6 percent higher than it was in October of last year, before the oil crisis. Intervention in exchange markets by the Federal Reserve and other central banks, while not extensive, has helped to prevent exchange rate fluctuations from becoming unduly large and upsetting to the calculations of firms operating in international markets.

Other oil-importing countries have fared less well during this difficult period of high and rising oil prices. For many of the less developed nations around the world, the rising costs of fuel and fertilizer have shattered plans for economic development. Industrialized nations also—notably Italy and to a lesser extent other countries such as Japan—have experienced severe strains in their international payments accounts. And all oil-importing countries have suffered a significant loss of consumer purchasing power due to the massive increase in fuel costs.

Unless the price of oil declines materially, the oil-importing nations as a group cannot avoid sizable deficits in their current international accounts. This situation is fraught with danger for the stability of international financial markets. It is by no means clear that private financial institutions will be able to recycle the huge surpluses of the oil-exporting nations to the many nations of the world that are experiencing current account deficits. A substantial decline in the price of oil is, in my judgment, essential and requires the closest attention of the world's statesmen.

Strains in the international financial system will, of course, be reduced if the oil-exporting nations use their surpluses to provide assistance to countries with current account deficits—if not directly, then indirectly through international financial institutions. Tension in international financial markets will also be lessened if countries throughout the industrialized world, besides practicing conservation in the use of oil, assign high priority to gaining control over their internal inflationary problem. Most of them are now relying on monetary or fiscal restraints for that purpose, and the worldwide boom in economic activity is therefore abating. If we and other nations around the world persist in this struggle, the raging fires of inflation will eventually burn themselves out.

In our own country, the battle against inflation has relied heavily on monetary restraint. The Federal Reserve recognizes that a restrictive monetary policy is bound to cause some inconvenience and even hardships. While we have tried to apply the monetary brakes firmly enough to get results, we have also been mindful of the need to avoid a credit crunch.

Thus, the supply of money and credit has continued to grow. During the past 12 months, the narrowly defined money stock—that is, currency plus demand deposits—has increased 5½ percent, while the loans and investments by commercial banks have risen by 12 percent.

Since the beginning of this year, the annual rate of growth of these two magnitudes has been a little higher—6¼ percent for the narrow money stock and 13½ percent for total bank loans and investments. For one category of credit—namely, business loans of commercial banks—the annual rate of growth has been much higher, in fact over 20 percent during the first half of this year.

Clearly, the American economy is not being starved for funds. On the contrary, growth of money and credit is still proceeding at a faster rate than is consistent with general price stability over the longer term.

Yet, the demand for money and credit has been rising at a very much faster pace than the supply. This huge and growing demand for borrowed funds reflects the continuing strength of business capital investment; it reflects the efforts of many firms to rebuild inventories that were depleted by earlier shortages and slow deliveries; it reflects the inflated prices at which inventories must now be replenished; and it reflects, to some degree, anticipatory borrowing by those who fear that credit may later be unavailable or be still more costly.

In any event, with the demand for credit expanding much more rapidly than supply, credit markets have tightened, and interest rates have risen to levels such as we have not previously known in over a century of our Nation's recorded experience.

For example, the rate of interest that commercial banks charge on short-term loans to their largest and best known business customers has risen to 12 percent. In recent weeks, many of these same business firms have been paying from 11½ to 12¼ percent in the commercial paper market. Long-term interest rates have also risen substantially. The highest grade corporate bonds are selling at yields around 10 percent; rates on tax-exempt securities have been averaging about 6½ percent. Homebuyers now face mortgage interest rates of 9 percent or more.

These interest rate levels are disquieting. They cause difficulties for many individuals and pose a threat to the viability of some of our industries and financial institutions. But we cannot realistically expect a lasting decline in the level of interest rates until inflation is brought under control. When the rate of inflation is 11 or 12 percent, an interest rate of even 10 percent means that the rate of return to the lender in real terms, is negative.

Evidence is accumulating that the restrictive policy pursued by the Federal Reserve is helping to moderate aggregate demand by reducing the availability of credit to potential borrowers and disciplining inflationary psychology. In the first half of last year, the credit extended to private domestic borrowers increased at an annual rate of $165 billion and amounted to about 14½ percent of the priavte component of the gross national product. Estimates for the first half of this year suggest that the rate of aggregate private credit expansion has fallen to about $145 billion, or 11½ percent of private GNP.

Of late, many businesses attempting to borrow at commercial banks have found it more difficult to obtain loans. The public securities markets have also been less receptive. Since the beginning of this June, cancellations or postponements of corporate bond and stock offerings have amounted to almost $2 billion. State and local governments have also been affected; cancellations or postponements of municipal security offerings since early June have amount to about $800 million.

Some sectors of our economy now face unusually difficult problems. The housing industry—which had already been suffering from the erosion of workers' purchasing power, from rising construction and land costs, from fears of a gasoline shortage, and from overbuilding in some areas—is now experiencing added hardships because of soaring interest rates and reduced availability of mortgage credit at savings institutions and commercial banks. Public utilities have also been caught in a squeeze; the rates charged to their customers have lagged behind the prices of fuel and other materials, while rising interest rates have been adding to the costs of debt service.

During the recent boom, some carelessness crept into our financial system, as usually happens in a time of inflation. Some commercial banks permitted their liabilities to grow much faster than their capital. They also allowed dependence on volatile funds—such as overnight loans from other banks, certificates of deposit, and Eurodollars—to reduce their liquidity. The great majority of our banks have been managed prudently; but in some instances unhealthy practices have turned up—such as speculating in foreign exchange or acquiring large amounts of long-dated securities.

Striving for quick profits is a characteristic feature of an inflationary boom. In fact, our entire business system has come to rely on credit too heavily, as so often happens in a time of exuberance. But financial adventuring on the part of banking firms—whether in the United States or abroad—is especially deplorable, since mistakes on the part of individual banks can have pervasive effects on the state of confidence.

Taken as a whole, however, the commercial banking system in the United States is entirely sound, and it can be counted on to continue to function efficiently. My judgment is based on the actual condition of our banks, and it reflects also the state of readiness of the Federal Reserve to deal with such temporary financial problems as may arise.

The Federal Reserve stands ready, as the Nation's lender of last resort, to come promptly to the assistance of any solvent bank experiencing a serious liquidity problem. Besides, the Federal Reserve has long had on hand well-laid contingency plans for assisting, if the necessity should arise, other types of enterprises experiencing liquidity problems.

The need to activate these plans appears remote. But the resources of the Federal Reserve are enormous, and there should be no uncertainty about our readiness to deal with financial emergencies.

Tensions in financial markets have lessened in recent weeks, but they may continue to trouble us until more evidence appears that the rate of inflation shows promise of diminishing, There are a few hopeful signs that price increases may abate during the second half of this year, but they are inconclusive.

The role of the special factors that served to accelerate price increases during the past year or two is now waning. Food and fuel prices have recently contributed less to the rise in the consumer price level than they did in 1973 or early 1974. The boom in our own economy and that of other nations has tapered off, and the pressure of demand on available industrial capacity should therefore continue to diminish.

The underlying problem of inflation, however, remains very grave. The Federal budget continues to be in deficit. Farm prices, which had a downward trend during the past 10 months, have again staged a spirited recovery in the past few weeks. Shortages of materials and component parts—for example, steel, aluminum, coal, bearings, electric motors, forgings—continue to be troublesome.

Most serious of all, the rise of wage rates has accelerated sharply this year, while industrial productivity has been stagnating. Hourly earnings in the private nonfarm economy rose at an average annual rate of 10 percent during the second quarter, and labor costs per unit of output rose faster still.

Progress can still be made this year in slowing the rate of advance in our price level, and it is urgent that we do so. We must face squarely the magnitude of the task that lies ahead. A return to general price stability will require a national commitment to fight inflation this year and in the years to come.

For a time, we should be prepared to tolerate a slower rate of economic growth and a higher rate of unemployment than any of us would like. A period of slow growth is needed to permit an unwinding of the inflationary processes that have been built into our economy through years of neglect. I believe the American people understand this, and are prepared to make the sacrifices necessary to stop inflation.

There are, of course, risks that a period of slow economic expansion will lead to a gradual weakening of demand for goods and services, to a deterioration in the economic outlook, and to cumulative recessionary tendencies. Public policy cannot ignore this possibility. But the principal danger our country faces today is from the corrosive effects of inflation. If long continued, inflation at anything like the present rate would threaten the foundations of our society.

The proper course for public policy, therefore, is to fight inflation with all the energy we can muster.

Monetary policy must play a key role in this endeavor, and we in the Federal Reserve recognize that fact. Our actions this year have signaled a firm resolve to stick to a course of monetary restraints until the forces of inflation are under good control. We are determined to reduce over time the the rate of monetary and credit expansion to a pace consistent with a stable price level.

However, monetary policy should not be relied upon exclusively in the fight against inflation. Fiscal restraint is also urgently needed. Strenuous efforts should be made to pare Federal budget expenditures in fiscal 1975. The Congress should resist any temptation to stimulate economic activity by a general tax cut or a new public works program.

Greater assistance from fiscal policy in the fight against inflation could, I believe, have dramatic effects on our financial markets. Even if no change were made in the course of monetary policy, interest rates would tend to fall and the stock and bond markets revive. Such developments would be of enormous benefit to the working of financial markets and to industries such as homebuilding that depend heavily on credit.

There may well be justification for governmental assistance to housing or other activities that are especially hard hit by a policy of monetary restraint. An expanded public-service employment program may also be needed if unemployment rises further. But Government should not try to compensate fully for all the inconvenience or actual hardship that may ensue from its struggle against inflation. Public policy must not negate with one hand what it is doing with the other.

There are other actions that would be of help in speeding the return to general price stability. Fresh efforts should be made to bring our Nation's business and labor leaders together to discuss their common interest in checking the wage-price spiral. A degree of governmental intervention in wage and price developments in pace-setting industries might also be helpful. In the construction industry, the pace of wage increases is once again accelerating, and the progress made earlier through the Construction Industry Stabilization Committee could easily be lost. Reestablishment of that committee would be in the public interest. The Board of Governors would also urge the Congress to reestablish the Cost of Living Council and to empower it, as the need arises, to appoint ad hoc review boards that could delay wage and price increases in key industries, hold hearings, make recommendations, monitor results, issue reports, and thus bring the force of public opinion to bear on wage and price changes that appear to involve an abuse of economic power.

Encouragement to capital investment by revising the structure of tax revenues may also be helpful, as would other efforts to enlarge our supply potential. For example, minimum wage laws could be modified to increase job opportunities for teenagers, and reforms are still needed to eliminate restrictive practices in the private sector—such as featherbedding and outdated building codes. We also need to enforce the antitrust laws more firmly and stiffen penalties for their violation.

A concerted national effort to end inflation requires explicit recognition of general price stability as a primary objective of public policy. This might best be done promptly through a concurrent resolution by the Congress, to be followed later by an appropriate amendment to the Employment Act of 1946. Such actions would heighten the resolve of the Congress and the Executive to deal thoroughly with the inflationary implications of all new governmental programs and policies, including those that add to private costs as well as those that raise Federal expenditures.

This illustrious committee has on past occasions provided timely and courageous leadership to the Congress and to the Nation. The opportunity has arisen once again for the Joint Economic Committee to help our country find its way out of the great peril posed by raging inflation. Our people are weary, and they are anxiously awaiting positive and persuasive steps by their Government to arrest inflation and to restore general price stability. The Federal Reserve pledges to you its full cooperation in your search for ways to restore a stable and lasting prosperity.

Thank you.

Senator PROXMIRE. Thank you, Mr. Burns, for another brilliant statement, and for a most welcome, well-balanced series of proposals for meeting our most serious problems.

Mr. Burns, you have been a close friend and supporter of President Nixon for many, many years, and I think an extremely valuable counsel to the President on many occasions. It has been publicly reported that you have been to the White House; however—I should put it this way—you have not had a private meeting with the President this year since January 1.

Is this the case or not?

Mr. BURNS. That is the case. But I would not exaggerate the importance of that. I have participated in several quadriad meetings. I speak my mind fully and freely on practically all occasions. On those occasions when the quadriad met, the President was aware of my views, he learned from me what he would have if I had met with him privately.

Senator PROXMIRE. How many formal meetings of the quadriad have you attended since January 1?

Mr. BURNS. I would have to check my records. I think three or four. But these are not formal meetings. They are very informal.

Senator PROXMIRE. Mr. Burns, in your past meeting with the President, did you meet with him usually at his request or did you call to ask the President if you could see him, or was it both your initiative and his initiative?

Mr. BURNS. We have done it both ways.

Senator PROXMIRE. Have you taken the initiative in the past year to ask the President to see you?

Mr. BURNS. I have not taken the initiative in the past few months.

Senator PROXMIRE. In view of the overwhelming importance of the Presidency of the United States in economic policy—only he can appeal to the country, and only he can initiate many actions; he is the No. 1 legislator, even though we have our separation of powers—I think it is unfortunate that a man of your very great ability—and everybody acknowledges your high competence in this area—has not for one reason or another counseled with the President.

Mr. BURNS. Let me just state for the record that I have written to the President from time to time; I think he knows my views pretty well.

Senator PROXMIRE. As you know, with policies as complex as those of our economy it is a matter of give and take, a matter of your giving your views and his giving his, learning from each other and understanding your position. It is one thing to read in a newspaper and another to hear from a third person what your views are. It would seem to me that there is just no substitution for direct, personal consultation with the President.

Do you agree with that?

Mr. BURNS. I agree with that.

Senator PROXMIRE. Mr. Burns, I think you are right about fiscal policy—as you know, you and I both called for a sharp reduction in spending—I think you are right about monetary policy and about wage restraints. But acknowledging all that, it seems to me that even if we were following the kind of fiscal policy you and I proposed, and the kind of monetary policy you are pursuing, and the kind of wage restraint that you advised, that we still would suffer from the most serious aspects of our inflation.

I think few people realize what has happened.

Steel has increased in price by 30 percent in the last year. I defy you or any other economic historian to give me any other year in our history when steel increased by 30 percent. I have gone back this morning, and I find it increased sharply after World War II, but nothing like that amount.

I find that chemicals increased in price by 30 percent last year. There was only 1 year in our history when chemicals increased that much.

Nonferrous metals increased by 48 percent; oil, by 82 percent.

Isn't it a fact that no matter what of fiscal or monetary policy which we followed, they couldn't have a significant effect on these immense price increases? Nobody can tell me that if we had greater restraint in wage increases we would have a lesser inflation in any of these areas, or indeed if we had a fiscal policy under which we had a balanced budget or a surplus that it would have had a significant effect in most of these areas. Don't we need something more than the traditional tools to cope with the kind of inflation we suffer from?

Food is another example. Of course that has been the big one. There are indications that it may be very bad in a few months.

I can't see fiscal policy or monetary policy helping very much. So what do we do to meet these very large increases in the fundamental costs of our economic society.

Mr. BURNS. Senator, it will take some time to unwind the kind of inflation that we have been experiencing and are now in the midst of.

To give just one example, public utility rates at the present time have been lagging, and because they have been lagging our public utilities industry is in great difficulty. That isn't the only reason, but it is the major reason. I have no doubt that the public utility rates need to go up, in the interest of some balance in our economy.

Now, this will release new inflationary forces. Our price system is now in disequilibrium, and time will be needed before this process of inflation is unwound. Fiscal policy can help, and monetary policy can help, and some of the other proposals that I have made will help.

Senator PROXMIRE. How long will it take, Mr. Burns? You say it will take some time, 3 or 4 or 5 years?

Mr. BURNS. The truth is that neither I nor anybody else knows. We should be prepared for this unwinding process to last 2 years anyhow, and it may last a good deal longer.

Senator PROXMIRE. When we have a situation where we have an increase in steel prices of 30 percent and an increase in profit of 54 percent by steel, an increase in chemicals of 30 percent and an increase in chemical profits of 60 percent, and in nonferrous metal 48 percent increase in price and a 145 percent increase in profits, and in oil an increase of 82 percent in price and an 82 percent in profits. Obviously these companies are taking extraordinary advantage of the situation. In some cases, not in the case of steel, but in other cases this is based on a good profit year the year before. It seems to me that there is something wrong with our antitrust laws, and we weren't following through with the kind of public discussion and jawboning, identification of unjustified price increases as we should be in a much more vigorous way.

Isn't that correct?

Mr. BURNS. I agree with all that.

Senator PROXMIRE. You have proposed in your statement that we—you had one sentence on the antitrust laws—

Mr. BURNS. It is a powerful sentence, if you read it carefully, Senator.

Senator PROXMIRE. It is a powerful sentence. But don't you feel that the Government should find a way of combining the power we have, the procurement power, the antitrust power, and the enormous publicity power the President of the United States has, to make a real fight to hold back and certainly prevent any future price increases of anything like this kind?

Mr. BURNS. We certainly should strive to accomplish all that.

Senator PROXMIRE. Under these circumstances if we rely as heavily as we have on monetary policy, with some meager help—and it seems to be meager on the basis of what the Congress is doing lately and on the basis of what the President is doing on fiscal policy—it seems to me that the impact on housing and State and local governments and small business is going to be disastrous. During this period that you have discussed, of indeterminate length—it may be 3 or 4 years—housing is likely to be under an enormous handicap. They are already going under the wringer. State and local governments, small business—you stated in your statement that we must tolerate a slower rate of growth and higher rate of unemployment. It seems to me the risk is not just cumulative from the standpoint of what might happen, but also the actions of the Federal Government to counteract it, the political realities that we have to deal with. As a member of the Senate I am very sensitive to the fact that neither the American people nor the Congress are going to stand still for this kind of a slowdown, this kind of burden in these areas, they are going to act. So it would seem to me that we can't simply say it is going to take time to shake it up, just be patient. The people are not going to be patient. If we live up to the provisions of the Employment Act of 1946, we simply can't let unemployment go to 7 percent, or 6½ percent, for that matter, it would seem to me.

So what is your advice under these circumstances? Don't we have to find some way of more effective action in a shorter time than simply saying that it will take years, and we simply have to be patient?

Mr. BURNS. You may notice that in my statement I recognized the need, in the event the unemployment rate rises, for ameliorative steps by the Government. Without going into detail, I suggested that a good way—in fact, in my judgment probably the best way of doing that—would be to expand public service employment. This could be done through a triggering device. I have worked on this in some detail, and if you are interested, I will present it to you.

Senator PROXMIRE. The difficulty is, you see—the general language in your statement is that we mustn't go too far, or stimulate.

Mr. BURNS. I will present for the record if you like a plan in some detail.

Senator PROXMIRE. Fine.

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

AN EXPANDED PUBLIC SERVICE EMPLOYMENT PROGRAM

Such a program could be triggered if and when the national unemployment rate averaged more than 6 percent for a three-month period. Assistance would be directed to local areas, as designated by the Department of Labor, where the unemployment rate was higher than this average, say, 6½ or perhaps 7 percent.

The program could be detriggered when the national unemployment rate fell below 6 percent for a three-month period. Once this occurred, no new employees could be added to the program, and funding would be terminated entirely in 90 days.

Some basis for administrative flexibility would be desirable in order to avoid an overly mechanistic approach to the program's triggering and detriggering provisions. To this end, the President, with the concurrence of the Congress within 30 days (under special rules of procedure), could be given authority to hold up triggering of the program at the 6 percent unemployment rate, to detrigger before unemployment had fallen below the 6 percent level, and perhaps also to hold up the detriggering for a brief period—even after the unemployment rate had fallen below the 6 percent level.

It is recommended that the average compensation under the program be limited to an annual sum of $5,000 and that total funding not exceed $4 billion. This would permit the employment of 800,000 temporary workers on average for a full year, and probably more during periods of peak need.

The program would be administered by State and local governments, under direction of the U.S. Department of Labor, perhaps assisted by advisers drawn from the ranks of personnel managers in private industry. It would be anticipated that employees under the program will be put to work at useful pursuits as determined by the employing governmental unit.

Such a public service employment program would make it possible for the Federal Government to continue longer with a basically restrictive economic policy as inflation is being brought gradually under control. Fears of the damaging social effects of widespread unemployment—which is always an obstacle to effective inflation control—would be calmed.

The program is inherently flexible and responsive to changing circumstances. It could be triggered in and triggered out, both nationally and locally, as economic conditions may require. Since the program is a contingency plan, it might in fact involve no budget expenditures. In any event, outlays of as much as $4 billion in a full fiscal year would be extremely unlikely.

The recommended average wage of about $100 a week is low relative to private rates of pay. Quite apart from budgetary implications, there needs to be a strong incentive for the temporary public employees to shift to private sector jobs as these become more readily available.

A partial source of financing the program could be an increase in the minimum Federal income tax from 10 percent to 20 percent (which probably ought to be done in any event, for reasons of equity). Another possibility is a higher Federal gasoline tax (which may be desirable in its own right as a conservation measure); such a tax could not only fund the public service employment program but also finance an income tax credit to reimburse lower-income groups for the higher gasoline tax.

Senator PROXMIRE. Does this mean that you would trigger public service employment with, say, 6 percent unemployment?

Mr. BURNS. Definitely, yes.

Senator PROXMIRE. It would trigger that to the extent of providing enough jobs so that you wouldn't have more than 6 percent unemployment in the future, is that the way it would operate?

Mr. BURNS. I don't know how to guarantee that, Senator. All that I can propose, and all that any honest man can really say on this subject, is that if unemployment rises, steps will be needed to deal with it. We should take steps of a kind that will not commit us to permanently expand it. The public service employment program is something that could be triggered in and triggered out. I would be entirely willing, in the event that unemployment rises to a 6-percent level, to see legislation that would provide for some 800,000 jobs, say, which is not insignificant.

Senator PROXMIRE. Thank you very much. That is most helpful. My time is up.

Senator Percy.

Senator PERCY. Mr. Burns, I would like to join the chair in thanking you for this testimony. In a city in which credibility is tested constantly, your credibility before this committee and before the American people has never been subject to doubt. Your forthright statements are once again deeply appreciated.

The Chair asked you about your meetings with the President. There is a meeting today at 3:30 p.m. with the Cabinet.

Do you have any reason to believe that that meeting will deal with the No. 1 problem in the country, inflation?

Mr. BURNS. I don't know what the subject of this Cabinet meeting is.

Senator PERCY. Is it rather unusual that the Cabinet has met so infrequently, and the time and attention given to economic problems has been so little, when the problem of inflation is without any question the No. 1 problem in the minds of the American family, business and labor? Has this problem really been given only haphazard attention this year?

Mr. BURNS. Without quarreling with that statement or contesting it in any way, I would merely say that I attended a breakfast meeting this morning which started at 7:30. It was a meeting in the White House. Five of your colleagues in the Senate were there. That meeting was attended by Mr. Rush, Mr. Ash, Mr. Simon, Mr. Stein, and myself. That meeting did deal with the subject of inflation.

Senator PERCY. Is it your feeling that economic issues are being moved up to a very high priority and a very important place in the administration's thinking now?

Mr. BURNS. I am an impatient man. While I think that economic matters are being attended to in the White House. I would like a little more energetic action, yes.

Senator PERCY. David Rockefeller, over the weekend, used the word "panic" in a front page story in the Washington Post that was picked up across the country. From a conservative banker this was a rather shocking word to use. I see no use of that phraseology or even the feeling of panic in your own considered statement. Certainly you point with concern, deep concern, to certain areas. But do you have any basis for believing that we are on the verge of a panic?

Mr. BURNS. No, I do not. I tend to approach problems of this sort in a cool manner, especially when other people get emotional and panicky. It is a time when a cool head helps.

Senator PERCY. I think the word was used by Mr. Rockefeller as a warning to his fellow bankers to be certain that their financial houses are in order, that they do not put profits ahead of soundness. I see in your statement sufficient warnings of that, and probably the combined statements would be adequate warning, then, that just pressing for the last dollar of profit would be inexpedient and certainly the wrong course.

Mr. BURNS. I endorse heartily your comments, Senator. This is a subject on which I could become eloquent, but I will not do so now.

Senator PERCY. It has been said that the stock market is subject to three forces, the three I's: Inflation, interest rates, and impeachment. I would like to have your comment on all three of those. Could we start with the subject you have not mentioned in your testimony, impeachment.

How much of our present uncertainty, how much of our present inflationary forces, depression in the market—which puts pressure on debt, and removes away the possibility of equity financing to renew businesses and the expansion of existing businesses and distorts the economy—how much is attributable to the uncertainty surrounding the impeachment question? How will we resolve this question and get on with the Nation's business once we get this behind us in a proper fashion?

Mr. BURNS. That is a very difficult question to answer, Senator. My own impression, like that of most people, is that impeachment is adding to uncertainty in the business and financial world, and that this is exercising a negative influence. But when you try to document an opinion like that, you run into difficulties.

For example, while the Judiciary Committee was holding its hearings, I felt it my duty to watch with special care hour by hour, what was happening in the most sensitive market of all; namely, the foreign exchange market. The foreign exchange market was remarkably stable. I believe the dollar actually, on balance, strengthened during that period.

This does not conform to commonsense, but it is a fact. Therefore I can only repeat, my impression is that it is a negative influence. Thinking about the matter, I can't see how it can be anything else. Looking for evidence it is hard to come by hard evidence. I do draw one conclusion; namely, that many of us, perhaps most of us, have come to exaggerate the importance of what happens in this city as far as our economy is concerned. The strength of our economy lies in the thinking and the actions of the American people. They go on planning their lives, affected by what is going on in this city, but fundamentally moved in the larger sense by their own considerations.

There is great strength in the American people and in our economy. We must never assume that what we do here in Washington, important as it is, is decisive for the fortunes of the American economy.

Senator PERCY. I will concur with that.

Now, as to inflation, you stated in your statement the proper course for inflation is to fight it with all the energy we can muster. I would like to ask your reaction to some approaches that have been taken to the economy. It has been suggested, and will be suggested again, that we reduce taxes, personal income taxes, by increasing the personal exemption.

Do you feel, as I do, that would be a disastrous course for us to go on and that we should resist the temptation even in an election year to reduce taxes?

Mr. BURNS. I join you completely in that, Senator.

Senator PERCY. Is it possible to increase taxes so that it would benefit the economy but not remove incentives for exploration and development, for instance, for oil?

Are there some taxes that could be increased with some effect to help narrow the gap or remove the budget deficit in 1975?

Mr. BURNS. That would be possible. But I think I would concentrate on the expenditure route.

Senator PERCY. How deep do you think we can go? We have a range from the Cabinet figures of Mr. Ash of maybe $2 or $3 billion, to those of Secretary Simon of about $10 billion, and I have heard some reports as high as $20 billion.

What is your own feeling as to what we can actually take out of the fiscal 1975 budget, taking into account that we are already in that year?

Mr. BURNS. I think we could reduce our planned expenditures for fiscal 1975 quite safely anywhere from $5 to $10 billion. And we should try to shoot for the higher mark.

Senator PERCY. I concur once again, and I think the Chair does.

From the standpoint of interest rates, what do you foresee ahead, and what forces or changes have to be made in the fight on inflation in order for interest costs to be brought down?

Mr. BURNS. In my judgment, if there is persuasive evidence in the country that Federal expenditures are being cut back, it would lead at once to some decline in interest rates.

That decline could become very large if evidence accumulated that inflation is actually being brought under control. In our country as elsewhere, the rate of interest will adjust to the rate of inflation. When the rate of inflation comes down, the level of interest rates will also tend to move toward lower levels.

Senator PERCY. Thank you. My time is up.

Senator PROXMIRE. Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Vice Chairman. And thank you, Mr. Burns. Your statement as always is fascinating.

I also appreciate the comments you made about the committee and its courageous leadership in past years.

It seems to me that this year what we need, before we develop the courage, is a plan. It concerns me that 10 years ago we knew what the economic goal should be, and it was just a question of whether we had the courage to impose a tax when we got into Vietnam and things like that. But I wonder if we aren't in an entirely different economic ball game than we were 10 years ago. Maybe we are too constrained in thinking only of remedies which were applicable 10 years ago.

We have had the economies of the industrialized world in a simultaneous boom, and the lesser developed countries are finding that they can unilaterally or multilaterally increase the prices of their commodities. As you said so eloquently in your statement, the current inflation is worldwide in scope. So when we talk to the people of this country about what we can do to control inflation domestically, whether it is by monetary restraint or fiscal policy, I don't think we can sell the same old policy. If you have a worldwide problem, you can't solve it on less than a worldwide basis.

I think we need some new economic thinking, Mr. Burns. Do you agree with me?

Mr. BURNS. I would welcome some new and sound economic thinking, yes.

Representative MOORHEAD. Certainly, I wasn't suggesting unsound new thinking. But maybe you should be getting some young person of a generation below yours and mine, to develop some new ideas.

Mr. BURNS. Don't discriminate against aging individuals.

Representative MOORHEAD. I don't mean to discriminate against anyone, Mr. Burns. I just think we need a new pathway. I am not saying that the old path is bad, but I just don't think it is enough.

I think if we had perfect fiscal restraint, perfect monetary restraint in the United States, we would still be facing a worldwide inflationary problem, from which we couldn't isolate ourselves.

Mr. BURNS. The simple answer to that is, yes, you are entirely right. But I am not going to stop there.

I want to make two comments. First, the foreign trade in our economy is a relatively minor factor. So that while there may be price-raising influences coming from the outside, let's not exaggerate the overall impact. That is point No. 1.

Point No. 2, the United States is recognized around the world as the leader in economic policy. If we pursue policies here which restrain inflation, the policy that we pursue will spread across the world, and we will lead the world in curbing inflation rates.

I am speaking, of course, only in the context of the industrialized sector. That is the main part, economically speaking.

Representative MOORHEAD. That is a very good point, Mr. Burns. If we, as the economic leader of the free world, can control our inflation, it will be an example and an influence on the rest of the world.

Mr. BURNS. Exactly; yes.

Representative MOORHEAD. I take it from your discussion with Senator Percy that you think that the most effective policy we could have now is fiscal restraint, and that you would exercise restraint particularly on the expenditure side. Is that correct, sir?

Mr. BURNS. Yes.

Representative MOORHEAD. Now, getting back to courageous policy. We all have to recognize that when we face an election that we do have to have some courage here. But let me point out to you that one of the things that the people back home object to is the thought that the military budget is used to stimulate the economy, and that the expenditure restraint is on the social programs.

I think they would accept reductions in social programs if they were accompanied by reductions in expenditures for the military-industrial complex. But without that I think they would feel that they are being singled out for excessive sacrifice.

There are other things in your statement that are particularly interesting. It seems to me that with leadership from Washington, we could begin to practice extensive conservation, particularly with respect to the use of oil and other commodities. We should create the attitude in this country, that the good things in life aren't just from increasing quantity, but rather from increasing the quality of life. This, in my opinion, would be an extremely significant anti-inflationary move.

I would say that I agree with you that we sometimes exaggerate the importance of the effect of this city of New York City on the economics of the entire country. We forget that the basic economy across the Nation is a lot better than either Wall Street or Pennsylvania Avenue thinks it is.

Last week Walter Heller testified before this committee and suggested that the continuation of the present monetary and fiscal policies might well lead to an unemployment rate of 7 percent. Yet in your statement you say: "The demand for labor has remained strong."

Are those two statements inconsistent?

Mr. BURNS. No, I don't think they are inconsistent. I commented on the present situation and the recent past. Mr. Heller commented on what he sees looking into his crystal ball.

Representative MOORHEAD. Does your view of the crystal ball differ from his?

Mr. BURNS. Well, I haven't been blessed with as good a crystal ball as other economists. I do believe that unemployment is likely to rise. But whether it will go to 5½ or to 6 or to 7 percent, I simply don't know. I marvel at my professional colleagues who know everything down to a decimal point looking into the future. A good scholar knows much less even about the past.

Representative MOORHEAD. Let me see if I can summarize what I think you said in response to the vice chairman's questions. If the policies of fiscal and monetary restraint did result in an increase in unemployment, the solution should not be across the board expansion, but rather a rifle shot policy to aid the particular geographic areas or population groups who suffer high unemployment. Is that correct, sir?

Mr. BURNS. That is precisely my thought. Public service employment has two benefits. You can trigger it in and trigger it out as conditions warrant.

You can trigger it in and trigger it out in individual localities, as conditions develop in those localities.

Representative MOORHEAD. Even though you disavowed the existence of the crystal ball, it does seem to me that in your statement you were giving us a rather optimistic look ahead by saying that the boom has tapered off, and the pressures of demand on available industrial capacity should therefore continue to diminish.

Am I reading too much optimism into that statement?

Mr. BURNS. The very next sentence is the answer to your question. The very next sentence reads: "The underlying problem of inflation, however, remains very grave."

And I go on to cite reasons for that judgment.

I wish I could be optimistic about the general price outlook. As yet I cannot be.

Representative MOORHEAD. Thank you, Mr. Burns. My time has expired. I appreciate your testimony.

Senator PROXMIRE. Congressman Brown.

Representative BROWN. Mr. Burns, it is always delightful to see you here.

Do I understand from the thrust of your formal presentation and your responses to the questions I have given that if Congress and the administration don't cut spending and balance the budget, that you are going to keep the screws tightened down on the money supply and handle the problem of inflation as you can to the degree that you can?

Mr. BURNS. I would not link the two that closely or that mechanically. In fact, I can visualize circumstances under which, without visible cutbacks in Federal expenditures, it might still be the judgment of the Federal Reserve that monetary policy should be relaxed. The two are related, but there is no simple mechanical or very close relation between them.

Representative BROWN. Of course, you did not mention the prospect that if we don't cut back that you would relax the money supply. So I guess that is not one of the alternatives.

Mr. BURNS. What we try to do in monetary policy depends on economic and financial developments. Those developments we can foresee only very imperfectly. Therefore, in the absence of fiscal action, conditions might develop, to be sure, when we would ease up on our monetary policy. That could happen, for example, if the rate of inflation clearly diminished.

Representative BROWN. If the administration and the Congress don't cut Federal spending and don't try to balance the budget, and the screws are kept tight, I guess that what we would face is the prospect of higher interest rates, or at least continuing high interest rates with the resulting limits on investments that result from those interest rates. I saw where one of the suburban communities in Washington, for instance, just cut its plans for expansion because of the high interest rates. It seems to me that this lack of investment then raises the immediate prospect of the possibility of increased unemployment.

So I would like to turn it around and ask, if we want to try to avoid an increase in unemployment, and if we do cut spending and show the necessary fiscal restraints, would it be possible that we could ease up some on the money supply and thus encourage private expansion by having some more investment funds available, so that the private sector could take up the slack of reduced Federal spending?

Mr. BURNS. Well, the answer is, it would certainly be possible. If the Federal budget were cut back, we in the Federal Reserve, of course, would give that some weight, perhaps very considerable weight. But I cannot give you my promise as to what Federal Reserve action would be in that event. That would depend on unfolding circumstances.

Representative BROWN. As I understand, in response to other suggestions you suggested, we might cut the Federal budget by $5 to $10 billion. With about 30 percent of our Federal budget being in controllable expenditures and the rest being in so-called noncontrollable, that would mean a cut of $5 to $10 billion from a budget of only approximately $90 billion.

Senator Proxmire has proposed a $10 billion cut in the total budget which, if you apply it only to the noncontrollables, is about 11 percent on the basis of the fiscal year. Of course, we are into the fiscal year and this hasn't passed our House of the Congress yet. The question is, are we going to be able to cut enough out of the so-called controlled costs to get in a $5 to $10 billion cut, or are we going to get some new thinking on what our controllable expenses and what our uncontrollable expenses of the Government are?

Senator PROXMIRE. Will the gentleman yield?

My position was that we could cut $10 billion. My position also is that if the President would ask the Congress to pass a resolution which would make the impounding action unnecessary, but would provide authority to the President to withhold temporarily spending on highways, and spending in other areas where they are fixed, that I would feel that that would help and reach a much larger proportion.

Mr. BURNS. Well, the term "controllable" and the term "uncontrollable" as used by budgetary authorities continues to trouble me. I have my own definition. My own definition of what is uncontrollable is as follows:

Interest on the public debt is an uncontrollable expense; contracts calling for payment of money during a given fiscal year are uncontrollable expenditures; and certain minimum number of Federal employees, I would call that also an uncontrollable expense. Everything else is controllable.

Congress after all is in the business of legislating. Congress can legislate cuts in programs. Therefore, if the Congress saw fit to do so, much larger cuts than the $5 to $10 billion that we have been talking about could be made.

Now, whether that is desirable or not, or whether it is achievable or not, are separate questions.

I feel very uncomfortable when I am told that only a very small part of the budget is controllable. Statements like that proceed on the assumption that we have no Congress, that the Congress can't legislate. That is ridiculous. A Congress which has legislated various spending programs could add to those programs, could subtract from those programs, could add new programs, and could eliminate old programs.

Representative BROWN. I notice that you have left out such things as trust fund, automated increases in social security, and retirement of civil service personnel, and the military and so forth.

Mr. BURNS. I have. Those expenditures are based on existing legislation which can be left intact, or which may be changed.

Representative BROWN. May I move to the unified budget.

Are we ignoring things that have a significant impact on interest rates and inflation, such as the guarantees on loans for housing, student aid, railroads, aircraft companies, that sort of thing, and the impact of those on Federal borrowing and interest rates?

Mr. BURNS. I think we are. Take fiscal year 1974. The Federal budget deficit, under the unified budget, was $3½ billion in that fiscal year. That is the figure that is normally cited. It is not a figure that I work with exclusively. I start with that figure. Then I add the budget outlays, which in that year came to $2.4 billion. Then I add also the net outlays by Government-sponsored agencies, which came to $15 billion. Therefore, taking this enlarged, and to my mind true, Federal sector, you have a deficit not of $3.5 billion but of $21 billion. That is the deficit that has to be financed. When the Federal Government goes into the market for $21 billion of money net, that inevitably has an effect on interest rates.

Representative BROWN. So that $3.5 billion really is a figure to make politicians and taxpayers feel a little more comfortable, but it really doesn't have anything to do with how much money the Federal Government is borrowing, the impact that borrowing has on interest rates, and what that does to all of us on inflation.

Mr. BURNS. Well, I wouldn't describe it just that way. I would say it is an incomplete figure.

Representative BROWN. I would like to come back to that budget if I have time, but for now I have one other question I would like to ask.

I switch to a comment you made in your statement, operations are not involved in and impacted by international trade and money markets, and floating exchange rates, and that sort of thing.

Do we need a new banking law to eliminate what you referred to in your statement, that some carelessness has crept into our financial system?

Mr. BURNS. Yes, I think we do. And before too many months pass, the Federal Reserve will come forward with a reform program, one that I think we need badly.

Representative BROWN. As I understand it, we talk about a two-tiered banking system in this country, but we really have regulation of the banks by about four or five different agencies, is that correct?

Mr. BURNS. Well, more than that. You have the Federal Reserve. You have the Comptroller of the Currency. You have the Federal Deposit Insurance Corporation. You have the State banking commissioners in 50 States. And there are large areas of our banking system that are totally unregulated.

Representative BROWN. With all that regulation, with all those choices——

Mr. BURNS. With all that regulation we still have gaps, and we have a curious spectacle, that if a bank doesn't like one regulator, it can just turn around and choose another regulator. This is not a healthy condition. I am not going to be popular among bankers when I say this, but it is time to call a spade a spade.

Representative BROWN. We wind up with the Franklin National Bank and with the local banks in the Washington area investing in industrial wines, whatever they are, and a few other things. This seems to me to be rather unhealthy for our system, and certainly would have an impact on inflation, since many of those bank loans are insured. It seems to me that if we got into a collapsing banking system in this country, then we would surely move into more inflation, because you would wind up printing more money in order to pick up all those guarantees, wouldn't you?

Mr. BURNS. If you ever got into a collapsing banking situation, you would have a depression, and we would worry about that rather than inflation. But we are not going to have a collapse of our banks, nothing like that.

Representative BROWN. We were very close that that, however, with one major bank, weren't we?

Mr. BURNS. One major bank was in real difficulty, yes. But that is only 1 out of 13,000 banks in this country.

Representative BROWN. My time is up, Mr. Vice Chairman.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. I am delighted to welcome you here. I broke away from a meeting in the Foreign Relations Committee to have the privilege of asking you a few questions.

I understand that you have already commented in response to Vice Chairman Proxmire's questions about a standby program for public service jobs. I understand that you could support the figure of 800,000 jobs being triggered by a 6-percent unemployment rate.

Is that a correct figure?

Mr. BURNS. That is a correct statement.

Senator JAVITS. The bill that I have introduced with Senator Nelson contemplates 500,000 jobs at a total cost of $4 billion.

Mr. BURNS. My figure is $4 billion, but I get 800,000 jobs out of it whereas you get 500,000. The difference must be that I assumed a lower average wage for public service employees than you did in your calculations. Whether your figure is more nearly correct than mine I don't know.

Senator JAVITS. But my figure is based on the early experience under the Emergency Employment Act.

Mr. BURNS. Your figure is based on experience, yes. Under the existing program the average wage for public service employees has been $8,000. Using that figure, you will get your results. That is the way you proceeded. I lowered the figure from $8,000 to $5,000 and then got mine. This is clearly, you see, an area for judgment.

Senator JAVITS. I really have no quarrel with that, except to point out that I was bound by the Emergency Employment Act which we have now been through, and that one of the big accommodations for my new proposed bill, which now seems to have sufficiently high level sponsors, from yourself, Secretary of the Treasury Simon—I don't mean that you have all endorsed the bill or anything like that, but there is a feeling that this needs to be done, and even encouraged—is its successful record. Within a month after the jobs ended 70 percent of the people were able to get other jobs. That is a fantastic result.

I am delighted to hear you say what you have, and we shall certainly pursue it, and we value greatly your advice.

I would like to ask you whether you think the Federal Reserve money policy is too tight in view of the following facts: One, the fact that you yourself recommend some tax advantages for equipment and modernization; and second, that we are, as it were, gambling with the weather in terms of the crops in this country, which don't look nearly as good as they did, and that that would again have a very restrictive effect upon those who are concerned with these raw materials, both in terms of the income they produce and of their export, bearing in mind that we don't want a sensational breakout of food prices, because of the lack of credit, and therefore, the necessity for sweating the consumer for all the traffic will bear.

Mr. BURNS. Well, Senator, I think we are on the right track in the Federal Reserve. Our policy is not imbedded in concrete. We, of course, will, as we always do, watch with the closest care the economic and financial developments.

You spoke of inadequate harvests. That is certainly true of the corn crop, the way things are developing.

But it would seem to me that a faster rate of monetary expansion in this country than we are having would be more likely to raise prices than to lower them.

You spoke also of some tax readjustments that I would favor. That is true. I would favor tax readjustments of the kind that would tend to stimulate investment. I think the volume of business capital investment that we have had, particularly in the raw materials industries, has been seriously inadequate, and has contributed to the recent two-digit inflation that we have been experiencing.

But any tax bill that I would subscribe to at the present time should have a neutral effect on the budget. While I would be inclined, for example, to modify the capital gains tax, the modifications that I would make would not involve a significant loss of tax revenue this year. And to the extent that they did, I would try to offset that by raising the minimum tax. I think the minimum tax of 10 percent is just too low. Raising it from 10 to 20 percent might not yield much revenue, but it would yield some, and it would, I think, promote equity, which is always important in a tax system.

So, I would make tax adjustments of a kind that would leave total Federal revenues substantially unchanged at this time.

Senator JAVITS. Would you raise the 7-percent rate or the 4-percent rate on investment tax cut?

Mr. BURNS. I don't think that at the moment that I would raise the 7-percent rate. I would raise the 4-percent rate affecting public utilities to 7 percent.

Senator JAVITS. Mr. Burns, I would like to say that I agree with you about both those matters, and I shall do my best in that regard.

But I would like to ask you this about utilities. They are in terrible trouble now on raising money. What do you think of the idea of some kind of RFC or other specialized Federal attention, as they are responsible for 40 percent of the capital invested in the country, and for an enormous part of its employment, and they are really up against it, paying rates of interest which simply cannot be paid based on the likelihood of speed in their rate adjustments?

Mr. BURNS. This is a matter that I have been giving attention to recently, and will be giving very much attention to during the coming week. I think that our public utility commissions are continuing to do business as usual in an abnormal time. In the case of numerous public utilities, rate increases are justified, needed, and essential. Delays such as we have been having can be cut back severely, and should be cut back. I think a mechanism can be found for achieving that.

Second, I think that some tax adjustments can be made. We mentioned one, a simple adjustment of the investment tax credit. The Treasury is developing some new ideas in that field. And I will be evaluating those.

Third, I think that our commercial banks should be particularly responsive to the needs of our public utilities by providing bridge loans.

Now, whether we should go beyond that and establish some agency resembling the old RFC is a question that does deserve consideration. But I have not reached any conclusion on that.

Senator JAVITS. Just one wrap-up question, Mr. Burns, which I think the country would be interested in because of your enormous reputation. You heard the President outline the administration's economic policy. It has been called the oldtime religion or the oldtime medicine. You have made some proposals yourself, like public service employment, a much more effective monitoring agency than the President has set up for wages and prices.

Would you give the country and the world the benefit of your opinion of what the United States ought to do in terms of the tone of its general fiscal and monetary restraint and budget reduction?

Mr. BURNS. I think that we have to start with the fact that the general public does not really understand monetary policy. It is something of a mystery to most of our citizens. Some have faith in the Federal Reserve. I wish there were more people who had faith in the Federal Reserve. Many do not. But there is one thing that people do understand. They understand that a reduction in Federal spending will mean a reduction in aggregate demand for goods and services, and that upward pressures on prices will be reduced to that extent. The public can also understand that when the Federal Government has a balanced budget, it does not need to go into the market to borrow. On the other hand, when the Federal finances are run at a deficit, the Government does enter the market to borrow and thereby serves to raise interest rates.

So I would put every emphasis on reducing Federal spending, not only because of the objective results, but because this would fit the psychology, the thinking of the people, so that governmental efforts in this direction and in other directions will become more credible to the American public.

I would start with that.

Next, I would recognize the fact of life—and what is the use of blinding ourselves to it—that in the kind of economy we have, there are abuses of economic power by some of our corporations and by some of our trade unions. And the simple device of ad hoc boards, which would have the power to delay price or wage increases in key pace-setting industries, and publicize the results of hearings and so on, I think this is something that the public could understand.

I think that it would win general support. I think it could be helpful.

The public also can understand the need to increase productivity. I didn't go into it because my statement was too long as it is. I have talked about that. And it is a factor that you have mentioned and fought for repeatedly over the years.

Local productivity councils are something people could understand. They could see how, when you establish productivity councils in individual towns, individual business establishments, factories, offices, and so on, striving for greater efficiency, and a reduction in costs, that such councils may serve to lower prices.

I think that all programs should be developed, not only with an eye to what is sound economically—of course, you have got to start with that and not deviate from it—but the programs must also be attuned to popular comprehension of these matters. Having struggled with monetary policy for some years, I can see why public understanding of monetary policy is so difficult for the average man. He is apt to take it on faith or to reject it on faith.

Senator JAVITS. Thank you very much, Mr. Burns. That is very illuminating. My time is up.

Senator PROXMIRE. Mr. Burns, in response to Senator Percy, you have said that we sometimes exaggerate the effect of what happens here in Washington. You said the House Judiciary Committee hearings had no negative effect on foreign exchange; in fact, the dollar strengthened. I can think of reasons why that might happen.

The speculators might have felt that the President was being nudged toward the door and celebrated. But at any rate, I am sure you would not regard the actual transfer of Presidential power from President Nixon to Vice President Ford as a minor economic event. That would signal the end of the Watergate trauma, it would mean that we would have a new man in office, with all of the effect of a new man, a honeymoon period, the approval that we saw with President Truman when he moved in, and so forth.

Under these circumstances, what effect would this have in your view on inflationary expectations?

Mr. BURNS. Senator, in all these matters you are far more expert than I, and I doubt that I could really be of any help to you.

Senator JAVITS. Would the Senator yield?

Senator PROXMIRE. Yes.

Senator JAVITS. There are just the two of us here.

I think, Mr. Burns, it would be very useful to give an answer to that question, because you say yourself that there is an enormous erosion of confidence with respect not only of our own banking system, but the world banking system. Some very sensible and important people think there is danger of some great cataclysm.

Wouldn't it be useful, therefore, to give an opinion as to what a change in the direction of this country would mean?

Mr. BURNS. I think that the Federal Reserve must stay out of the problem of impeachment politics. That is a direct answer to your question.

Senator JAVITS. Well, if we do it, we will be the lucky ones.

Senator PROXMIRE. Mr. Burns, let me press you just once more on this.

I realize you want to stay out of impeachment politics. But you are recognized as an economist with extraordinarily good judgment. I am not asking you any opinion on the President's guilt or innocence; it would be absolutely improper, and you wouldn't be qualified, I would agree, to give any particular opinion on that.

What I am asking for, however, is your opinion on the economy and the effect of this transfer of power on the economy.

Mr. BURNS. Let me think out loud with you just a little. Whatever the cause may be—and I think there are many causes, and Watergate is certainly a major cause, but it is not the only one—I think that there has been a certain erosion of mutual confidence and trust in one another and in our institutions. This has been going on for some years. Once we put Watergate behind us one way or another, one source of the decline in trust and confidence in institutions, agencies of Government, and individuals in Government, in politics, Senators, Congressmen, and the Federal Reserve, would be eliminated. I think, therefore, there would be some improvement. But the rebuilding of the confidence and mutual trust, on which our entire civilization rests, will take some years.

Senator PROXMIRE. Isn't it clear that with the specific reaction of labor and management to a new President under these circumstances, the prospects of achieving cooperation and restraint in the inflation area would be improved?

Mr. BURNS. Well, I would draw a distinction between the rhetoric of cooperation and the reality of cooperation. The rhetoric will improve faster than the reality. That is my judgment.

Senator PROXMIRE. How about investor confidence? We have had an extraordinary performance in investors not wanting to invest in equities, and concern about savings under these circumstances. It seems to me that this kind of a change could have quite a profound effect in this area. And you are certainly expert in this area, much more than we are.

Mr. BURNS. I would say that as far as the stock market is concerned, the fortunes of the stock market depend fundamentally, first, on corporate profits, and second, on the level and direction of interest rates. Corporate profits in this country have been dangerously low. That is my judgment. Interest rates have been dangerously high. That, I think, is everybody's judgment. In truth, lasting improvement on the stock market will not take place unless and until there is confidence that profits will improve and that interest rate levels will come down.

Senator PROXMIRE. Profits have enormously improved in the first and second quarters of this year. Stocks are selling now at almost record lows, the price earnings raise shows. So the profit element it seems to me has been at least temporarily improved. This is a matter of expectation I presume you are talking about.

Mr. BURNS. You know our financial press has been reporting an enormous increase in profits. I have no quarrel with the reports, except that the figures are not analyzed sufficiently.

Let me tell you the story about profits as I see them. We have an estimate of corporate profits before taxes of about $150 billion for the second quarter. These are all annual rates.

Now, these figures as reported include profits of Federal Reserve banks. I don't know why they do that. But that is what the statistics show. But let's eliminate that.

Next, let us get rid also, not permanently but for analytical purposes, of the profits of financial corporations and of the foreign subsidiaries of our businesses. My reason for that adjustment is that what I want to look at is the hard core of domestic business; namely, the domestic nonfinancial enterprises of the country, where the world's work, our own work, is largely done.

And then we are left with the profits of domestic nonfinancial business. The figure for the second quarter is about $119 billion, down from $151 billion with which we started.

Next, I would remove income tax that is paid by corporations. After all, profit after taxes is the only real profit.

Senator PROXMIRE. When you say down $151 billion, you say after having removed these elements, you are not talking about a drop in profits.

Mr. BURNS. Yes. But I will come to the historical comparison in a moment. I am still working on the second quarter figures.

We remove from this $119 billion figure, corporate income tax, and also inventory profit. I remove inventory profit because it is an illusory kind of profit.

Senator PROXMIRE. You might separate those, too, because as I understand it, the effective tax rate in the last 5 years has dropped from 43 percent to 36 percent.

Mr. BURNS. I can give you those figures separately, and I will in a moment. But now having made these adjustments, what you have, as I see it, is an approximation to the true profit of domestic nonfinancial businesses. There are other adjustments one might make, but I am not going to do it now. Thus the figure, which started out at a level of $150 billion, is now down to $32 billion.

Next, I have before me figures——

Senator PROXMIRE. $32 billion from $119 billion.

Mr. BURNS. From $150 billion. We started at $150 billion.

Senator PROXMIRE. I understood the step from $150 billion to $119 billion. From $119 billion to $32 billion, which is, of course, the big drop, are you converting this into——

Mr. BURNS. No, I am doing nothing except eliminating——

Senator PROXMIRE [continuing]. Inventory profit.

Mr. BURNS. Corporate income tax, and inventory profit. That reduces the figure from $119 to $32 billion for the second quarter of this year.

Now, let's look at historical figures——

Senator PROXMIRE. Let me just interrupt to say that, as I understand it, there are a lot of questions about this inventory profit situation.

As a matter of fact, the profits don't necessarily reflect higher inventory prices, but in many cases, perhaps most of these cases, inventroies are sold at prices set in long-term contracts. As a result, the increase in spot market prices is not representative and exaggerates the real increase in inventory values. This would reduce the actual profits by more than the proper amount.

Mr. BURNS. That is a controversial point. I am taking the figures on inventory profit as reported by the Department of Commerce.

Now, the figures that I have adjusted, as described, go back to the first quartear of 1969. The figure for the first quarter of 1969 was $31.2 billion. It declined during the remainder of 1969, it declined during all of 1970, and then began reviving in 1971, and reached a peak of $38.6 billion in the fourth quarter of 1972. And then there were some irregular movements. The figure for the fourth quarter of 1973 was $38.1 billion. And for the first quarter of 1974, $30 billion. And for the second quarter, $32 billion.

That is my analysis of profits.

Actually, if I tried to make an adjustment for the method of reckoning depreciation—because depreciation is counted on a historical cost basis instead of replacement cost basis—that figure of $32 billion would be lowered, and there may well be other adjustments. You suggested one, Senator, and I can't say that you are wrong. There might be an upward adjustment.

What I am trying to convey to you is that the profits picture as it is being reported ignores many things that have been happening within the corporate world. And in my judgment profits in the aggregate are too low.

Now, in some industries——

Senator PROXMIRE. Let me ask you, are all these figures current dollars?

Mr. BURNS. All these figures are in current dollars.

Senator PROXMIRE. Was this an analysis by the Federal Reserve staff?

Mr. BURNS. This is basically an analysis by my staff.

Senator PROXMIRE. Will you give us the details of that?

Mr. BURNS. I will be glad to supply you the details for the record, the calculations of what I have just described in full detail.

Senator PROXMIRE. Thank you very much. This is most interesting. Because that certainly contradicts all the evidence that has been reported, and what you see in the financial press.

Also I am going to ask the staff of the Joint Economic Committee to analyze it, and I will put this analysis in the record also.

Mr. BURNS. Very good. I would be very glad to see their analysis.

Senator PROXMIRE. We will send it to you.

Mr. BURNS. Thank you.

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

HON. ARTHUR F. BURN'S ANALYSIS OF CORPORATE PROFITS

CORPORATE PROFITS

[Billions of dollars at seasonally adjusted annual rates]

Year and quarter	All corporations (before income tax)	Nonfinancial corporations (before income tax)	Domestic profits, nonfinancial corporations— Before income tax	After income tax— Including inventory profits	Excluding inventory profits
1969:					
1st	89.0	76.9	72.6	37.1	31.2
2d	88.0	75.3	70.9	36.0	30.9
3d	82.2	69.7	65.0	32.5	30.1
4th	80.5	68.1	63.5	31.6	24.5
1970:					
1st	76.1	63.4	58.3	29.8	23.6
2d	74.7	61.2	56.8	28.8	24.0
3d	75.7	61.7	57.0	28.6	24.2
4th	69.8	55.5	50.9	25.3	21.5
1971:					
1st	78.7	64.0	60.0	30.7	26.2
2d	83.5	68.4	63.0	32.3	27.5
3d	85.7	69.8	65.7	35.4	29.1
4th	86.7	70.0	64.1	35.3	31.0
1972:					
1st	92.3	75.2	70.8	39.9	34.1
2d	96.0	78.7	73.9	41.6	35.1
3d	100.2	82.4	76.9	43.3	36.0
4th	108.2	90.0	83.8	47.0	38.6
1973:					
1st	120.4	101.7	94.7	54.2	37.7
2d	124.9	105.6	98.6	56.6	36.7
3d	122.7	103.0	95.6	55.0	37.5
4th	122.7	102.3	94.3	54.4	38.1
1974:					
1st	138.7	118.0	104.8	61.0	30.0
2d [1]	150.5	129.2	118.6	69.3	32.0

[1] Preliminary.

Source: Department of Commerce, except data for 2d quarter of 1974 which are Federal Reserve estimates.

As you know, total corporate profits before taxes rose sharply in the first quarter of this year but inventory profits accounted for almost all of the increase. In the second quarter, total profits appear to have shown another large increase, with inventory profits accounting for about half the rise.

Inventory profits are, in a sense, fictitious profits; they develop during a period of rising prices because the income statements of many companies do not reflect the full cost of replacing inventories used up during the period. But they are taxed like any other profits and thus only part of the amount shown as inventory profit is actually available to the company; the rest of the inventory-replacement cost constitutes a drain on other funds.

Chart 1 illustrates the process by which the substantial increase in total profits before taxes turns out to have been a significant decline in profits available this year for purposes other than inventory replacement. Information on second quarter profits is so tentative and incomplete at present that I should like to focus the discussion primarily on the first quarter, for which considerably more information is available.

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The top line of Chart 1 shows profits before taxes of all corporations, which increased from a seasonally adjusted annual rate of $123 billion in the fourth quarter of last year to $139 billion in the first quarter of this year; preliminary GNP estimates imply a further rise to $150 billion in the second quarter. The second line shows the same measure of profits for nonfinancial corporations, including profit and dividend income from their foreign branches and subsidiaries; it also shows a sizable increase in total profits this year.

But when inventory profits are excluded, as in the next line, the first quarter increase all but disappears, and the implied second quarter rise is greatly reduced. In every nonfinancial domestic sector for which estimates are available, first quarter earnings performance is significantly worsened when inventory profits are excluded—as can be seen from Chart 2, which shows profits before taxes, including and excluding inventory profits.

Note particularly the curves for the transportation, public utility and communication sector. We don't normally expect inventory profits to be significant for these companies because inventories account for so small a proportion of their total assets. But, with the enormous rise in fuel costs, inventory profits have become relatively very large, especially for public utilities which are shown separately, on the only basis for which estimates are available. In this industry, profits before taxes and excluding inventory profits declined 40 percent in the first quarter and accounted for four-fifths of the $2 billion decline for the combined group.

The only domestic nonfinancial sector to show an increase in profits before taxes, after inventory profits are excluded, is nondurable manufacturing. But Federal Trade Commission data on manufacturing profits suggest that this increase, like the 65 percent rise in profits originating abroad, largely reflects developments in the oil industry.

The industry detail shown in Chart 2 is not available on an after-tax basis. For that, we have to turn back to Chart 1 and look at aggregate data. The fourth line of this chart shows profits of all nonfinancial corporations, after deducting both the cost of replacing inventories and liabilities for income taxes. These are the profits available for *additions* to inventories, investment in other assets, and payment of dividends. Profits from production abroad are still included, since these funds are available for use in this country if the company so desires.

This derivation finally makes full allowance for the impact on profits of understating inventory expense. Measured this way, there has been deterioration this year, and no real improvement since late 1972, in the volume of profits available for ongoing activities. Given the first quarter decline in adjusted profits, its apparent pervasiveness among industries, the volume of corporate spending plans, and—last but not least—pressure to increase dividend payments in light of the sharp increase in reported profits and the prospective demise of the restraint program, it is hardly surprising that corporate borrowing was so large this winter and spring. Such borrowing may appear inconsistent with line 1 on this chart. It does not appear inconsistent with line 4.

Faced with basically sluggish earnings, corporations apparently preferred to borrow high-cost funds rather than to cut back severely or postpone their investment plans. Perhaps they expected funds to cost even more or to be less available over the near-term. Perhaps they expected profits to improve as the year progressed, reflecting some combination of higher selling prices and lessened drain from inventory replacement costs. But over the longer run, the trend in adjusted profits has to shift dramatically if profits are to provide an adequate incentive for investment.

If one is interested in measuring profits as an incentive to investment, rather than as a means of financing it, one should probably look at available profits generated by domestic production only. This is done in the bottom line of Chart 1. As you can see, this measure shows a marked decline in the first quarter, with—perhaps—a partial recovery in the second. Despite the inflation of recent years, the seasonally adjusted annual rate of domestic profits of nonfinancial corporations in the first half of 1974—after inventory profits and income taxes—was probably only about 5 percent above the 1969 level. And while the impact of inflation on inventory replacement costs has been eliminated from the figures charted in this bottom line, no allowance has been made for the amount by which depreciation allowances, based as they are on original cost, are increasingly falling short of fixed asset replacement costs.

The Department of Commerce prepares several different sets of current-cost depreciation estimates. They vary considerably, depending on the depreciation method used, but they have one thing in common: the spread between historical-cost and current-cost depreciation has widened steadily with the result that allowance for the understatement of both inventory and fixed asset replacement costs leaves profits after taxes, even in 1973 and even in current dollars, little higher than they were in 1969 and in most cases only marginally higher than the amount paid out in dividends.

Chart 1

CORPORATE PROFITS

Seasonally Adjusted Annual Rates

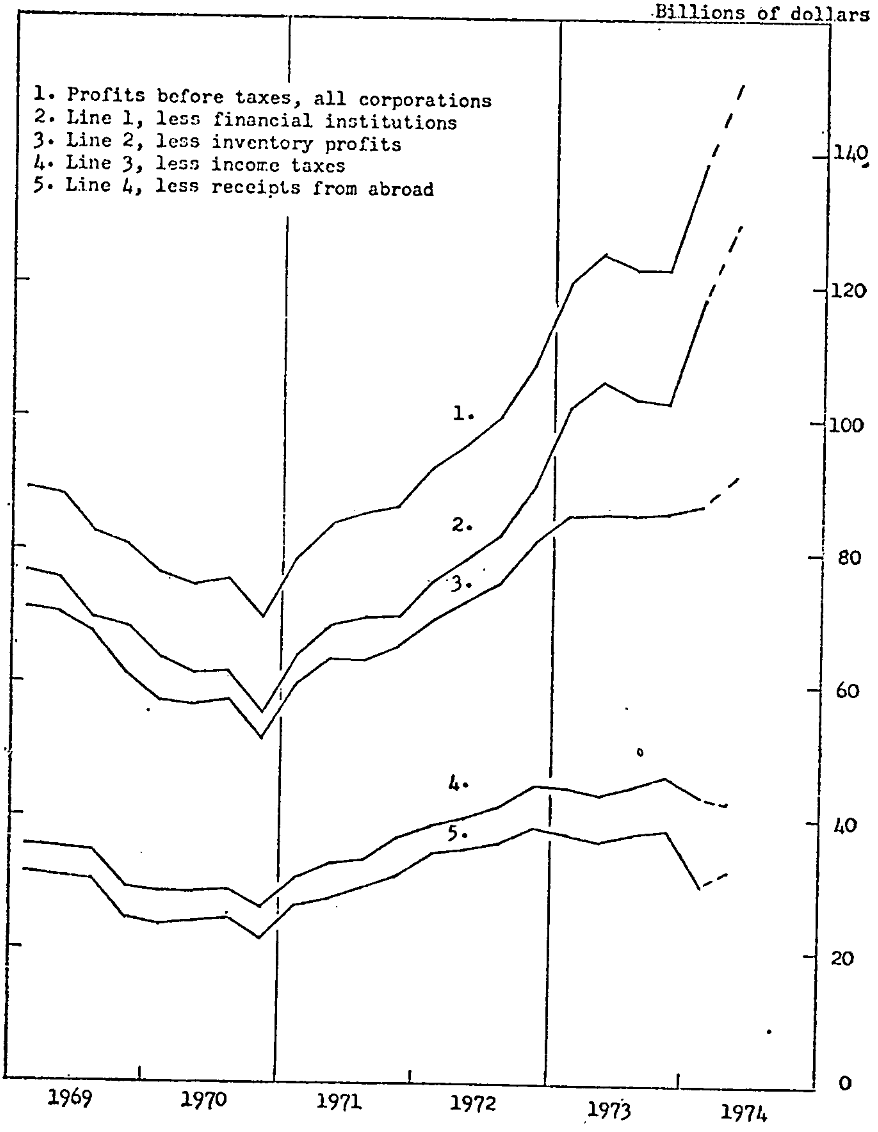
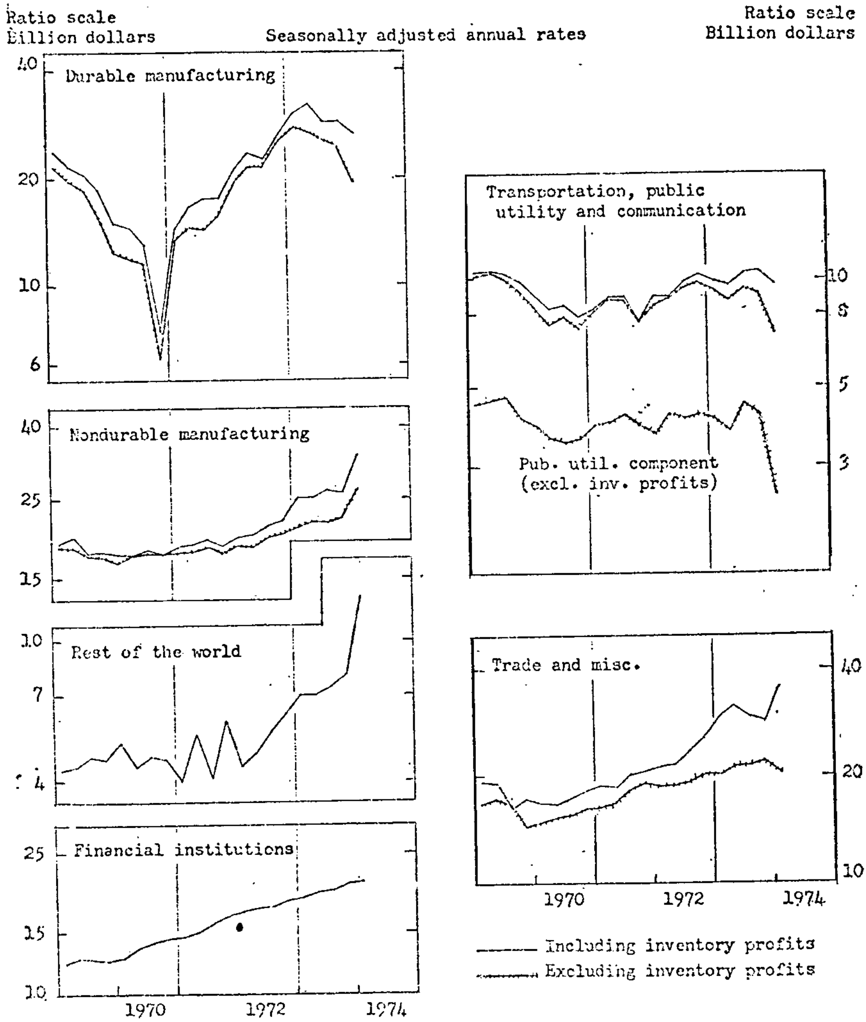


Chart 2

CORPORATE PROFITS BEFORE TAX

Including and Excluding Inventory Profits



AN EVALUATION OF HON. ARTHUR F. BURNS' ANALYSIS OF CORPORATE PROFITS

(By the Joint Economic Committee Staff)

This evaluation comments on each step of Mr. Burns' analysis of corporate profits as outlined in the table on p. 285. (See also chart 1 on p. 287.)

1. *Exclusion of income of financial corporations.*—This adjustment makes no significant difference in the pattern of profits changes. The proportion of total corporate profits going to nonfinancial corporations declined during the recession of 1970–71 from about 86 to 80 percent and then recovered as business improved. In any case, a shift between the financial and nonfinancial sectors merely represents a change in shares between classes of investors and not a shift from capital to other factors of production. Therefore, it should not affect the total return to capital.

2. *Exclusion of profits from foreign operations.*—When assessing funds available for domestic investment, it must be understood that profits earned abroad may be repatriated to the United States for this purpose just as profits earned in this country frequently have been invested abroad. The dollar devaluations of the recent past should tip the balance of intracorporate capital flows toward the United States. Exclusion of profits from foreign subsidiaries is necessary, of course, in measuring the current profitability of domestic operations.

3. *Exclusion of inventory profits.*—The component of profits attributed to inventory profits has become a very large share in the last 2 years. Its exclusion is based on the argument that inventory profits must be reinvested to maintain the inventories. There are two possible elements of exaggeration here:

(*a*) First, the estimate of inventory profits probably is overstated because the increase in wholesale price indices on which it is based is overstated during periods of inflation. These indices are based mainly on list price and spot market quotes which typically advance ahead of prices actually paid under pre-existing contractual arrangements.

(*b*) Second, the cycle of inventory management involves stockpiling in excess of current needs during inflationary periods. As inventory prices stabilize, purchases decline more or less sharply, and a phase of inventory depletion frequently follows. In this case, some inventory profits are not reinvested concurrently to maintain stocks but remain free for alternate uses.

In general, any discussion of appropriate or "necessary" levels of corporate profits should be tempered by recognition that investments are not undertaken in response to past or present profits but rather in anticipation of future profits over a more or less long run. Today's profits affect investment only because:

(1) They may be factored into expectations about profits several months or years hence or

(2) they may provide otherwise unavailable resources for investment or in some real sense may lower the costs of such resources.

It must be borne in mind that high profits today will not be reinvested if prospeccts are bleak for the future. If future prospects are bright, on the other hand, outside funds can be raised more or less readily to augment those from internal sources. The fact that outside funds are very costly at today's rates of return is a reflection of today's policy of constricting demand.

Senator PROXMIRE. My time is up.

Senator Percy.

Senator PERCY. Mr. Burns, we just had a major wage settlement involving all the Communications Workers of America, 750,000 workers, and the telephone companies.

Could we use that as an example of the recommendations you had in your statement urging that the Cost of Living Council be reestablished with power and authority to monitor the economy and appoint an ad hoc review board that could delay wage and price increases in key industries? The administration has just sent legislation to Congress proposing a monitoring agency, but it does not contain any authority for holding up wage increases. Have you discussed this difference in your recommendation and the proposal of the administration with Mr. Rush, Mr. Stein, and Mr. Simon? How important do you think the authority to hold up a wage increase would be?

Mr. BURNS. I have not discussed this question with members of the administration recently. But in earlier months this was the subject of frequent conversations among us.

I feel that without my suggestion, which I think is a modest one, the monitoring device would be quite ineffective. There is an element of compulsion in my suggestions, but it is very minor. The delay that I would contemplate would be some 30 or 45 days at most, and after that, these boards, or the Cost of Living Council, would have no enforcement powers.

Now, in the absence of a device like this, price or wage increases will take place that will suggest to many an unwise use of economic power.

It is extremely difficult to roll back price or wages. It is not only difficult to achieve, but it causes great confusion to business people, and great unhappiness to the working people. A minor delaying device would, I think, avoid problems of this character.

Senator PERCY. Did you have an opportunity to study the wage settlement of the communications workers and the telephone companies?

Mr. BURNS. No, I have not.

Senator PERCY. I was rather impressed with the way that was worked out. I think the president of the CWA and John deButts and his colleagues of A.T. & T. tried very hard, from my conversations with them, to bear in mind the inflationary effect. But it was their judgment, taking into account productivity increases that have been very apparent in that automated industry, that they could do this without it having an adverse effect upon inflation. I was pleased that they were very conscious of this. In fact, most labor leadership—Senator Javits and I talked with George Meany last week—are aware of the fact that inflationary increases are defeating in the end. George Meany did indicate that he would be very willing to work closely, I think he put it, with the congressional powers, in encouraging the establishment of productivity councils, productivity committees, by management and labor throughout the country, and that organized labor would be pleased to work with management in finding ways to reduce unnecessary costs, make our operations more effective and efficient, and our wage increases more meaningful.

Do you place high significance on that aspect of what labor and management could do? You have commented on productivity, and the fact that it has not been increasing, it has actually declined a bit. How important is that as a fact or in fighting inflation?

Mr. BURNS. I think it is enormously important. I think a constructive dialog between our labor leaders and business leaders is long overdue. I think it is essential.

Senator PERCY. The vice chairman mentioned unemployment.

Your statement indicated that we might have to tolerate a somewhat higher level of unemployment. In seeking to offset that, some in the Congress have advocated tax reductions to stimulate the economy, which I for one reject, and I am glad that you do.

Do you feel that one of the better ways would be to have standby authority for public service jobs which would put people to work that are unemployed, and would move them from welfare rolls to payrolls, and would provide productive enterprise and keep them active and busy until the economy does pick up?

Mr. BURNS. I would strongly favor that approach.

Senator PERCY. Do you feel it would be desirable, however, rather than just adding cost and budgetary items, to offset that possibly with, say, a simple removal of the deductibility of gasoline taxes at the State and local level from the Federal income tax? It would yield $600 million. It is a principle that when we put a few items in the budget that involve cost, we try to find a revenue item that will match it and offset it and be self-liquidating in a sense.

Mr. BURNS. I think that is a very wholesome principle, yes.

Senator PERCY. I would like to see us try to provide the money at the same time we provide the job opportunities should we need them. I think your support of that concept would be helpful.

You mentioned the pressure of oil prices. I have forgotten exactly the words that you used. But the sense of it was that something must be done, there must be a creative effort, an attempt to bring down the price of oil.

Do you have any specific suggestions as to what can be done? Secretary Kissinger has talked about consuming nations working more closely together. Certainly we could reason with the oil-producing countries as to the disastrous effect the present pricing policy is having on the developing nations of the world. That is one approach.

Do you have any other suggestions that you can offer?

Mr. BURNS. Well, my program would be a three-pronged program. First, what we could do on our own we ought to do. The President announced some months ago the goal of achieving independence in the energy area. I think we ought to push Project Independence with the utmost vigor. In the process of doing that we would in effect be saying to the oil producing countries that they cannot count, looking to the future, on the price of oil remaining at anything like the present level. Now, this can be important in stimulating their thinking about their own self-interest.

Second, we need a much stronger conservation program than we have. Toward the end of last year, and early this year, we embarked on a conservation program. So did other countries around the world. But gradually we have returned to the old, lazy, wasteful ways. An active conservation program I think is essential. This requires cooperation among the oil consuming countries.

Third, I think that just as the oil producing countries have gotten together and established a cartel, so the oil consuming countries must get together and work out a common policy, and through political devices try to bring the oil producing countries to the path of reason, from their own viewpoint as well as the viewpoint of the world economy.

I think there is a lot of naive thinking in this area. Well-meaning people talk a great deal about recycling. What I think these people overlook is the fact that by raising the price of oil nearly fourfold, the oil-producing countries have released forces on the rest of the world that are likely to prove unmanageable.

Therefore, the price of oil has to come down, and it has to come down substantially. And even then there will be a major recycling problem. But then, hopefully, we will be able to manage it through our private financial institutions and through our international organizations. I think we are living in a world of illusions at the present time as far as the price of oil is concerned.

Senator PERCY. I thank you very much. I concur on the necessity of working together as consuming nations. It is disastrous to have a policy of just dog eat dog. Apparently they do not realize that they can't go it alone in this kind of battle.

Second, in this conservation program, if we could get passage on the floor, of the 55-mile-an-hour speed limit, that is at least something we could do not only to save oil, but 12,000 lives a year. We would be foolish not to take reasonable steps like that to conserve. Thank you very much indeed.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Mr. Burns, I am delighted to hear what you said about conservation. I think it is most shocking and shameful that our country would abandon its whole effort so soon.

I deeply believe—and please, no comment is needed from you—that it is attributable to our problems with the President. It takes a President who is firmly in his seat to lead the country in that kind of a way. That is real austerity in the face of a grave emergency. I believe that the Arabs will be convinced that we are in earnest if we cut oil consumption and gasoline consumption in this country about 15 percent, as we did in the early time of our conservation program, and that the other nations of the world can be similarly enlisted. So I thoroughly agree with you.

I might say, on the monitoring agency, I thoroughly agree with you, too. I am going to amend the bill which I put in to carry out the ideas that you have just offered. I want to crank in my own ideas.

I also have put in a measure which I hope you will look at, for regional productivity councils, the bill provides $50 million, which will be sufficient to organize 1,000 of them as we had in World War II.

I am glad Senator Percy has introduced in the record that we have the promise of very effective cooperation from the AFL–CIO.

I did have a couple of questions to ask you. Secretary Simon, testifying before us the other day, was rather optimistic about the fact that through the present machinery we would be able to work out this problem of somewhat loose Arab money which is being put out on demand while banks are lending for 5 years or thereabouts. This could cause a great world crisis, of course. You don't seem to be as optimistic about that. What do you think the central banks of the world can do about that situation?

Mr. BURNS. I hope that the world's political statesmen, as I suggested earlier, will go to work on the price of oil. Then I think the central banks, of course, can be helpful. But in the absence of a significant decline in the price of oil, I for one cannot be at all optimistic about this problem being handled. It would be easy for me to say to you, oh, well, we central bankers will take care of it. I don't know whether we have that much good sense or that much power. I don't think we ought to attempt to undertake that which it isn't at all clear that we can manage.

Senator JAVITS. Mr. Burns, we have the grain and the Arabs have the oil. It is true, there are not all that many Arabs. But there are 30 million in Iran, which has kind of been the leader in raising prices. Has there been any discussion about dealing with bushels of grain in buying barrels of oil? The price can go very high, just as high as for oil. If people have to eat, they can't eat their oil.

Mr. BURNS. There has been some inconsequential talk on this subject.

Senator JAVITS. Don't you think it deserves consequential thought?

Mr. BURNS. The answer is yes. But I wouldn't stop with wheat.

Senator JAVITS. I am just talking about food and fibers.

Do you feel that is a problem for statesmen or for the central bankers, or both?

Mr. BURNS. It is hardly a problem for central bankers. Central bankers can at best suggest.

Senator JAVITS. But in the economics of the world, it can be a factor can it not?

Mr. BURNS. Oh, yes.

Senator JAVITS. The last question I want to ask you is about whether or not we need, in view of the fact that the demand for credit is such a big point in the inflation and interest rates, some kind of a regulatory mechanism for credit. Like we had during the war—some kind of advisory council on what ought to be credit priorities.

Mr. BURNS. I would see no harm in that. There might be some advantage in having an advisory group of financial people.

Senator JAVITS. I think it was called the Capital Issues Committee during the war.

Mr. BURNS. Yes. My recollection is not too good, Senator. We had such a body functioning, I believe, during the Korean war, and then it was quite ineffective. My recollection about World War II is insufficient for the purpose of this discussion.

It is one thing to have an advisory group which would suggest ways of conserving credit funds, stressing some uses and not others, or stressing some uses more than others. A mandatory system would trouble me. To put through a mandatory system—let me tell you where my thinking takes me. You could, for example, exempt credit for homebuilding entirely. You could exempt small business and have a certain cutoff point on size. But then you would be left still with an enormous task. Here is a governmental body, let us say, that will determine how much credit can properly be allocated to Ford Motor Co., to General Motors, to General Electric, and to smaller business concerns. This would require great knowledge and understanding of the interrelations among various corporations. For example, you might approve an expansion of capital for the automobile industry, and fail to approve, or there could be a lag in approving, capital expansion for suppliers. The different parts of our economic system are so interrelated, and knowledge of individual areas would need to be so detailed and so thorough, that I would despair of a committee with enforcement power doing a really constructive job in this area. I would rather trust the market.

Senator JAVITS. But with an advisory committee.

Mr. BURNS. An advisory committee, I think, could be helpful.

Senator JAVITS. But it should originate in the Treasury of the Government rather than with you?

Mr. BURNS. Well, I don't know. I think we ought to talk that over and decide which is the best originating agency.

Senator JAVITS. I hope very much you will, Mr. Burns.

Mr. BURNS. Thank you very much.

Senator JAVITS. Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Mr. Burns, you were with the National Bureau of Economic Research at one time?

Mr. BURNS. Oh, yes.

Senator PROXMIRE. Didn't they make a study of forecasting and conclude that the forecasters were pretty good for 6 months and after that you might as well ask a taxi driver—well, not a taxi driver, maybe, but anyway a Member of Congress—anyway, somebody who was not very competent?

What I am getting at is this. The forecasts have been very good in periods of the past, with some notable exceptions, such as last year's dismal effect on prices. You may not have a crystal ball, but you do have a fine staff. You have an econometric model, and you have excellent judgment. Would you rule out a continued level of growth over the next 6 months of only 1 or 2 percent?

Mr. BURNS. No; I would not rule it out.

Senator PROXMIRE. Does it seem likely?

Mr. BURNS. It seems plausible; let me put it that way.

Senator PROXMIRE. Under those circumstances would you feel that there is a possibility of a 7-percent unemployment?

Mr. BURNS. With a rate of growth as low as that, it would take quite some time before an unemployment rate of 7 percent was reached. With a rate of growth of that magnitude you could reach by the end of the year or early next year 6 percent, but not 7. That would be my best guess.

Senator PROXMIRE. I would say that you rule out at least as very unlikely a rate of growth of zero for the next couple of quarters.

Mr. BURNS. Do I rule it out? No; I do not rule it out.

Senator PROXMIRE. You would regard it as unlikely?

Mr. BURNS. I expect a sluggish economy, Senator. What does a sluggish economy mean? Does it mean a small plus, does it mean a zero change, does it mean a small minus?

Senator PROXMIRE. Does the range of 5½ to 6 percent unemployment seem plausible to you?

Mr. BURNS. Yes; it is.

Senator PROXMIRE. How about prices? Do we have much prospect in the coming year of having prices eased so that the rise in prices would go below 10 percent as you said? They were about 11 percent most recently.

Mr. BURNS. Well, I would be a very unhappy man if I thought that we have no chance of doing it. I think we definitely have a chance of doing it. The place that I would look for a decline particularly would be in prices of industrial materials. With the growth of world demand tapering off, the prices of sensitive industrial materials since this April by and large have no longer been rising on the average, in fact, they are a little lower than they were in early April. If the slow rate of growth continues the rest of this year, which seems likely to me, then a decline in the prices of industrial raw materials could well take place.

Senator PROXMIRE. The wholesale price index, though, rose at a very sharp rate in June and July. It was led, of course, by plastics, chemicals, steel, petroleum, and so forth.

Mr. BURNS. That is true. But you take prices of sensitive industrial materials——

Senator PROXMIRE. And nonferrous metals too, were up sharply.

Mr. BURNS. That is true. But take prices of aluminum scrap, steel scrap, copper wire bars, lead, they have been unchanged in recent weeks. The price of tin has declined. The price of wool has declined. The price of cotton print cloth, the price of rayon goods, the price of hides, the price of rubber, the price of lumber, the price of plywood, and even fuel oil and gasoline have been unchanged in price in recent weeks. There is a certain tendency toward stabilization in these prices of sensitive materials.

The Federal Reserve index on sensitive industrial materials prices shows a peak in April and a definitely lower level in July. What the development will be in future months I cannot say. But if the tapering off in aggregate demand continues, this is the area where I would expect price declines of some magnitude to take place. That will tend to spread out over the coming months.

Senator PROXMIRE. So part of this might be brought on by the drought. You referred to wool and hides. Both are animal products that I imagine might be affected by the same elements that would tend to increase meat and wheat prices and so forth.

The 10 percent inflation forecast which Wharton and Chase have made, do you regard that as plausible or implausible?

Mr. BURNS. I do not know. Sure, one could have 10, 12, 8, or 7 percent. You could sit around and listen to these professional colleagues of mine debate whether the price level at the end of the year will be rising 7 or 8 percent. No one ever knows what he is talking about.

Senator PROXMIRE. You suggested and you emphasized—it was a strong sentence in your statement—enforcement of the antitrust laws. This morning Mr. Kauper, head of the Antitrust Division, is reported as urging a revision of the antitrust laws to remove some of the difficulties of proving antitrust violations and shorten the time it takes to file and complete antitrust cases. Do you support that?

Mr. BURNS. I support that. I would also support much stronger penalties than we have under existing law for violations. Violation of the antitrust law is a crime, and the punishment should fit the crime. At present, in my judgment, it does not. I believe the maximum penalty in terms of dollars is only $50,000, and that is a mighty small penalty for an officer of one of our large corporations.

Senator PROXMIRE. In my judgment, President Nixon is responsible for undermining antitrust enforcement by ordering Attorney General Kleindienst and Antitrust Chief McLaren to desist from prosecuting the big corporations, and threatening to fire McLaren, saying he wanted him out within an hour.

Furthermore, the President's nominee for Chairman of the Council of Economic Advisers, Mr. Greenspan, has gone on record as bitterly opposed to our antitrust laws, and has vehemently attacked the Sherman Antitrust Act.

Roy Ash has spoken of the need for relaxing the antitrust laws.

What assurance do you have and what assurance can you give us that the antitrust laws will be vigorously enforced under this administration?

Mr. BURNS. How well our laws are enforced depends partly on the Executive. It depends partly on the Congress. If you and your colleagues in the Congress are not satisfied with the enforcement that we have, and if you speak out loudly and clearly, there are all kinds of steps, as you so well know and understand, Senator, that you can and you ought to take in that event.

Senator PROXMIRE. Mr. Burns, the difficulty is that the executive branch executes the laws and enforces the laws, we do not.

Mr. BURNS. You have clubs of your own.

Senator PROXMIRE. We have two powers. One is the power of legislation. And according to what Mr. Kauper said, I am delighted to hear your support for that change in legislation. We have the power of investigation. But we do not have the power of enforcement.

Mr. BURNS. Well, the power of investigation—don't you underestimate that. To the extent that this becomes a subject of serious interest on the part of the Congress, we ought to have hearings on that subject once a month, let us say, and bring the facts to light. Then the rascals, if there are any, will begin behaving very properly.

Senator JAVITS. Would the Senator yield at that point for one question?

Senator PROXMIRE. Yes.

Senator JAVITS. Is it not a fact, Mr. Burns, that the antitrust laws urgently need modernization and revision, and, therefore, that is even more reason for our exercising our investigatory powers?

Mr. BURNS. This is what my attorney friends tell me. I do not know enough about antitrust laws. But I have no reason to question their judgment.

Senator PROXMIRE. It seems to me that a person who does not believe in the antitrust laws, or thinks they should be taken off the books, may not be qualified to be the Chairman of the Council of Economic Advisers. What do you say to that?

Mr. BURNS. The man who has been nominated to that post is a former student of mine. And I never criticize my former students. I love them all.

Senator PROXMIRE. He seems to be a student of Ayn Rand right now.

As you know, fuel prices, especially gasoline prices, are at an all-time high in this country, and yet there is a surplus of oil on the world market. Consumption is down, and the production of all fuel is down. If more market forces were operating normally, would not fuel prices be going down instead of remaining at the present level, and does the maintenance of high prices suggest that this may be collusion?

Mr. BURNS. I do not know enough about that market to speak with any feeling of confidence. My impression is that while the prices in the spot markets have come down, the posted prices are still being maintained, and most of the oil that is sold to the oil companies is governed by posted prices rather than by spot prices. I believe that is true, and, therefore, I would assume that the maintenance of monopolistic prices by the oil producers is the chief explanation of the kind of price level that we have in our markets for oil and oil products.

Senator PROXMIRE. Is that not reinforced by the fact that the oil companies have cut back production so that they are operating well below capacity now, far below what they were last year, when their capacity is greater, at a time when they have an abundance of crude? I am talking about production of gasoline.

Mr. BURNS. That, I do not know. I have not been following the statistics on production of gasoline. I have been following rather closely statistics on production of crude oil in individual countries and in the aggregate. Their production has been rising. That is why you have a surplus.

Senator PROXMIRE. I would like to move into one area, and then I will yield to Senator Percy.

I would like to quote to you from what I think is a very disturbing observance by Mr. Mullaney of the New York Times on July 14. He said this:

> In past periods of surging demands the Federal Reserve Board has issued warning to the Nation's banks to curb their lending. Why not now? Why not a public pronouncement from Washington that the banks should refuse loans for some specific, not generalized, specific selective nonessential uses, for anticipatory borrowing plans by business to avoid higher costs later? The Government

has been relying on a single solitary weapon, high interest rates, to fight a very modern inflation. It is indeed high time to haul in more energy and more imagination to fight a rampaging fire which seems clearly out of control and threatening even greater distortions, and more grievous losses throughout the economy.

What is your view of the notion that the Federal Reserve Board is called upon here to tell the banks that they should reduce loans in specific designated areas?

Mr. Burns. Let me comment on that. This is a question that I and my colleagues on the Board have considered from time to time. I have been advised that a pronouncement made publicly through a letter addressed to individual banks—somehow September 1966 sticks in my memory, the date may be wrong—had confusing and unfortunate effects. Now, in view of this experience as described to me by our staff, I hesitate to take that approach. However, I have talked to bankers very extensively, individual bankers and groups of bankers, on this subject. My views are quite well known among the bankers of the country, or at least those who run the larger banks of the country.

In view of the discussions we have had at the Federal Reserve Board, where this history of pronouncements of this sort is well known by some members of our staff, it is not at all clear that this would be helpful. This has been considered, and maybe should still be done. I have very much of an open mind on that. But I have been persuaded at least thus far, not to do that through letters or through public pronouncements. I have done it quietly to the best of my ability.

Senator Proxmire. My time is up.

Senator Percy.

Senator Percy. Mr. Burns, in your statement you mention that public utilities have also been caught in a squeeze. In talks with public utility officials across the country—and I have talked with virtually all of them in Illinois in recent weeks—they are gravely concerned about their ability to raise capital to expand to meet their contractual demands. What recommendations would you make for finding ways for utilities to be able to provide expansion? According to the comments of Secretary Simon recently, it appears quite unrealistic to hold down rates in the presumed interest of consumers when the consumers' interests are served not only by the price they pay for the services but their ability to get those services. There seems to be two adverse factors: One, that the financing of expansion is extraordinarily difficult in a controlled industry, a regulated industry; and second, they are at a disadvantage in the investment tax credit, and they only get a 4-percent credit against a 7-percent credit for the rest of American industry. Would you care to comment on those two phases of it and what recommendations you would make?

Mr. Burns. I would certainly favor putting public utilities on the same basis as other industries; in other words, raising the investment tax credit from the present level of 4 percent to 7 percent.

Senator Percy. I presume that would cover telephone companies who are also at a depressed level and yet have to keep rates down and meet future supply?

Mr. Burns. There are various administrative and tax adjustments that the Treasury is now studying, and that I will be studying with members of the Treasury staff very soon. What they will come to, I cannot say.

I think that our public utility commissions are continuing to operate on a business-as-usual basis, which means that there are long delays in granting necessary increases in the rates. A concerted effort, I think, must be made to expedite the handling of these rate cases by our public utilities.

I expect to be a little wiser by the end of the week than I am now, through meetings I will be attending with a group of utility executives and financiers involved in public utility financing. Another nationwide conference is now in the process of being projected to deal with this problem. At the moment, I would definitely work on these two fronts: speedup in the handling of utility rate cases and raising the investment tax credit.

I would do a third thing, and that is to advise the bankers over the country of the importance of bridge loans for public utilities.

Senator PERCY. I noticed in surveys recently that the Government, more than any other part of American life, is blamed for inflation. I do feel that a certain responsibility must be borne by the Government. You have indicated that decisions are not made promptly enough. Certainly, I have a number of utilities recently who are in the midst of their expansion plans, bringing plants onstream, and yet the Federal Energy Office had not made the decision as to whether or not they were going to have adequate supplies to get those plants underway. I think John Sawhill's decisiveness in this question of letting them know when he was going to make a decision, it was going to be made the 31st of July, and the basis on which that decision would be made, cleared the air immensely. The decision was made on schedule, and I certainly commend it. But I see in the bureaucracy, cases pending 10 years, such as railroad cases, and similarly, rate cases. It is that indecision of Government that hamstrings business. An adverse decision would be better sometimes rather than the constant delay in knowing where you stand with respect to a Government regulatory agency.

You mentioned in your statement that there are a few hopeful signs that price increases may abate during the second half of this year, but they are inconclusive. Having just seen headlines in the paper in the Midwest about the drought, and the effect it is going to have on higher food prices, I would be most grateful for specificity and hopeful signs that you see, if there are some.

Mr. BURNS. I have already commented on that. The rate of growth of our own economy, and of the economies around the world, is certainly diminishing. We are in a period of sluggish economic expansion. With the rate of increase in demand for goods and services definitely diminishing, the pressure on industrial capacity is being reduced. This is already being felt in the market for sensitive industrial raw materials.

Senator PERCY. A hopeful sign is the investment of a large amount in capital, $20 billion this year. That would bring on a stream of supplies, and should hopefully bring prices down in the future.

Statistics released July 18 by the Department of Commerce indicate that an inventory investment amounted to $15.1 billion in the second quarter of this year compared to $16.9 billion in the first quarter. In your judgment, has there been excess buildup of inventories, and if so, what effect would it have on the production later this year?

Mr. BURNS. That is an extremely difficult question to answer, Senator. Our statistics on inventory are very inadequate. One of the casualties of our massive inflation has been a decline in the reliability of our statistical system. The recent revision of the inventory figures indicates where large errors in these figures may lead. Before we are through, you will find that the recently revised figures will be changed, and changed significantly once again. I do not know how to answer that question. I do know this, that the inventory picture is very uneven, and that in the case of many materials and many components, there are still great shortages being reported by purchasing agencies over the country. But I cannot give you—and this is about the first time in my professional history that I have felt so helpless on this subject—now a statement on the inventory position of this country. I cannot do it because our statistics on the subject in large part are guesses.

Senator PERCY. You have commented on its effects on profits, of course, which is an important factor.

The President mentioned in his economic message some time ago in Los Angeles that there is a tradeoff between increasing supplies and certain other objectives such as in protecting the environment. I have heard many businessmen complain that one of the factors contributing to inflation and higher prices and costs is environmental control measures that they thought were too stringent. Would you care to comment on this balance that must be obtained between economic growth and also preserving our environment, and not having growth today at the expense of livability in the future.

Mr. BURNS. I think that we have passed legislation in the environmental field and the health and safety area which is imposing very heavy costs on business enterprise. And we have not given enough attention to that.

I am not suggesting even remotely that the legislation that we have passed in this area was bad legislation. What I am suggesting is that we have tended to neglect the cost raising effect of legislation of that type. A large part of the investment that is now undertaken by our business firms is not going to contribute to the productivity of those businesses, to the profitability of those businesses. It has been undertaken in response to legislation by the Congress and by the individual States, legislation designed to protect the public, but legislation which has been serving to raise costs. I think it would be very salutary if the Congress would get into the habit, when passing legislation which involves raising costs for business, to recognize that an inflationary factor is thus being released, and, therefore, that some offset elsewhere needs to be found, if we are ever to have an approach to general price stability.

Senator PERCY. I want to thank Mr. Burns for the extraordinary contribution he has made toward the understanding of our problems and the clarity of his suggestions toward a solution. I regret that Senator Javits and I had to be in and out. But we have one element of uncertainty cleared up. The Foreign Relations Committee has now determined that there is no inconsistency between Secretary Kissinger's testimony and the examination that we have made. We felt we ought to get over and vote on that and remove that uncertainty. But we are sorry that we have to leave.

Thank you.

Senator PROXMIRE. Thank you, Senator Percy.

I could not agree with you more on this last statement with respect to our facing squarely the inflationary effect of imposing environmental, safety and health and other regulations on industry. I have voted for all those, and I would vote for them again, I think they are excellent legislation. It is what we should do. And we should do it with our eyes open. As you say, we should find some way of timing it and some way of adjusting it so that it does not have the enormous inflationary effect it has. It is in the billions of dollars a year when you accumulate all of these things together.

In your statement, Mr. Burns, you said: "The Federal Reserve stands ready, as the Nation's lender of last resort, to come promptly to the assistance of any solvent bank experiencing a serious liquidity problem." Can you tell us whether this promise was employed with regard to the Franklin National Bank? Would you briefly describe what you did for the Franklin Bank?

Mr. Burns. The answer to your question is, "yes." It certainly was applied to the Franklin National Bank. We came to the assistance of that bank promptly and on a massive scale. If we had not done so, that bank would have had to close.

Senator Proxmire. You provided funds at what rate of interest to the Franklin Bank?

Mr. Burns. We provided funds to the Franklin National Bank at our discount rate, which is 8 or 8½ percent, depending on the kind of paper that is used at the discount window by the borrower. I believe, in the case of Franklin National, about one-fourth of the sum that we have been lending has been at an 8-percent rate, and the remaining three-fourths at an 8½-percent rate.

Senator Proxmire. Why is it fair to bail out a bank with a subsidized rate like that? Eight percent is far below what they could have gotten, what a sound, solvent bank could have gotten in the market, maybe 4 percent below. It is a very substantial subsidy. How did you justify that?

Mr. Burns. The 8 and 8½ percent discount rate is the rate that is now effective, has for months now been applying to any bank that borrows from the Federal Reserve.

Senator Proxmire. In an extraordinary circumstance like this, where the borrowing is so heavy, would it not be wise to adjust the rates, it is not what appears to be a taxpayer's subsidy of tens of millions of dollars.

Mr. Burns. I do not think that the amount is decisive. If we adjusted our policy, Senator, it ought to be on another principle, not the amount that is borrowed, but the period over which the borrowing takes place. In other words, discounting at the window is ordinarily for very short term purposes—for a few days, a week or two or three.

Senator Proxmire. This is a great exception to this. You say that one-quarter is paid back. But you do not anticipate having that billion dollars paid back in the next few weeks or months, do you?

Mr. Burns. It will be some time before that loan is repaid, yes. Of course, at the beginning we have not known about that. There are legal questions here that had not been finally resolved by our staff. We have looked into the possibility and the desirability of having a special discount rate that would apply to loans, whatever the size may be, that turn out to be of lasting or long duration.

Senator PROXMIRE. Why not simply adjust the discount rate to a realistic market rate? Why should it be so far below?

Mr. BURNS. That has been proposed time and again. And we have made a study of the discount rate problem several years ago, and that proposal was made. There is a lot to be said for that proposal, and there is also something to be said against it; namely, that if we adjust the discount rate to the market rate, we lose one instrument of policy that we presently have. The discount rate, as it has been used by the Federal Reserve and by other central banks, has been an important signaling device, and you lose that power or that advantage when you adjust——

Senator PROXMIRE. It has been an important signaling device. But as an instrument of substantial monetary policy it does not compare with buying and selling Federal securities, does it? It has been a very limited modest instrument, and for long periods it has been very close to being in disuse, has it not, really?

Mr. BURNS. It is less important as an instrument of monetary policy, certainly, than open market operations are.

Senator PROXMIRE. It is my understanding that the discount rates in other countries have been above the market rate, it has been a penalty rate, available if necessary, but with a penalty required.

Mr. BURNS. Yes, that has been done. But also experiments have been tried in adjusting the discount rate to the market, and these experiments have been abandoned too. So there is a great variety of practice here. I am not ready to say to you that our practice is the best.

Senator PROXMIRE. Does the Federal Reserve Board stand ready to provide the same kind of bailout service to any bank, big or small?

Mr. BURNS. There is no question about that.

Senator PROXMIRE. Regardless of size?

Mr. BURNS. There is no question about that.

Senator PROXMIRE. I can understand protecting bank depositors——

Mr. BURNS. Let me just go back. There is no question about it if the bank is solvent. The bank has to be solvent before we lend. We are not bailing out poor bankers or bankrupt banks.

Senator PROXMIRE. In this case, you had a bank which speculated in foreign exchange to a considerable extent. I imagine there are many reasons for a large bank like this to have difficulties. But I can understand protecting bank depositors. We have a law on the books that protects them to a very considerable extent with Federal deposit insurance. I can see why the Federal Reserve Board steps in to provide additional assistance to see that no depositor loses anything. Stockholders are something else, and management is something else.

Mr. BURNS. We are not protecting stockholders, and we are not protecting management. We pay no attention to that. We are protecting the financial systems, both domestic and foreign. If we had sat by and refused assistance to a $5 billion bank, the consequences for the financial system could have been disastrous.

Senator PROXMIRE. Does this mean that no bank, no matter how incompetent, is going to go to the wall? You say that if it is insolvent, you would not bail it out.

Mr. BURNS. That is correct.

Senator PROXMIRE. But short of that, you will bail out every one of the thousands of banks no matter how poor their management policies or how incompetent they have been? Does this not involve some kind of incentive for taking a high risk, knowing that the good old Fed will always take care of you?

Mr. BURNS. I do not know that I would want to say that we would do it universally or to that degree. I want to point out that there is a very important distinction between saving a bank or a banker. We do not save bankers; we save banks when it will serve the national interest. I think that is the responsibility of the Federal Reserve Board.

Senator PROXMIRE. What do you mean by solvent?

Mr. BURNS. By solvent, I mean that when you compare the assets of a bank with the liabilities, you find that there is a net equity position left.

Senator PROXMIRE. It is a matter of great judgment in almost all cases, is it not?

Mr. BURNS. We make the best use that we can of such accounting skills as are available.

Senator PROXMIRE. How do you reconcile this, what seems to be—it would certainly seem to a layman to be a soft and easy policy with respect to Franklin, and available to other banks apparently—with the well-known opposition to other Government bailouts of large corporations and your own views about private enterprise? There were over 10,000 bankruptcies last year. Small businesses are always failing. That is part of free enterprise, the freedom to fail. How do you reconcile this bailout of the banks?

Mr. BURNS. Senator, you cannot compare the consequences of a bank failure with the consequences of a failure of a manufacturing or trading enterprise. It is no accident that since the earliest days of our Republic we have regulated banks. Our Government has regulated banks because it has recognized that banking is an activity that is peculiarly connected with the public interest, that it has a public dimension. When a bank fails, the whole community may suffer. In the kind of interdependent world that we have today, there may be a domino effect, a ripple effect, that can spread doubt and uncertainty and even panic across the Nation. It may cross national boundary lines. Let us not compare the consequences of a failure of a business of a given size with the consequences of a bank failure.

In any case, Senator, ours is a central bank. We have been given the power and the responsibility to serve as a lender of last resort, particularly for banks. The Congress has not asked us to bail out individual businesses which are on the verge of bankruptcy.

As far as banks are concerned, we have no interest in individual banks. We are interested in the financial system, the preservation of its integrity.

Senator PROXMIRE. What your statement implies is that there is a very heavy responsibility on the quality of regulation.

Mr. BURNS. Yes, that is true.

Senator PROXMIRE. The quality of regulation must be sufficient as to at least mitigate if not completely prevent this kind of problem.

Mr. BURNS. You are quite right.

Senator PROXMIRE. Are the recent difficulties we have run into in San Diego, and with the Franklin Bank, and some of the other difficulties that some people seem to apprehend—there was an article about, there is a hurricane going to hit but nobody knows whether it is going to hit—is this due to failure in our bank regulatory system?

Mr. BURNS. I think our bank regulatory system leaves a great deal to be desired.

Senator PROXMIRE. It leaves a great deal to be desired?

Mr. BURNS. Yes, sir.

Senator PROXMIRE. But give us a bill of particulars? I am a member of the Banking Committee, and I will be delighted to do all I can for it.

Mr. BURNS. I certainly shall.

Senator PROXMIRE. We will welcome that.

Mr. BURNS. I think it is high time that we revamped our regulatory machinery.

Senator PROXMIRE. You will recommend improvements in bank supervision and regulations that are specific and that you feel would help improvements?

Mr. BURNS. I will recommend some drastic changes, because I will consider them major improvements.

Senator PROXMIRE. That is very welcome.

I just want to clear up some confusion. I understood that you testified before the Ways and Means Committee of the House, and you said that you favored a change in the tax laws to provide an increase in the investment credit from 7 to 10 percent to be combined with an increase in the corporation income tax from 48 to 50 percent so that there would be no loss of revenue, but so this would be more incentive to investment. I understood you to tell Senator Javits today that you did not favor an increase in the investment credit. Is that a change in your view, or did I misunderstand your earlier testimony?

Mr. BURNS. In my testimony before the Ways and Means Committee, I was asked the question whether I would favor an increase in the investment tax credit to be coupled with an increase in the general corporate income tax rate. That was a new thought to me, and I gave no definite reply, as I recall. Congressman Mills asked me to write to him on the subject, which I have done. I will be glad to send you a copy of that letter, which I ended by being rather lukewarm on that proposal.

Senator PROXMIRE. Fine.

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

AUGUST 1, 1974.

Hon. WILBUR D. MILLS,
House of Representatives,
Washington, D.C.

DEAR WILBUR: At the House Ways and Means Committee Hearing on July 15, you asked for my thinking on the desirability of raising the corporate income tax from 48 to 50 per cent, and using the revenue gain to raise the investment tax credit from its present level of 7 per cent to a higher percentage. Among other things, you asked whether this shift would leave the business community better off.

In general, industries that have larger than average investments in eligible machinery and equipment per dollar of profits would be better off; other industries would be worse off. The effects on individual industries vary greatly. Using past data as a guide, the greatest beneficiaries would be the transportation industries (especially railroads, airlines and pipelines), electric and gas utilities, coal mining and mining of nonmetallic minerals, and some branches of manufacturing—such as the paper, petroleum refining, and the primary metals industries. On the other hand, firms engaged in wholesale trade, retail trade, and finance would be worse off. Also, firms whose profits have declined to such an extent that they cannot now take advantage of allowable investment tax credits would receive no relief. A numoer of firms in the public utilities sector might fall into this category.

Considered as a permanent feature of the tax structure, I believe the proposed change would be undesirable. A higher permanent level for the corporate income tax would be a drawback, since the higher the rate, the weaker are the incentives for efficiency in business enterprise. I also would be cautious about raising permanently the average level of the investment tax credit, since this would accentuate the discriminatory features of this device—that is, the tendency to favor industries that invest heavily in machinery and equipment over those that invest in other ways, or that are generally less capital-intensive.

There would be some advantages, however, to considering a temporary change of this kind in the structure of business taxation, for—on balance—I believe the proposal would encourage additional outlays for machinery and equipment. The incentive to increase investment would apply to all firms with profits regardless of whether or not they benefit from the two-pronged change in tax rates. There would, however, be a considerable time lag—probably a year or more—before any material benefits would be realized in the form of increases in productive capacity.

These short-run benefits would be of some value, but probably not of major significance in the battle against inflation. And it might be that this change in the tax structure could not be achieved in a timely fashion. It is therefore not clear to me that it would be worthwhile to expend such energy in trying to get this proposal through the Congress. I would be glad to reevaluate my opinion when the tax bill gets closer to passage.

Sincerely yours,

ARTHUR F. BURNS.

Senator PROXMIRE. Just one other question. I would like you to put on your professor's cap——

Mr. BURNS. I always wear a professor's cap.

Senator PROXMIRE. Keep it on, then, and see if you can help us with a problem that seems to be puzzling many economic commenators, and many Members of Congress. You have argued that the 6-percent increase in the money supply is a reasonable increase, and an increase which as I recall, is at the top end of the range within which we would like to maintain money supply growth. In past years I have asked you if there should not be some adjustment for the increase in the cost of living. You have said very firmly, no. Now, it is argued that when you have a 10- or 12-percent inflation—for simple purposes, let us say 10—and you have a growth rate that you would like to see, say, at 2 percent and you want to slow it down a little bit, that you would need, in order to have the increase that the money supply stays neutral, an increase of 10 plus 2, or 12 percent. If you have an increase in the money supply on that basis of 6 percent, you are tending to starve the economy for money to a very considerable extent. It means either the velocity will have to speed up greatly, or the interest rates have to increase. You have to ration credit in one way or another, and it exerts considerable sharp restraint. Is that analysis correct, or do you feel that there is something missing here, that a 6-percent increase in the money supply is a reasonable expansionary policy, or at least not a very stringent policy?

Mr. BURNS. I do not think it is a very stringent policy, no. If you tried to adjust the rate of growth of the money supply to the rate of growth of dollar value of the gross national product, you could not, over the long run, ever return to price stability.

Senator PROXMIRE. Admitting that, is it not very important to try to adjust it realistically to what the inflation actually is, recognizing that, of course, if you had a 12-percent, or maybe a 12 plus 2, a 14-

percent increase in the money supply, it might be highly inflationary, that you have to recognize that there is a certain realism here in the fact that you do have, in fact, as a fact of life, an increase in the cost of living, and if you do not provide enough money to finance it, you are going to have a very strenuous restraint?

Mr. BURNS. Well, as you know, in this area we have been striving for a middle course. A 5- or 6-percent rate of growth of the narrow money supply is definitely too high from a viewpoint of general price stability in the long run. On the other hand, such a restricted rate of growth of the money supply, given a 2-digit inflation, will mean a decline in the real money supply; that is true.

If we are ever to return to general price stability, a middle path, I think, has to be selected. Whether the right figure is 5, 6, or 7, one can argue about. But it cannot be zero, in my judgment, nor can it match the rate of growth of the dollar value of the Nation's output.

Senator PROXMIRE. Why would it not be roughly equivalent, if you have a 6-percent increase in the money supply and 12 percent inflation, to have a 6-percent decrease in the money supply if you have zero inflation? I think we would all recognize that is being very restrictive.

Mr. BURNS. If we had zero inflation, Senator, we could afford some luxuries that we cannot afford at the present time, as far as the money supply and bank credit are concerned.

Senator PROXMIRE. I do have this final point. You conclude your statement with a generous offer of "full cooperation" with the studies of inflation which this committee will be undertaking under the resolution which passed the House last week.

The Joint Economic Committee, as you know, has only a small professional staff, whereas the Federal Reserve has a large and well-qualified staff of professional economists. I hope very much that we can draw on your offer of "full cooperation" by obtaining technical advice from your staff and perhaps by having your staff do some special studies for us.

Mr. BURNS. We will be very glad to do that.

Senator PROXMIRE. I am going to ask the committee to explore with you and your staff the special type of assistance we might be able to get from you. Will that be agreeable?

Mr. BURNS. Entirely.

Senator PROXMIRE. As you pointed out, this committee has a very difficult and responsible task, and we very much need your assistance and cooperation. And I am extremely grateful for it.

Thank you very much for another fine presentation. We appreciate it.

Mr. BURNS. Thank you, Senator.

Senator PROXMIRE. The committee will stand in recess until 10 o'clock Wednesday morning, August 14, when we will hear Mr. I. W. Abel.

[Whereupon, at 1:07 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, August 14, 1974.]

EXAMINATION OF THE ECONOMIC SITUATION AND OUTLOOK

WEDNESDAY, AUGUST 14, 1974

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

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the committee) presiding.

Present: Senators Proxmire, Humphrey, Bentsen, Javits, and Schweiker; and Representatives Moorhead and Carey.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, and Courtenay M. Slater, senior economists; William A. Cox and Carl V. Sears, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order. This morning it is a pleasure to welcome as our witness Mr. I. W. Abel, president of the United Steelworkers of America and chairman of the Economic Policy Committee of the AFL–CIO. And I take it, Mr. Abel, you will be speaking as chairman of the Economic Policy Committee of the AFL–CIO.

In just the short period since Mr. Abel accepted the committee's invitation to testify, a new President of the United States has been sworn into office. President Ford has indicated that he wants to move swiftly and vigorously to deal with inflation and that he will urgently seek the advice of Congress and of business and labor leaders as well as of professional economists.

In response to the President's request, contained in his address to Congress Monday night, the senior members of the Joint Economic Committee wrote to President Ford yesterday to inform him that interim conclusions and recommendations by this committee for dealing with inflation will be available within 6 weeks, that is, by September 23, which is what the President requested in his message to Congress on Monday night. These will be followed by a more detailed and complete report which will be filed by December 31 under the terms of Senate Concurrent Resolution 93.

This assignment to which the committee has committed itself will not be an easy one. If there were easy answers to inflation, we would have solved the problem long ago. However, the inauguration of a new President gives us all hope that the spirit of cooperation so essential to dealing with this problem can be achieved. A question of great interest to this committee is the attitude which labor will take toward renewed efforts at wage and price restraint.

Labor was not treated fairly under the wage and price controls. Wages were controlled more effectively than prices, and this contributed to an actual decline in the real value of the average worker's weekly pay and a sharp decline. Will it now be possible to design a program which will be fair and which will win the cooperation of all major groups, including labor? The Banking Committees of both the House and the Senate will begin consideration this week of new requests for a Cost of Living Council. The readiness of labor and business to cooperate in a new effort of this type is obviously the key to whether such a renewed effort is worthwhile.

Thus it is most fortuitous that we have Mr. Abel here this morning to meet with the committee. He may feel that we put him on the spot with our questions. I assure you, Mr. Abel, we do not do so out of any desire to harass, but because we need urgently to know your assessment of the outlook, your views as to what constitute reasonable wage increases at the present time, your attitudes toward the profits presently being made by business, and your preferences as to the type of price-wage monitorying agency, if any, which should be established.

So, Mr. Abel, go ahead any way you wish with your statement. I have read your excellent prepared text. I read it last night and was considerably impressed by it. Obviously this is one which you gave a great deal of thought to, and it is a constructive and a helpful program. We have had testimony now by a number of top economists of the administration, and I have been disappointed in that they did not have constructive programs. We hope they will change with the new President.

If you wish to read your statement in full, that is fine, but if you would prefer to summarize or abbreviate any part, the entire text will be included in the hearing record.

So go right ahead, sir.

STATEMENT OF I. W. ABEL, CHAIRMAN, ECONOMIC POLICY COMMITTEE, AFL–CIO, AND PRESIDENT, UNITED STEELWORKERS OF AMERICA, ACCOMPANIED BY FRANK L. FERNBACH, ASSISTANT

Mr. Abel. Thank you, Mr. Vice Chairman.

My name is I. W. Abel, president of the United Steelworkers of America. I appear here this morning before the committee as chairman of the AFL–CIO Economic Policy Committee, and I am accompanied this morning by my assistant, Mr. Frank Fernbach, who handles our economic special studies projects here in our Washington office.

I want to thank the vice chairman and members of the committee for this opportunity to present the views of the AFL–CIO on national economic developments and trends.

The inauguration of President Ford on August 9 has given the American people and the national economy a psychological lift. The importance of such a boost to the spirit of the American people cannot be overestimated.

However, this psychological boost must be supplemented, quite rapidly, by an economic program designed to solve, not perpetuate, the economic problems that face the American people.

At its meeting in Chicago, August 5 and 6, the AFL–CIO Executive Council devoted considerable attention to the sorry state of the national economy. Not since the end of World War II have the American people been faced by an economic situation as serious, as complex, or as dangerous. The problem was compounded by misguided policies of the last administration, by neglect, and by widespread public distrust of the Government's ability to deal with economic difficulties.

These problems have by no means gone away with Mr. Nixon's resignation. It is our hope that both the Congress and the new Ford administration, now that the national nightmare is over, will turn their full attention to setting these matters straight.

The AFL–CIO Executive Council declared last February and again last May that the American economy had been in an inflationary recession since the final months of 1973, and recent Government figures bear that out.

The dimensions of the problem are unchallengeable.

Inflation is continuing to climb. The average worker's buying power is declining. Unemployment is up and is expected to rise during the coming months. The highest interest rates in 100 years and a money crunch are creating depression conditions in the homebuilding industry and serious trouble for other parts of the economy.

The recession is continuing and appears to be deepening. A long, drawn-out recession, combined with continuing inflation, stares America in the face.

The stepped-up rise of prices was set off by the Russian grain deal in July 1972. The price rise began to accelerate in the second half of 1972, during phase II of the last administration's so-called stabilization program, a one-sided program of controls on workers' wages and heavily weighted in favor of big business and big banks.

Inflation was aggravated by devaluations of the American dollar and vast exports of farm products and crude materials in short supply, such as steel scrap, copper scrap, and even wastepaper.

It was aggravated further in 1972, an election year, when the Federal Reserve supplied a rather easy flow of money and credit, at slowly rising interest rates, which encouraged speculation and the buildup of installment and business debt.

Added pressures on the rising prices of key farm products, raw and crude materials, resulted from hectic speculation and profiteering in the essentially unregulated commodity exchanges.

The energy emergency in the autumn of 1973 and the winter of 1973–74, with the extraordinary rise of prices of oil and petroleum products, added still further to accelerating inflation and the economic woes of the American people.

The last administration's response to these developing troubles, which it set off and, in large part, encouraged, was to adopt restrictive monetary and fiscal policies in early 1973. By the late winter and early spring of 1974, the Government's economic program boiled down to very tight money, sharply rising interest rates, and a holddown on expenditures for essential programs, such as low- and moderate-income housing.

These policies could not possibly curb this rising tide of inflation. But they hit homebuilding first and hardest; residential construction, which declined in 1973, is now in a depression. They were a major factor in throwing the American economy into today's continuing recession. They generated even more inflation by raising costs and prices.

Moreover, these policies, and the money crunch they created, now present the threat of a deepening recession, business failures and high unemployment, while inflation persists.

Take a look at these facts, Mr. Vice Chairman:

Inflation, with its very marked effects on food and fuel prices, which have been spreading to the prices of industrial goods, utilities, and services, has had a particularly devastating effect on most retired people, and on low- and middle-income families with children. Their living standards have been undermined.

The buying power of the average worker's weekly takehome pay has dropped to about the level of 1965, 9 long years ago.

The number of unemployed rose more than 750,000 between October 1973 and July 1974. If unemployment reaches a 6-percent rate, which Government economists say is possible by the end of this year, it would mean an additional 650,000 jobless. The way things are going at present, the rise of unemployment may be considerably greater than that.

In recent months, the real volume of retail sales, after accounting for higher prices, has been about 5 percent below the same period of last year.

A housing shortage has been developing, while both housing starts and building permits have been falling sharply.

Confronted by the highest interest rates since the Civil War, many cities and counties are postponing bond issues and delaying investment in public facilities and services.

Public utilities are cutting back plant expansion programs. Even such large corporations cannot afford today's interest rates, since they are also faced by inflated fuel costs.

These actions by local governments and public utilities mean cuts in heavy construction, reduced orders for machinery, fewer jobs, and increasing unemployment.

The monetary policies of the last administration have brought the American economy to the edge of disaster.

A decisive change is needed to begin to lift the economy out of its present mess and onto the road to balance and health.

A decisive change in economic policies is also essential to maintain the psychological lift of the past few days and restore public confidence in the Government's ability to manage economic problems with fairness, equity, and justice.

Against this background, Mr. Vice Chairman, it should come as no surprise that workers are reaching for higher wage settlements at the bargaining table. The stepped-up inflation of the past 2 years leaves them no other choice but to try to stem their losses through negotiations with their employers.

By the time Mr. Nixon stepped down from office, the inflation rate was more than double what it was in early 1969.

Over the 12 months that ended in June, the consumer price index shot up 11.1 percent, and even higher prices are already inescapable.

During the 12 months through July, wholesale prices climbed 20.4 percent. Wholesale farm prices have turned up, and during the past quarter, wholesale prices of industrial goods rose at an annual rate of 30.4 percent. These increases are now on their way to the retail market and the consumer.

In June, the buying power of the average worker's weekly take-home pay was 4.5 percent lower than the year before and nearly 7 percent lower than in October 1972. June was the 15th consecutive month in which the average worker's buying power was below the level of the year before. It stands, as I said earlier, at about the level of 1965.

The Labor Department tells us that during the 12 months ending in July, the average worker's hourly wage rose only 8 percent, and that includes all wage increases, cost-of-living adjustments, and the long-delayed rise in the Federal minimum wage from $1.60 to $2 an hour.

Wage settlements reached in major collective bargaining contracts during the April–June quarter this year carried an average first-year increase of 9.2 percent, or 7.4 percent over the life of the agreement, plus cost-of-living escalators in many of the agreements.

So workers are still falling short of the 11.1-percent increase in living costs over the past year and are still losing ground.

The incomes and living standards of workers, pensioners and others living on low fixed incomes are being squeezed. But other types of incomes and costs are shooting up sharply.

Even though real economic growth has been declining, corporate after-tax profits jumped 28 percent in the second quarter of this year, according to a preliminary estimate by the First National City Bank of New York. The bank said "the advance appears to be largely, if not entirely, due to rising prices."

That 28 percent profit increase came after a 19-percent increase in the first quarter, when the economy was in the sharpest decline since the recession of 1958. It followed profit boosts of 26 percent in 1973, 25 percent in 1972, and 17 percent in 1971.

The prime interest rate, which the commercial banks charge on loans to the major corporations, jumped from 6 percent in early 1973, and 8¾ percent in the first half of last March to 12 percent at present. That is a rise of 100 percent in the past 18 months and 37 percent in 5 months.

The tight money, high interest rate policy, enforced by the Federal Reserve, is putting the economy through a wringer, It has pushed the economy to the brink of disaster. A depressed home-building industry, declining national production and increased unemployment have been added to runaway inflation.

This spectacular rise of interest rates is adding sharply to inflationary pressures. It is directly boosting prices throughout the economy, as business passes on increased interest rate costs. By creating slump conditions, it is depressing productivity and adding to upward pressures on unit costs and prices. In the name of fighting inflation, the Federal Reserve has become an engine of inflation.

These interest rates are boosting the taxpayers' burden. Interest payments on the Federal debt rose $5.3 billion between fiscal years 1973 and 1974, much of it due to higher interest rates. It is also increasing the interest payment burden of State and local governments.

Along with the immediate damage, the Federal Reserve's policy is building higher costs into the economy for many years in the future.

For example, payments on principal and interest for a 25-year, $25,000 mortgage at a 10-percent rate are $227 a month. That is $66 a month more, every month for 25 years, than the same mortgage at 6 percent. So over 25 years, the buyer will pay $68,000 for his $25,000 mortgage, or $19,800 more than he would pay at the 6-percent rate.

The Federal Reserves' goal is to further slow down the economy. If it succeeds, it will increase unemployment, which has already risen from 4.6 percent of the labor force to 5.3 percent last October. That is an increase from 4.1 million to 4.9 million jobless.

The high interest squeeze is creating further weakness in the economy, in addition to the depressed state of home-building and weakness in retail sales.

Major cities and counties have found it impossible to float needed bonds issues at current interest rates, resulting in the postponement of improvement in community facilities and services, as well as curbing the growth of job opportunities.

Public utilities, confronted by these interest rates and high fuel costs, are cutting back plant expansion despite the need for additional gas and electricity facilities, adding to the 10.6-percent unemployment rate among construction workers and cutting the expansion of jobs for utility workers.

Such cuts in private and public investments now pose the danger of widespread reductions of the large inventories business accumulated in the past year. The result could be cancellations of orders for goods in the coming months and a general drop in production, working hours, and employment.

Moreover, the Federal Reserve policy is discriminatory. It favors the powerful big-city commercial banks, wealthy money lenders, and money-laden major corporations. But it hits workers and consumers, home-builders and home-buyers, communities, smaller businesses and even those corporations, like public utilities, that need lower-interest loans. While all of these have been starved for credit, there has been a continuing flow of loans for other purposes, such as foreign loans.

Governor Andrew Brimmer of the Federal Reserve Board reported last month that American banks increased the flow of money to foreign borrowers by $8.5 billion during the first 5 months of this year.

"Only a small share of the rise in bank loans to foreigners has been associated with export financing," Brimmer said. "Instead, it appears that, with the termination of nonexport foreign lending restraints, banks have de-emphasized export financing and intensified their interest in developing other foreign lending and investment opportunities."

Nothing could be clearer than the fact that the tight money, high interest rate policies worked against the interests of the American economy and the American people.

These policies can reduce the rate of inflation only by subjecting the American people to the suffering of a depression or extended recession.

High interest rates and the rising price of homes, plus the phase-out of Federal low- and moderate-income housing programs have brought a sharp drop in residential construction since early 1973.

Prices of homes and rents for new apartments have risen sharply. Credit for builders' loans is drying up and available only at very high rates. Moreover, the upward spiral of interest rates, led by the major commercial banks, has resulted in the large-scale withdrawal of funds from savings and loan associations and mutual savings banks, which are the main source of mortgage money.

Housing starts during the first half of this year were 31 percent below the comparable part of 1973, and in 1973, they were 13 percent below 1972.

Price inflation and the cutback in federally assisted home production have also shifted production toward the high end of the price scale. Less than 5 percent of new homes sold are now priced at under $20,000, and less than 30 percent at under $30,000. The median new home sales price is up to about $36,000.

As a consequence, most American families have been priced out of the housing market. It would now require an $18,000 income to meet total home-ownership costs on a home with a $30,000 mortgage, which rules out about three-fourths of American families.

The annual rate of 1.6 million housing starts in 1974, so far, is barely keeping pace with the annual increase in households over the past 2 years. It does not allow for replacement of an estimated 700,000 units lost from the housing supply annually due to demolitions, fire, flood and other causes, and it does not begin to allow for housing to accommodate the mobility and migration of the population. The overall production deficiency creates housing shortages which breed more inflation.

Mr. Vice Chairman, the question of where low and moderate income families will find adequate housing has been ignored by the Federal Government. The rapidly increasing conversion of housing to condominium status is bringing crisis to hundreds of thousands of families that are being displaced because they cannot afford to pay the price.

In addition, it is estimated that as much as 25 percent of the housing units sold this year will be condominiums, and that fact is creating new problems for those who can afford to buy them, as well as for those who cannot. Many of these people are finding themselves saddled with escalating management and recreational fees under long-term contracts, as well as mortgage payments. There is no adequate consumer protection at Federal, State or local government levels.

The housing chaos reacted by the last administration has to be cleaned up as quickly as possible.

We of the labor movement urge the new administration and the Congress to restore residential construction to a level that will meet the needs of the American people by taking these steps:

One, we recommend the administration should use the remaining unused contract authority for housing assistance payments to make new commitments that will support the construction of additional units under the section 235 home ownership assistance, and section 236 rental housing assistance programs. It should also utilize such additional authority as the Congress may enact in support of conventional low-rent public housing and assisted housing for the elderly.

Two, the Congress should enact sufficient additional contractual authority for annual assistance payments under the conventional public housing, section 235, and section 236 programs that would permit those programs to be fully implemented during fiscal years 1975 and 1976.

Three, the Congress should enact pending legislation that would permit direct loans and housing assistance payments to provide housing for low and moderate income senior citizens.

Four, the Congress should enact proposed legislation that would provide for middle income home mortgage financing at lower interest rates than those presently available, through mortgage purchases by the Government National Mortgage Association.

Five, the Congress should adopt legislation to protect American families from abrupt displacement from apartment houses being converted to condominiums, and to protect consumers who purchase condominiums against hidden, long-term charges.

The AFL-CIO is convinced that the tight money, high interest policies pursued by the Federal Reserve are a dire threat to the well-being of the American people. We belieev that an immediate and thorough change in monetary policy is essential. We trust President Ford will agree.

For our part, we seen an urgent need for much lower interest rates, combined with a selective monetary policy based on social and economic priorities. In our view, the extension of available credit should be eased for high priority objectives, and tightened for low priority purposes.

Therefore, Mr. Vice Chairman, the AFL-CIO:

One, urges the Congress to take immediate action to direct the Federal Reserve System to allocate available bank credit on a selective basis, to allocate a significant portion of available bank credit, at reasonable interest rates, for such priority purposes as housing, community facilities, and expansion of essential public utility plants and to curb the flow of credit for such activities as gambling casinos, land speculation, hoarding, foreign loans, and foreign subsidiaries of American companies.

The Federal Reserve System should also be directed to provide a sufficient expansion of money and credit, at lower interest rates, to encourage the needed expansion of economic activity and job opportunities.

Two, we urge establishment of a direct lending program by the Federal Government to provide mortgages at reasonable interest rates for middle income housing, as well as expansion of Government programs for low and moderate income housing, which have been curbed in the past 2 years.

Three, the AFL-CIO calls on the Congress to establish a fair and equitable means of raising the required volume of Federal revenue to meet the Government's obligations for maintaining its operations and expanding essential programs.

Elimination of the major loopholes in the Federal tax structure and adoption of an excess profits tax can raise as much as $30 billion of additional revenue. Proposals for further tax cuts for business, which the administration and big business spokesmen are advocating, should be rejected.

The average taxpayer will be able to obtain a genuine tax break when everyone pays his fair share of the Federal tax burden.

Four, the AFL–CIO reiterates our request to the Congress to enact Government controls on exports of agricultural and other products in short domestic supply, to be maintained until shortages are ended and inflationary pressures on prices of such products subside.

Effective Government regulation of the commodity exchanges, including margin requirements, is needed to curb price boosting, excessive speculation, and profiteering.

The Government should rebuild America's stockpile reserves of agricultural products and raw materials which have been depleted in the past 2 years. The reestablishment of such reserves to adequate levels as rapidly as feasible is necessary to serve as a price-stabilizing factor, as well as for national security and to help meet domestic or foreign emergencies such as floods, shortages, or famines.

Five, we urge the Congress to appropriate the funds needed for a large-scale public service employment program. Substantial Federal grants to the States and local governments are required to create jobs for the unemployed and provide unmet public services.

Six, and finally, Mr. Vice Chairman, the AFL–CIO calls on the Congress to enact a special program of Federal grants to States, local and Federal governments and Federal agencies to accelerate short-term public works construction and repairs in areas of high unemployment.

Mr. Vice Chairman, there is a great deal more to be said about the grave state of the American economy, but I have confined this testimony to those areas where, in labor's view, the greatest dangers lie. These are the areas that we believe most urgently require the immediate attention of this committee and the Congress.

For 5 years the economy has been given heavy doses of the wrong medicine. The resulting imbalances and inequities cannot be allowed to continue very much longer.

We in organized labor have great faith in the strength and resiliency of this Nation and its institutions, including its economy. But the time has come to return to a sane, humane system of national priorities and to make the policy changes that are necessary to restore the national economy to health.

American workers and the American people are in deep economic trouble, and they are looking to this Congress and President Ford for relief. That relief must come soon, if we are to escape economic chaos.

Thank you, Mr. Vice Chairman.

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

Again, as I said, this was a very helpful presentation, and it provides as such a welcome balance for our hearings. We have heard one song sung over and over again by a series of administration witnesses, and you come in with a view that is quite different and has a lot of merit.

There is a great deal in here with which I heartily agree. Your analysis of the causes of our present plight, I think, is sound. In your statement, what you say about housing is most constructive. Congressman Moorhead and I have just been in 4½ weeks of conference on the housing bill, so we are very concerned about that. I am also chairman of the Appropriations Subcommittee that handles the money for housing, so we are delighted to get this enlightened view of the necessity, absolute necessity of moving head with the depressed industry which is suffering very seriously.

You had a startling revelation that just had not been called to my attention in your statement. I think it tells us a lot about what kind of policy is likely to be effective. You point out that retail sales in real terms have dropped 5 percent this year. Just think what that means. Here is the year of our worst inflation; effective demand has gone down, and the prices have gone up. Now, when we take the first kind of an economic primer, we learn that when demand falls, prices are supposed to fall off; or on the contrary, if demand goes up, and people want to buy more, then prices go up. But it has not been working that way. It has been working in quite a contrary way.

I would like to ask you before I get into some other specific questions, because it is very helpful if I can quantify this, what you would foresee if the present policies are continued in general by the new administration. We hope they will be changed to some extent along the lines that you recommend. But supposing they are not. What do you predict is likely to happen to growth for the rest of this year?

Mr. ABEL. Quite frankly, Senator, we are very much disturbed that if this present policy is continued, we will see the unemployment rate grow. We will see a falling off of industrial productivity as a result of what is already taking place in the building at excessive rates of industrial inventories. Naturally, the inability then of people to meet their obligations, their debts and so on, and a real spiraling movement then into a deep economic depression.

Senator PROXMIRE. Well, I want to get as specific as I can, and I want to ask you about each of them. First, growth; second, unemployment; and third, prices.

What do you expect to have developed as the year goes on, say by the end of this year, in terms of the growth of the economy? As you know, it declined 7-percent annual rate the first quarter; 1-percent annual rate the second quarter; and so far the evidence is that it has been fairly stable in this quarter, but it may have moved down a little bit further. What do you anticipate for the rest of the year?

Mr. ABEL. I myself feel strongly from what I have seen, Senator, and with the limited knowledge I have, that with the exception of basic industries such as steel and aluminum, I think we are going to see a further reduction of productivity. I think that in both the steel industry and the aluminum industry—where productivity is much higher than the rest of the economy, and higher, I might say, than the normal, average growth—that we will see, still see a continuation——

Senator PROXMIRE. A continued reduction? Do you expect production to decline?

Mr. ABEL. No. I expect in the basic industries for it to continue.

Senator PROXMIRE. But overall?

Mr. ABEL. But overall I think there will be a decline.

Senator PROXMIRE. How about unemployment, which the administration says it will go between $5\frac{1}{2}$ and 6 percent, and Walter Heller said it would go up as high as 7 percent. Do you have any views on that?

Mr. ABEL. I think it is very possible that Walter Heller might be correct. I would point out that while we talk in terms of the number of unemployed—and I make the point in my testimony here that it has increased by 700,000, and if we go to 6 percent it will be another 650,000—a very important fact in regard to this that we are over-looking is the fact that for each unemployed, we are talking about four people. So that when we say that there are already 700,000 added to the unemployment rolls, we are talking pretty much of 3 million people who are deprived of an adequate income. This is an important factor in our view.

Senator PROXMIRE. How about the prices? Again, the administration says they think price increases will drop between 7 and 8 percent. Others say that will continue close to double digit. We have had this recent wholesale price index which is the biggest increase we have had in a year, in July, an increase, as you know, of 3.7 percent, a whopping increase.

Mr. ABEL. I can only remind you in that regard, Senator, in 1971 when the President instituted the freeze, and then the Pay Board and Price Board, we were told then that we were going to roll back the rate of inflation to 2.5 percent. We established, I remind you, our wage guidelines. On that assurance, allowing 3 percent for economic growth and 2.5 percent for inflationary growth, we established the 5.5 limitation on wage adjustments, but never did we even approach the 2.5 limitation on cost of living or inflation, and we see no immediate steps in that direction now. It is now 11 percent and going higher. When we see the roll-in——

Senator PROXMIRE. So you do not see any reason to expect price increases are going to abate at all unless we adopt——

Mr. ABEL. Not at all. I think a good example of this is automobile pricing at the present time. We have had an oversupply of automobiles. Every dealer is loaded to the hilt. Unemployment is rather high at the present time in the auto industry. But the prices keep going up on automobiles.

Senator PROXMIRE. That is right. We see a reversal of the demand drops off so prices go up, and it ought to be exactly the opposite.

Mr. ABEL. So it is a clear indication that the administered prices we have——

Senator PROXMIRE. What I was getting at, these are fixed—fixed corporate prices, and we are going to have to get tough and cut down. Mr. Kauper of the Antitrust Division has been talking about a fight to stop big corporate price fixing, and we hope he gets into it, I hope President Ford gives him lots of support, and I also think that we in Congress ought to give as much support as we can.

Let me point out, your fine statement contains a number of recommendations—credit allocation, housing assistance, tax reform, agricultural policy, public employment, public works—but you do not really tell us what to do about inflation. All of us are puzzled about what to do. Cutting the budget will help, but as strongly as I support spending cuts, I know that will not do the whole job. Or even the main part of it. Steel prices are up 40 percent. Now, you are in the steel industry. That is your industry; you are expert in that industry. There has never been a year when we have had anything like that. There was 1 year right after World War II when they went up 22 percent. But 40 percent in 1-year, you know, you can go a whole decade without a 40-percent increase, and a 1-year 40-percent increase, nobody can tell me that wage increases are responsible for a 40-percent price increase. There is no indication that I know of, of a demand situation that really would justify that kind of an increase.

In the past 12 months, crude oil prices are up 78 percent, sugar prices up 88 percent, industrial chemicals up 50 percent. Now, this kind of an increase is something that is really at the heart of our inflation. The kind of policies we are talking about would not stop these runaway price increases. I think we just have to have some kind of an agreement—some kind of a business, labor, Government getting together to call a halt to this.

My first question to you, of course, is labor willing to do that?

Mr. ABEL. Labor has always been willing, in fact, more than willing I would say to cooperate in every respect, as we have said repeatedly, make every sacrifice needed, providing that all segments of our economy make equal sacrifices, that there be equity in whatever type of a program is necessary.

Senator PROXMIRE. President Ford has now been pushing a price monitoring agency, and a wage-price monitoring agency is being pushed very hard. The House is about to mark it up today. The Senate is setting hearings on it tomorrow, and we want to push it through, he wants to have us push it through rapidly. He called me on the telephone, and that has not very often happened to this Senator by any President. He called me yesterday and asked me to support it, so he must be calling a lot of other people. How do you feel about it?

Mr. ABEL. Well, I would have to say this with respect to what they have been talking about for the last few weeks. The need for legislation to establish this kind of a monitoring system, certainly in my view, the President has this at his command now. He has the Economic Council, he has the Cabinet members who are the Secretaries of Commerce, Labor, and Agriculture. All of these people have the economic data at their fingertips that he can call upon and say, let us have a look at what is going on, let us monitor this thing. If he is talking about this sort of thing that people have advocated, then, I think he already has it. All he has to do is to utilize the people that he has at hand.

Now, if he is talking on the other hand of establishing once again a sort of an advisory, tripartite advisory council of labor and business, the public, I think some good can come of that. We have had similar bodies during the Kennedy and Johnson administrations. I think they were helpful in advising and assisting in these areas. Something like that I believe could be helpful.

I would say this, off the top of my head, that whatever the proposals are, I am sure that the labor movement—and President Meany, is the one that should be responding to that degree, and I am sure he will in a few days here—will be more than willing to sit down and listen to any kind of a proposal, and to extend every cooperation with some assurance that we are not going to get the same kind of shabby treatment that we were subjected to in 1971.

Senator PROXMIRE. That is mighty welcome.

Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Vice Chairman. Mr. Abel, I welcome you particularly in your capacity as president of the United Steelworkers of America, because the headquarters of that great union are in my congressional district. I consider you to be a close friend as we have flown back and forth between Washington and Pittsburgh on numerous occasions. So I welcome you, sir.

I also want to commend you on this excellent statement. I do not think that any statement on the economy has analyzed the situation with such insight and offered more helpful solutions to problems that I find terribly difficult to analyze.

Mr. Abel, you were talking to the vice chairman on the subject of productivity, and you mentioned productivity in the steel and the aluminum industries which, of course, you are familiar with. I know that you and the steel industry have been leaders in having labor and management sit down and work together toward increased productivity.

I wonder if you could tell us a little bit about your experiences, emphasizing, in particular, how your experiences could be translated into other areas of the economy?

Mr. ABEL. Well, quite frankly, Mr. Congressman. we have been very much interested, concerned, I might say, both the industry and our members with the unique problems of the steel industry. Here again, I take this occasion to point out that it came about mainly because of our lax trade policies, and the unfairness of much of our policies in the foreign trade area. Because of this kind of a loose policy, we found that roughly 20 percent of the American steel market had gone to foreign producers. At that point we both recognized we had a mutual problem, one of coping with foreign competition, as well as one of reviving a basic industry that this country greatly needed, not only in the past, but in the future. So we set about to see how it was we could jointly approach this problem. We did it in two ways. We came to Congress, we came to the then administration for aid with respect to trade policies. We did, with the great help of our good friend, Senator Humphrey, work out some voluntary import quotas with competing companies. Then we got looking at our productivity problems, we established productivity committees in every steel plant across this country, and from the top of the industry to the plant level, and from the top of our union to the plan level we have been working on these problems. I am happy to say that we have made great progress.

The imports have been cut from 17.3 million tons in 1971 to just a little below the 12-million ton rate as of now. In productivity, while the rest of business and industry in this country dropped below the normal 3-percent growth rate last year, the basic steel industry productivity improvement factor was in excess of 10 percent. So, I think this is an indication that we have done a good job. I think that both the industry and our members and the economy of this country is much better off because of this approach.

I would go further and say again that a lot of the encouragement for our efforts in the productivity area came from a tripartite committee on productivity that was set up by the Federal Government a few years ago, but now, too, has gone out of existence.

Representative MOORHEAD. Would one of your recommendations to this committee be to reestablish a tripartite committee on productivity?

Mr. ABEL. Yes. I think this is very helpful. You know, a lot of times in our society and in our way of life we recognize the need to do something, but we are maybe a little reluctant on our own to take that step for fear that it might not meet with popular approval. I think this is the case too often. In our case, it has met, I am happy to say, with overwhelming approval and participation by our people, because again here we recognized what has happening to our industry, and in turn, there are jobs and communities in this country, and we put ourselves to these things.

In addition, I remind you that in our industry we were willing and able to sit down, and because of our mutual concern, work out what we called our experimental negotiating agreements which assured the industry, our members and the Nation that we would not be encountering basic steel strikes or lockouts. There would not be the need for the building up of huge stockpiles or the increasing of foreign imports. It has worked to the mutual benefit of all concerned.

Representative MOORHEAD. I think that you and your union have pioneered work in this area, Mr. Abel, and you are to be strongly commended for reaching this type of agreement. It benefits the members of your union and actually benefits the industry, too. It might be helpful to the committee if you could expand your remarks on this subject and give us more specific information which might be helpful to other unions and industries.

Mr. ABEL. Good.

Representative MOORHEAD. I notice that in your statement you discuss the need for a large scale public service employment program. In previous testimony before this committee the Chairman of the Federal Reserve System, Mr. Burns, suggested a $4 billion program which would be put into effect whenever national unemployment reached a rate of 6 percent.

What I would like to ask you, sir, is whether you think that dollar amount and that 6-percent trigger is approximately correct, or do you have a different level of funding or unemployment rate in mind?

Mr. ABEL. I have no idea, and I question whether anybody else has as to the total expenditure or the requirements. I think it depends on how we look at the needs, the problems, and the extent to which we want to go. With respect to unemployment again, this is a matter of judgment. Are we talking about overall unemployment or specific unemployment? As I point out here, in our building construction trades in this country today we have better than 10 percent unemployment. These are the highly skilled workers of this country who are unemployed because, again, of tight money policies, primarily. And the inability of people to afford housing is one example.

So, it depends on certain variances.

With respect to the need, the need is there, and certainly we should get on with it. I served, I am happy to say, on the Civil Disorders Commission in 1968, and we filed with the President and with the Congress a comprehensive report of things we felt strongly then that were needed in our major cities. Not a thing has been done with it. We have not cleaned out the slums. In New York City, as an example, where we toured Stuyvesant and Harlem, and witnessed the devastation around and the great need, we have seen nothing done about improving that. We have seen continuing building of multimillion-dollar skyscrapers in the center city of New York, but nothing about the slums and the conditions surrounding that great empire.

I would say that now is the time that Congress and the Federal Government should give some attention to the recommendations of the Civil Disorders Commission and get on with this job. I think now is the time we should give consideration to the needs of our major metropolitan areas for assistance in providing transit systems so people can get to their jobs and get home again. I think now is the time, we talk about national defense, you know, and even the President in his message to the Congress the other night and to the people, pointed out that this is one area that we were going to continue our efforts. I think it is time we recognized the futility of all of our efforts in national defense if we let our rail systems go completely to pot, as we are doing. The time is now to start rebuilding that rail system. Only the Federal Government can do it. Private enterprise is not going to do it. They wrecked it. The Federal Government will have to rebuild it, and I think now is the time to start on it, and these are the things that are needed now to help the economy. It will help unemployment, and it will do the things on a long range, lasting basis that this country needs.

Representative MOORHEAD. Thank you very much, Mr. Abel. My time has expired, and I must go to the other side of the Capitol where we are considering the establishment of a Cost of Living Council; so I am glad to have had the benefit of your answers to Senator Proxmire's questions on this important issue. Thank you very much.

Mr. ABEL. Thank you, Congressman.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Mr. Abel, I am delighted to see you here, and it is quite interesting to me that everything you are mentioning here has been very high on my agenda, and so I would like to be rather specific about the particular bills.

First, as to the monitoring agency about which you were asked, Arthur Burns recommends that we also crank into it the capability for the agency to have a "cooling off" period, or the power to stay a particularly vital wage or price increase as much as 45 days. The administration is not going for that, and Mr. Rush just testified upstairs before the new Budget Committee, of which I am a member, against it.

Do you have any feeling about whether the monitoring agency should or should not have any such authority?

Mr. ABEL. I would be opposed to it, Senator, again on the basis of our experience. We did encounter in the summer of 1971 the immediate freeze, which, of course, is all right for the fellow that has already had his, but for the ones that are in line, it certainly is an added hardship. Many people did suffer because of that freeze period. The same sort of thing happens today. I think certainly we have to look at things the way they are. If you have had yours, fine, and if you have something due you, you certainly should be given consideration in that regard.

But, then you can also start cranking in sort of the guidelines and the yardstick that is going to have to have a governing impact on us in the future. But, I would be opposed to any immediate freeze.

Senator JAVITS. I have legislation in on a monitoring agency, and also I understand yesterday a new bill was introduced by Senator Sparkman and Senator Tower. That will be out for hearing, Senator Proxmire said, tomorrow; and I expect to testify in favor of it.

Now, on the productivity council, which has been a long-standing legislative effort of mine, do you believe that the productivity council experience of World War II served a useful purpose, where we had 5,000 such labor-management councils on local and industry bases?

Do you believe that they would be a very useful tool now, and do you feel that labor would cooperate if it were done in good faith?

Mr. ABEL. I am highly in support of that kind of a program. Here again, as I say, our experience within basic steel has been very good. It has been beneficial to all concerned.

But again, I would point out these are mutual endeavors, and they have to be approached with that point of view. Workers cannot be expected by industry just to be utilized, used and discarded. They have to be accepted as equal partners and have the opportunity, if you please, and we have not, of going into management people and questioning their decisions, and recommending a different course. Even appealing to the next step, if we feel that there is merit to our views, in contrast to management's views. This is with respect to productivity, utilization of forces, the whole gambit. Quite frankly, Senator, it has been working, and working well in the steel industry.

Senator JAVITS. Well, now, do you have it on an industrywide basis, or plant, or company, or how is it set up?

Mr. ABEL. We have it in the basic steel industry from the very top of management in the industry to the plant level, the work manager, the foreman and supervisor, and we have it in the union from my level down to the shop steward, and the officers of the local union. One of my assistants, as an example, devotes practically full time to working with his counterpart in the industry, giving guidance and assistance to these productivity committees.

Senator JAVITS. Do you feel, Mr. Abel, that that could be approached through the AFL–CIO on an all-union basis?

Mr. ABEL. Very definitely.

Senator JAVITS. I have talked with Mr. Meany about it. I shall pursue it and pursue it with the President.

I note also that you are for some form of a budget of our food resources, which I thoroughly approve of, and that would include, would it not, a determination as to what we can or cannot export?

Mr. ABEL. Correct. Very much.

Senator JAVITS. Also, knowing you as I do, I am sure you would be for some reserve for famine and starvation and catastrophe, whether it happened here or happened anywhere else?

Mr. ABEL. That is exactly the point that we are making there, Senator. We are very much disturbed, have been and were at the time of the grain deals, and certainly now that concern is bolstered by the reduced crop that we are having because of weather conditions. This is always a danger and a threat to a society such as ours. We suggest, too, Senator, that we go beyond foods to having some kind of control on exports of raw materials. Here is an example in it again in the basic steel industry. We are hard pressed, and a lot of the price increasing comes not from wage costs, but as an example, scrap costs; and the price of scrap steel rose in this country from around $40 a ton to as high as $160 a ton because we were once again shipping all of the scrap to Japan and foreign producers who were in a position to bid the price up.

Senator JAVITS. You also, however, understand the need for a two-way track, and you want us to have some judiciousness about this.

Mr. ABEL. Right.

Senator JAVITS. The other thing I would like to ask you about is your feeling on the misallocation of credit. I am sure Senator Humphrey will question you about that, and I do not want to anticipate what he would say, but he has been very, very eloquent on that score. I take it that you would favor some form of control in that area, whatever we thought might be a feasible control?

Mr. ABEL. Exactly, and preference given to certain needs of society.

Senator JAVITS. I think you would find some comfort in the housing bill. We adopted the report in the Senate yesterday, and I think it is very strong.

Finally, on the public service employment, we are pushing ahead with the hearing on my bill with Senator Nelson for 500,000 public service jobs with a 6-percent unemployment trigger at a $4 billion price tag. The only difference between our bill, and it has been in for some months, and Mr. Burns' suggestion is that he set a low figure of $6,000 for jobs, and our experience is, it takes $8,000.

Do you feel, Mr. Abel, that with your estimate of 650,000 jobs as being the deficiency, and do you have a 6-percent unemployment, and this is national, it would be by our labor markets, that the 500,000 is a reasonable order of magnitude of public service employment with which to meet that kind of an initiative?

It is not job for job, but do you feel it is a reasonable shadow that the Government can do to help materially?

Mr. ABEL. I think, Senator, as always this is a beginning. I do not believe, of course, that it is going to be the end-all. I myself feel, you know, that it is wrong for our kind of a society to say we accept a 4 percent unemployment rate, a 5 percent or a 6 percent. I think, after all, it is the national policy, through act of Congress, that we are for full employment, we want everybody that is desirous of a job and able to perform a job, to have it. Certainly it is our view that where we have unemployment, we have public need, whether it be slum clearance, rapid transit development, public schools, hospitals, and God knows, the need seems to be never ending. We should be utilizing the resources we have, which include manpower and skills and ability along with our resources to alleviate these conditions.

So, while I hesitate to say that your proposal is the end-all, I am sure you do not intend it to be, it is a start in the right direction, and a good start. And we are for it.

Senator JAVITS. Thank you, Mr. Abel.

Thank you, Mr. Vice Chairman.

Mr. ABEL. I would just add, you know, Senator, I had the occasion to meet the other day with some German industrialists, and I find that they are very disturbed because there is an unemployment rate of 2 percent in Germany. We seem to be prepared to accept 6 percent.

Senator JAVITS. Yes. I thoroughly agree, and there is no magic in the figure except it represents a measure of the national urgency which would induce Congress to come through with this kind of an expanded public service employment program.

Thank you, Mr. Vice Chairman.

Senator PROXMIRE. Senator Humphrey.

Senator HUMPHREY. My good friend, Mr. Abel, I want to compliment you on your statement and to thank you for your constructive testimony.

Mr. ABEL. Thank you.

Senator HUMPHREY. We have received some very practical, sound advice here, much needed, might I say, because much of what we hear is what I call the old time religion economics which is basically the economics of high interest rates, tight money, balanced budgets, and investment policy. I happen to believe that there is merit to a degree in all of those, but the emphasis has been away from what I believe are the social necessities and the social needs of our country. As Senator Javits indicated, I was particularly pleased with your recommendation to the Congress to take immediate action to correct the Federal Reserve System to allocate available bank credit on a selective basis; namely, to take care of some of the needs of housing and community facilities, and so forth. There is no reason in the world that cannot be done.

Are there any members of organized labor on the Board of Governors of the Federal Reserve System?

Mr. ABEL. If there are, I do not know of them.

Senator HUMPHREY. You know, I think that banking is too important to be left to the bankers because they are locked in in a theology of their own. One of the things that really has bothered me about the Federal Reserve proposals is they are essentially banking proposals without adequate appreciation of the other needs of our economy. I just wanted to thank you very much for your recommendation.

I noted that you were concerned about the needs of the localities, the counties, State governments, local governments, for public works and public improvements. We have got a World Bank, you know, to help the world, I have supported it, and an Asian Development Bank for Asia, and our Government, our country is a big contributor or an investor in that. We have the Inter-American Development Bank for Latin America. We have made some effort to make a contribution to the African Development Fund now, which I have supported. But it always bothered me that we never took time out to have a national domestic development bank for our own country, so that you could have some long-term loans for public improvements and not just depend on the Congress or the last election as to whether or not you are going to get some grants, but to get long-term financing at low rates of interest for these important public projects.

There is a great deal of difference between financing private industry and financing public programs. Last evening I heard Senator Javits make a comment to the effect that we needed to take another good look at our credit terms, getting up to instead of 10-, 15-, and 20-year loans, getting to 40- and 50-year loans on certain types of projects, construction, or facilities because they have that lifespan. I think this is so necessary.

I want to question you a little about an area about which I believe I know something, and that is the food question. First of all, the Government has no national food policy, I should state very categorically. You have mentioned here, you reiterate your request to the Congress, to enact controls on exporting and other products in short domestic supply. I have looked upon, frowned upon, what we have called export embargoes, but I do believe there ought to be export licensing when you get to a situation where there is a short supply.

For example, we are in short supply right now, for the rest of this year, on corn, which will have an unbelievable effect upon the price of dairy products, beef, pork, and poultry. It is in the works, just as surely as we are looking at each other here today. And the Government is going right around, continuing to eat those jolly beans that I talk about, and pretending that it did not happen. But it is here. I think it was proper, in light of the lack of supply of corn as a basic feed grain for our own domestic economy, that the Secretary of Agriculture be required that in case any exports are made, that he must make a decision to license that export, to take a look at the supply situation, and if the supply is short, there shall be no license.

Mr. ABEL. I think, Senator, following the grain deal with Russia, you will find overwhelming support among the public for just that kind of a regulation. I do not think there is any question about it.

The American public was shocked by what took place in that case and the aftereffects of it. I would go further and say to you that I think that it is about time that some thought be given to, as well as a peek every once in awhile, into the commodity exchange markets. And see to it that we do not have this goings-on, whatever you might call it, and it scares me when I see it on television of this wild, so-called bidding in commodities. We witnessed soybeans, as an example, as we did a few years ago, going from $1.50 a bushel to $14 a bushel, by people who never saw a soybean. I think this kind of thing is greatly needed in this country.

Senator HUMPHREY. You will be pleased to know that I introduced legislation on strengthening the Commodity Exchange Authority, and that we have just completed the markup of this bill which is going to put real teeth into the Commodity Exchange Authority as an independent commission, not under the Department of Agriculture, but totally independent with new authority, with injunctive powers, regulatory powers, the likes of which this country has not had in the commodity area at any time. We have just finished this markup on the bill in the Senate, and we are going to act on it this year. The House has taken action on it already. I think our Senate bill is a little tougher than the House bill, and we will hopefully work those details out.

Now, on reserves, Mr. Abel, I have had a running battle here with the Secretary of Agriculture and others on reserves. I have had legislation introduced and refined after extensive hearings, and listening to every conceivable voice that wanted to be heard, of establishing a national grain reserve program. I think it is just as you have mentioned about the railroads being in such disrepair in this country, and we talk about national security. You have got to have holes in your head to talk about national security and not have a good transportation system. We talk about national security, and if we got in a war today, we have no food reserves. We had food reserves in World War I, we had huge food reserves in World War II, we had food reserves for the Korean war, and we had food reserves in the war in Vietnam. But as of now, all we talk about is more bombs, and for the amount of money that we are investing in three Trident submarines, we could build a food reserve in this country that would assure us of adequate supplies for the foreseeable future, for ourselves, for national and international emergencies, and for the consumer.

I have perfected legislation that will see that the farmer is not wrung out, so to speak, and the victim of depressed prices; where two-thirds of the reserves would be held on the farm by the farmer himself, and only a third of that in the Government hands. I wish to God that you could get the Secretary of Agriculture and the Committee on Agriculture to do something about it. Might I say I brought this bill up once in the Senate and got 26 votes. It is a much better bill now than the one we originally had, but we need to speak to, you have got to speak to people through your powerful organizations to get on the stick with this one because I can tell you that after this year, we are going to see what it would have meant to have had some food reserves. When we sold all of that wheat to Russia, every consumer in America was taken for a ride.

I believe that we ought to sell, but I think we ought to know how much we are selling, and I gather that is what you are saying here, that we ought to have some levels that we maintain for ourselves, is that correct?

Mr. ABEL. That is correct. I think there is need for some consultation with other people rather than just an act or a judgment on the part of the Secretary of Agriculture, whoever he might be, or any one individual. I would like to be of help, but I do not know in this instance what help we could be. I once, not too long ago, talked to the Secretary about the food situation, and particularly the pricing, and I was surprised that he said, well, when farmers could buy Chevrolets for $900 again, then maybe we could look forward to 79-cent steak. So these kinds of approaches do not seem to me to be very constructive.

Senator HUMPHREY. Of course, the point about a food reserve is you can see that the farmer has a good price when he producces it, and he is entitled to it.

Mr. ABEL. Exactly.

Senator HUMPHREY. At the same time, you can have some reserves to protect the needs of this Nation, and I am talking about national security, not only consumer needs.

The final thing—time is running out—I would like to just compliment you on your commentary on the housing proposals. It is so terribly much needed. And your information to us on the outflow of money. Constantly we hear that one of the reasons that the interest rates are high is because the Federal Government has to refinance so much, which is, of course, true. But the outflow of money from this country abroad is incredible, and that is what is drawing down the credit pool, so to speak, for the citizens of this country. You signal this for us, but, Mr. Abel, I weary of it. We know what you are saying is true, but we ignor it like it was not a fact, and I do not know what we are going to do about it except to keep pounding away at it here. I hope that when you talk with our new President, and I understand that he has had a talk with Mr. Meany, and I want to wish this new man well, I think he is a man that man faces up to reality, but I hope that you will recite some of these proposals that you have because they are all necessary.

We talk about how to control inflation, but nobody is talking about how to control recession.

Mr. ABEL. Some people think that is the way to control inflation, you know, is to have a recession.

Senator HUMPHREY. I noticed, according to our Joint Economic Committee, and I asked them to do a study for me, since 1969, in the 5½ years of the Nixon administration, we experienced two recessions and have lost $234 billion in production and incomes. As a result, Federal budget receipts were $46,900 million lower than they would have been at full employment, and that is 4 percent unemployment.

The incidence of this loss can be viewed more clearly if the figure for the entire economy is broken down by sectors. Corporate profits were $18.3 billion below what they would have been at full employment. Workers have suffered the greatest loss. The labor force lost approximately $129 billion in wages and salaries. Consequently, each worker's income was reduced by an average of $1,460 in those 5½ years.

Now, add on to this what you have pointed out in your statement of the loss due to inflation, where the real incomes of workers has been going down this year, last year, and the year before, and I think it is fair to say that the working people of this country have taken an unbelievable whipping.

Mr. ABEL. That is correct.

Senator HUMPHREY. Due to two things, inflation on the one hand, and recession on the other. We have simply got to get the attitude around here that the people of the country are what count, and not these statisticians and their charts that will tell you about what they cannot do.

I want to thank you very much. I am inspired by what you have had to say. I hope that your organization, the AFL–CIO will give us more of a boost on planning. There is no planning in this government, absolutely none, and on a capital budget. We try to pay everything by cash around here in this government, and if that is the way we had gone in the housing program, we would have been living in teepees and caves. But, if we are going to build a new dam, you have to appropriate the money, and if you are going to build a new office building, can you imagine building a new office building and paying cash for it? But we do it here. There is not a businessman in America who would do that without having this head examined. We would send him off to the top psychiatrist right quick. But, we run around here and we are going to build a new Federal office building and we have to put the money on the line. We need a capital budget, and we need to start to get ourselves budgeted according to the way people run things instead of the way we operate around this outfit.

My time is up I am glad, and I imagine you are glad of it, too.

Senator PROXMIRE. Senator Schweiker.

Senator SCHWEIKER. Thank you very much, Mr. Vice Chairman. First I would like to say to our distinguished witness that we are very pleased to have him here today. Being my constituent, I am really proud of him because I think Mr. Abel has done several things that ought to be public noted, which makes him more bona fide to advise this committee on what we ought to be doing. I think not only is he the distinguished labor leader of long-standing reputation, but I think he has given an innovative approach that could be used in terms of some very difficult and practical problems concerning special demands in industry. His unique and innovative approach, I think, qualifies him to be considered as a statesman, and around here when you call a person a statesman it is a pretty high compliment. That is the way it is intended, Mr. Abel.

Mr. Abel. It is a compliment in the labor movement, Senator.

Senator Schweiker. I think we can learn from some of the things you have pioneered, and innovated in the steel industry. You are able to represent your people while fulfilling your commitments to the national interests and the country, and that is why I think your recommendations are particularly appropriate. I was very intrigued in reading over one of your points that relates very specifically to an idea that I have been working on.

In your statement you urge the Congress to take immediate action to direct the Federal Reserve System to allocate available bank credit on a selective basis. I have been working with a somewhat similar proposal, a two tier approach to credit. This system would let the free market forces prevail, tight money, if you will, on less desirable credit objectives, permitting the free market level to seek its own force; however, on certain high priority national interest programs, it would provide for lower available credit. I would certainly include, as you have, housing into that area. I think that I might even carry this point further and suggest that there probably is some industry, possibly even within the steel industry, where the lack of capital expansion has either caused layoffs or the loss of domestic markets; therefore, we might include in that selective credit concept, industries whose searcity of product affects unemployment or industrial expansion.

I am just asking, and I do not know fully what you had in mind there.

Mr. Abel. We believe quite frankly, Senator, in all of these areas where assistance is needed, that we should be able to make these judgments, and these special dispensations, so to speak, wherever we feel that there is the need for this kind of support or encouragement.

Senator Schweiker. Relating to either unemployment or a shortage in a particular material, where there exists economic repercussions to the economy, that kind of a definition?

Mr. Abel. Right, very much.

Senator Schweiker. I think that this certainly is where we are going to have to go if this amount of credit——

Mr. Abel. Let me point out what I think is a current problem and one that could be fitting into this, is our public utilities. Certainly with the energy crisis that we experienced a year ago, this past year, the needs that we see in the future because of expansion necessities, one of the areas that we have to be getting on with is our public utilities, and they are bogged down because, No. 1, high interest rates, and No. 2, high prices. They could use some lower interest rate assistance to build our public utilities up to meet the requirements that are going to be here before any of us are ready for it. So, this is an area.

Senator Schweiker. I think the energy and utility area is a very excellent example. I know that there was a real problem in terms of the coal mines, which related to steel, and I do not know if that has been resolved yet, but that might be an area where a national interest would be expressed. This kind of a selective or second tier credit would be applied by some national determination. Would that be in order?

Mr. Abel. That is correct, because there again you have the failure of the free market to meet the need because of profitability.

Senator SCHWEIKER. In accordance with what you have said in your preliminary remarks, in many ways we are using policies 30 or 40 years old in terms of credit application that worked maybe for the 1950's and the 1960's, but are completely irrelevant and obsolete to the needs today. It reminds me of a person wearing a belt, and he has to keep his belt at a certain notch just to hold things in place, and that is necessary. If you keep taking in the notches, and tightening up on credit, you are going to kill the bean. I think that is really what we are doing, killing our national bean by across the board application, and I am sure that is exactly what you had in mind with your selective credit proposal. I really think this is a controversial situation that Congress is going to have to confront, but I do not see any other way out of the economic dead end we seem to have walked into.

Mr. ABEL. Correct.

Senator SCHWEIKER. I have a couple of other questions I would like to ask.

What about the jawboning approach? Do you think that that is a valuable approach or not? I did see, of course, that the President now is talking about the GM prices. Is this a weapon that we should be using selectively, or how do you feel this fits into the problem?

Mr. ABEL. I think it has some very definite usefulness. I think, here again, it is a question of degree and judgment. I do not think jawboning should be used to the extent, perhaps, of taking a baseball bat and just willy-nilly hitting people over the head with it. But, I certainly feel that persuasion has a very useful role in our kind of society, and I think especially when it is used by the President of the United States. I think we can all be brought to recognize maybe a little stronger social responsibilities if when we get out of line a bit somebody like the President of the United States calls us in and sits down and talks to us about the facts of life. I think it can be useful. I also recognize that without using good judgment it can be harmful.

Senator SCHWEIKER. It has to be used wisely and with discretion.

Mr. ABEL. Wisely, that is right.

Senator SCHWEIKER. The other question I had, there has been a proposal relating to the investment tax credit usage and, of course, this does affect steel very heavily because of the capital aspects of expansion of the steel industry. I just wondered whether you had any relative evaluation of whether this was a viable approach now or whether you feel the selective credit answer is a better answer?

Mr. ABEL. I think now is not the time to look at investment tax credit. I think the time is perhaps now to look at the overall tax structure and perhaps endeavor to revise the thing and get a new structure to provide equity, again, for all of the people. Now, there may be some areas, there might be justification for investment tax credit. But, I was amused this morning on the television to witness three of our top economists who are very much disturbed with the goings on on Wall Street, and the failure of people to be buying stocks, and their great suggestion to overcome the apathy in the market was for Congress to enact a tax credit exempting the first $1,000 of capital gains. This, of course, would inspire us all to go out to the market and to earn that $1,000. To me it is certainly unjustifiable and foolish to think that this kind of a recommendation would be helpful in any way.

Senator SCHWEIKER. What we really need, and I think you will agree, is a very selective application of the answer. I think we have dealt with generalities and have been without answers too long, which penalize us by distorting the issue. So when you use the word "selective" in your credit approach, I think that really describes the only way you are going to cure some of our ills, being most selective and not writing across the board which may cause as many problems as it purports to stop.

Do you agree with that?

Mr. ABEL. Correct. There is the crying need for a review of our whole tax structure in an overall, looking toward an equitable tax structure.

Senator SCHWEIKER. I certainly hope we do face up to the whole tax problem because of its inequities and its personal impact on individuals as well as the whole picture, and I certainly concur with that.

That is all I had, Mr. Vice Chairman. I appreciate the time very much, and I thank you.

Senator PROXMIRE. Mr. Abel, your 10 percent increase in steel productivity is startling and most encouraging. But, you see, this, it seems to me, highlights the absolute injustice of the enormous increase in the price of steel. Productivity of the worker has increased 10 percent, you tell us, and yet production, the amount of steel we are producing is actually down. A year ago it was down a little bit, and it is almost the same, but it was 2.781 million tons in July of 1973, and it is 2.775 million tons in July of 1974.

Mr. ABEL. It is fluctuating, Senator, between that figure and 2.9 million. A lot of this, I dare say, is because of the need to shut down facilities for repair, periodic repair, or because of breakdown.

Senator PROXMIRE. I understand that.

Mr. ABEL. When you are hitting close to 3 million tons, you are hitting full capacity.

Senator PROXMIRE. But they have been increasing capacity, they have been building more capacity, and their capacity is up. So again you have a situation in which demand, production, or sales are not, however you want to look at it, at a flat or a down. Wage costs, that is wage increases directly with productivity, those increases are about level, and yet we have this enormous increase in price. I think this is the guts of our inflation problem. It is the same thing in oil, chemicals, nonferrous metals, and food processing. They have been able to increase the price without any real justification in terms of their costs. So, I just feel that it is very important that we have action on the part of the administration and the Congress to give the muscle to call attention to that, and to prevent it in the future if we cannot roll it back. After all, this increase in steel, when one wonders why automobiles went up 10 percent, well, steel is a big element in the cost of a car. It is a big element in the cost of a house. It is a big element in the cost of a building. It is a big element in the cost of so many things, and it is the real bellweather in terms of inflation. Do you not feel that this kind of an enormous increase takes some real explaining on the part of the steel industry?

Mr. ABEL. I think any of these increases should require some explaining. I am, of course, not in any position to make that kind of an explanation for the steel industry, but I would say, and I feel I have somewhat of an obligation as a contributor, maybe, to their costs, but it has not all been wage costs, I hasten to say.

Senator PROXMIRE. Your documentation that you have given us this morning indicates that wage costs are probably most insignificant of all if you have a productivity of 10 percent and a wage increase of 10 percent, and that is a washout and the wage cost is zero.

Mr. ABEL. That is right. As I said earlier, the price of scrap, as an example, was allowed to run completely wild. We do have the fact of the steel industry for a number of years, and indirectly we then, the steelworker, have been pretty handy whipping boys for everything that happened from the standpoint of the economy.

Senator PROXMIRE. One indication that this is just sheer, unadulterated, concentrated economic power is the fact that profits are up 54 percent.

Mr. ABEL. Yes, the profits are up 54 percent, but there again, as you know better than I, percentages can be misleading; 40 or 50 percent of nothing is still nothing. There is no question the steel profitability has been down over the years, and most steel companies, in fact if not all of them, I think you will find, have over the years been required to reduce their payments to their owners, et cetera. In addition, you are talking about a very high-cost industry. When you are talking about expanding a steel mill or building a steel mill, you are talking about a $500 million or $600 million investment as against other industries where there is a much less requirement of capital expanditures.

Senator PROXMIRE. How would you use the excess profits tax?

Mr. ABEL. I agree with you that there is the need to justify profits in this industry as well as all other industries.

Senator PROXMIRE. How would you view the excess profits tax working in the steel industry?

Mr. ABEL. I think it would work well in the industry.

Senator PROXMIRE. Would it be applied to the steel industry in this case? This kind of big increase, I presume, would be based on profit experience in the past.

Mr. ABEL. I think very strongly that such an approach would have a very salutary effect overall in our economy.

Senator PROXMIRE. Let me ask you this: President Ford announced his intention of calling a summit conference on the economy, including people from various viewpoints. Have you been invited?

Mr. ABEL. No, I have not.

Senator PROXMIRE. Do you know if Mr. Meany has been invited?

Mr. ABEL. All I know is that Mr. Meany met with the President yesterday, I saw in the news. I have not talked with Mr. Meany.

Senator PROXMIRE. Do you regard that as a signal of Mr. Meany's willingness to cooperate with the new President?

Mr. ABEL. I would say so, at least to the point of listening and seeing just what the President might have in mind, and his view of the role of labor, and in coping with the problems that we are confronted with.

Senator PROXMIRE. What do you regard as a reasonable rate of wage increase at the present time? In your statement, you refer to workers falling short of the 11-percent increase in living costs over the past year, and is that implying that you regard 11 percent as a basis, and then on top of that you would have the productivity factor of some kind?

Mr. ABEL. That is substantially correct.

Senator PROXMIRE. A 13-, 15-percent increase, perhaps, something of that kind?

Mr. ABEL. If the economy goes that way, yes. What we have been using as the yardstick, and again it goes back to pretty much the assurances we were given in 1971 with the freezes and the phases of the participation in productivity, as well as a markup on inflation, in steel.

Senator PROXMIRE. So the AFL–CIO position is you should take the cost of living as a basis, and then provide for the productivity factor in negotiating a reasonable wage increase at the present time?

Mr. ABEL. As an example, Senator, in our basic steel agreements now, in our experimental negotiating arrangements——

Senator PROXMIRE. Of course, you do have a cost-of-living factor written in, do you not?

Mr. ABEL. Yes, we have both the productivity improvement factor and we have the cost-of-living factor, and our productivity improvement factor is a 3-percent national figure.

Senator PROXMIRE. Well, only about 20 or 30 percent of the unions have a productivity factor, have an escalator, a wage-price escalator factor in them.

Mr. ABEL. Correct.

Senator PROXMIRE. So you are in a minority, but you would regard other unions that do not move in the direction of an escalator as making a reasonable request if they asked for the cost of living plus some kind of productivity?

Mr. ABEL. That is right.

Senator PROXMIRE. Now, you have indicated also that you think that the large steel price increases I referred to earlier were not made necessary in any way by the rise in wage costs, is that right?

Mr. ABEL. That is correct, in view of the productivity improvements we have had.

Senator PROXMIRE. In your statement, you imply a suggestion of control of capital investment abroad, and I think that is a very interesting analysis you have. I think it makes some sense, but you do not include it in your recommendations at the end. I did not see that you specifically indicated that you thought we ought to limit capital investment abroad. You said that so much of the financing that we are providing is not for export and, therefore, providing jobs in this country, but it is simply financing operations abroad and, in effect, exporting jobs.

Do you regard control of this kind of capital as a desirable step for the Federal Government? Do you think we ought to enact legislation in that regard?

Mr. ABEL. Yes. We have been making strong arguments for years now against what we term the development of multinational corporations, the export of American capital and know-how to foreign countries.

I would point out that there apparently now seems to be developing a reversal, because some of these corporations or companies in other countries are beginning to realize that maybe the picking is better in this country today than it is in these foreign countries, because——

Senator PROXMIRE. So they are investing——

Mr. ABEL [continuing]. Their inflation is greater than ours, and their productivity is much lower than ours, and they are beginning to see that ours is perhaps a better opportunity here.

Senator PROXMIRE. One of the recommendations you have that Senator Humphrey discussed, but I am very concerned about it, Congressman Reuss has been pushing it, and that is the allocation of credit by the Fed. After all, the Federal Reserve Board members were not elected; they are appointed practically for life; they are appointed for 14 years. They are, as Senator Humphrey said, by and large bankers or banker oriented.

Why should they have this colossal power of allocating credit, and it would have to be an immense power, it seems to me, and it would not be enough for us to provide simply what I have been advocating as the direction that they provide funds for housing at a preferred rate which we have to have housing move ahead.

But, in addition, what they should have, it seems to me, if you are going to be consistent with going any further than housing, if the power to allocate a productive investment, if you are going to get more production in the economy, so you increase supply, so you do something about inflation, and they would have to have that kind of power.

I do not cotton to the idea of giving up that kind of authority, as I say, to a group of unelected officials whose competence I question. I have sat in on the appointment of almost all of these people before our Banking Committee, and several of them are not qualified and others have a very strong orientation toward banking and big business. I just do not think that we should let them call this very important turn in the economy as to where our resources would go.

Mr. ABEL. Well, I certainly agree that Congress should be the overriding watchdog or authority.

Senator PROXMIRE. Supposing we agreed that we should not permit any investment in gambling casinos and a few other unproductive areas. It is very hard to determine what is a productive investment and what is not, and once you interfere with the marketplace to that extent, it seems to me that you are going to have to have a very big and professional bureaucracy, and I am not even sure under those circumstances they would make the right decision.

Mr. ABEL. Certainly you would have to have certain guides established to determine, such as a distressed area, and if we have, let us say, what is determined a distressed area that should be given consideration, then that would be the basis of the consideration, whatever the need might be. I would hasten, Senator, to say to you that I share the concern over the broad authority of the Federal Reserve. I would remind you, I come from that part of Ohio where as a youngster, Jack Conskey's views on our monetary system got attention. I listened many long hours to a lot of those discourses, and I suppose as a result of that I too entertained a lot of concern and reserve with respect to the power and authority of the Federal Reserve and the reason for them to have this kind of complete exercise of authority over all of our economic lives.

Senator PROXMIRE. My time is up.

Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Vice Chairman.

I am delighted to see you again, Mr. Abel.

Mr. ABEL. Glad to see you, Senator.

Senator BENTSEN. Mr. Abel, I am deeply concerned about the problems of raising capital for industry in this country, and the shortage of capital, the liquidity crisis, how we are going to expand to create jobs that are necessary to take care of unemployment now and in future generations to come. I look at the record of industry for the last decade in this country, and I see the smallest percentage of GNP reinvested in manufacturing capacity in this country of any of the major industrialized societies in the world.

The one next in line to us is England, and they are in trouble enough. I know we are becoming more of a service-oriented society, but we are not going to be able to keep up our balance of trade, we are not going to be able to keep a strong defense effort, just by taking in other people's washing. We have to keep manufacturing capacity up-to-date and competitive.

So, let me touch on a couple of points here and get your opinions. I noticed you referred to the outflow of capital and that concerns me. I am on the Finance Committee, and we voted to do away with the interest equalization tax in January. Subsequent to that time, I think, we have seen a net outflow of capital of around $2.5 billion. It would seem to me that that is one of the things we ought to be monitoring. With the pressures on the monetary system in this country, to see that kind of an outflow of capital is of great concern to me.

Another subject that concerns me is seeing the Export-Import Bank participating in loans to set up manufacturing capabilities abroad. I do not agree with that, especially when I see that they do it with an interest subsidy, where they are loaning at 6 and 7 percent to set up, for example, a fertilizer plant in Russia with a direct loan of $180 million, and to do that at 6- and 7-percent interest rates when business in this country is short of capital and is paying 14 and 15 percent. I think that is unwise, and I do not think that is sound. I would like to have your comments on some of these points, Mr. Abel.

Mr. ABEL. Well, we certainly agree with the point you have made here on this business of giving subsidy loans to foreign countries, actually in some cases to become competitors of ours, while denying the same kind of consideration here at home. Certainly it is quite clear that some of our people in responsible positions have not heard of the old adage that charity begins at home, because we seem to take from ourselves to give to other people. We are much more generous abroad than we are here. We certainly do not subscribe to that. We think that we should be concentrating on the needs of our own people, our own country, and the needs to strengthen our society and our economy rather than devoting so much of our resources to others.

At the same time, we believe that we have a role, naturally, in helping the underdeveloped and the developed countries, and it is our view, Senator that this, of course, is a role, an important role for the United Nations. I would take this occasion to say to you in our view we should be giving greater support to the work of the United Nations rather than trying to play the big brother role in world affairs that we seem to be more and more developing.

Senator BENTSEN. Mr. Abel, I am concerned with the problem of many industries who are trying to raise capital through the stock market, and I look at some like the steel industry that might be selling at say five times earnings ratios. That means that they have to find an investment that will pay them 40 percent, prior to taxes, and you cannot find that kind of investment. They cannot go to the equity market and sell their stock. It makes no sense to try to do it to raise capital to increase capacity, to keep the jobs at home so that we can keep part of the steel market and not give it all up to the Japanese and to the Europeans.

I would propose a limitation, for example, on what bank trust departments in their voluntary pension funds, discretionary pension funds, can own in a way of a percentage of stock of a corporation, because what has happened is that they have gone to the higher performance glamour stocks, the very large corporations that are supposedly showing a very high rate of growth.

They have shown sort of a herd instinct in following each other, and what I would like to see is a further diversification. I think that is the important thing. I think we ought to have prudent institutional investment. I think that it would protect the pensioners better, and I think it would provide liquidity to the stock market, to companies perhaps not as high in performance, like the steel industry.

I would hope that your people would study that particular provision of limitations being placed on bank trust departments in some of their pension funds and how much stock they can own in a corporation.

Mr. ABEL. Certainly we will be happy to study the proposal and do what we can. I would point out to you, Senator, in that regard, in my view, certainly the Federal Reserve tight money policy has been perhaps the overriding contributing force to this kind of a situation.

Senator BENTSEN. I believe that.

Mr. ABEL. It seems to me quite clear that the investors today are not going to put their money in stocks of companies that pay them maybe 3 percent return, when even the Federal Government just last week floated bond issues that give them a 9-percent return, and you go from there on up to the 11 and 12 percent. They all have a contributing force in what is happening to the stock market as such, as well as the investment of private funds in corporate interests.

Senator BENTSEN. No question about that. We are having a recession in this country. Anytime you have two quarters with a declining GNP, that is the classic definition of recession, according to most experts. I always get concerned when an administration starts redefining what a recession is. I am convinced that we are in one, and if we keep up the high interest rates and tight money, I feel we will trigger something even more serious. The high interest rates crank right into the mortgage payments, and right into the cost of production, and it is passed right on to the consumer.

So I think it is the wrong policy.

Mr. Abel, the President has called for a cost-of-living task force. I also called for a task force when I was asked to respond to President Nixon on the economy, but mine is quite a different version from that proposed by the administration. The administration, in effect, has an in-house group, the Secretary of the Treasury, the Secretary of Agriculture, the chairman of the Council of Economic Advisers, a total of about eight, and it is a part-time effort on their part.

It seems to me that if we are going to have a group like this, we should try to find a group that would have an even-handed approach to business and labor, and work in the public interest first and foremost. In this area of cooperation between the Congress and the President, which I certainly welcome, it should be one that is made up not just by the President, but should be made up by the Congress and the President. The proposal I have offered, and I am going to testify before Senator Sparkman's committee at 2 o'clock, calls for a cost-of-living task force with five commissioners who would devote their full time to it, three of them being appointed by a bipartisan recommendation of the Congress, and two of them by the White House.

I know your concern about the cost-of-living task force, but in turn I would like any comments that you might have about it.

Mr. ABEL. We were very much opposed to the President's proposal because, in the first place, he had, and the President has now, at his command that kind of assistance without the enactment of legislation to establish it. So, we sort of viewed it as another gimmick, you might say, that is misleading.

With respect to some kind of an overriding or overviewing committee, as you propose, I am sure that labor will be quite willing to sit down and look at any kind of proposal designed to be helpful, and will be more than willing to cooperate so long as there is an indication that labor is going to be given consideration, and that out of whatever might develop, that the overriding motivation will be equity for all segments of our society. I think labor will be more than amenable to suggestions and proposals.

Senator BENTSEN. Thank you very much, Mr. Abel. My time has expired.

Senator PROXMIRE. Along that line that Senator Bentsen was inquiring, there is one additional authority or power that might be given to the President that he does not have under present law. Chairman Arthur Burns of the Federal Reserve Board suggested that the body be authorized to hold up big inflational wage or price increases for a period of 30 to 45 days while hearings would be held on it. It would not be allowed to stop it, but it would be able to focus public attention on it, get the facts on it, get the justification on it before it goes into effect.

Now, this would be a change and would permit, it seems to me, an opportunity to stop the kind of colossal increase that steel has had in the last year of 40 percent, and oil of 83 percent, and chemicals of 50 percent, and so forth.

Mr. ABEL. Let me just say this again, without looking at any constructive proposals or giving too much thought to it, but it sounds just at first blush like something heading down the road that has been in practice for many years in the rail industry where we have constantly had hearings, and investigations, and the first thing you know everyone is lost in a maze of records and activities, always running 2 or 3 years behind, and always in constant turmoil. Before one settlement is arrived at, a new set of demands are launched, and I for one, Senator, would hope that we take steps to relieve our society from this sort of an uncertain situation in the rail industry, without expanding it into other segments.

Senator PROXMIRE. Congressman Carey has come in, and we would like to welcome him as an excellent member of the committee, and we are honored to have him here. He is a very distinguished Member of the committee and the Congress.

Representative CAREY. Thank you, Mr. Vice Chairman. I am going back over to the floor as soon as I can on the House side to assist, I hope, Mr. Abel, in passage of the important general transportation bill that is before that body. I think that that kind of activity, long-range planning for the moving of people economically and conveniently to worksites and homesites is the kind of thing that you are talking about.

Mr. ABEL. Correct.

Representative CAREY. In terms of what we need in this country, and I hope the support of the AFL-CIO and your support will be enough to move that bill forward. I am pleased, Mr. Abel, to see also that in your leadership of a great labor organization your interest in the American lifestyle and quality does not end with the signing of a collective bargaining agreement or at the gate of the steelmill. I am particularly impressed by your address to the need for home production. It seems to me it would be a matter of simple commonsense, that as the President calls for this summit on the domestic side, the first thing he is going to see from that summit, when gathered there, if we look out at America, is that we are in what you would call a chaotic situation on housing. We are not creating any, especially for low-income, moderate-income families and elderly persons.

You have come up with this series of good ideas and fundamental ideas, and I do not want to indicate that you share my age span, you may be too young to remember this, but is it not true that when a President named Roosevelt ran into a depression that was in the housing market particularly, he came along with a series of emergency measures to get rid of the tight money problem, to get the Federal Government into the building of what we then called Government-created housing or publicly assisted housing? Is that not the first thing that the President should seek from the summit, that the family has a right to a decent place in which to live, and one which they can afford? So I would hope that you are invited to that summit, and I hope that you will tell the President that we have to get housing going again.

Is there any problem that you see on the horizon now from the summit that is going to get us out of the housing depression?

Mr. ABEL. No, there are none as of this moment. Certainly there is great need. As I mentioned earlier before you came in, Mr. Congressman, the recommendations we made as a result of our study by the Civil Disorders Commission, pointed to the grave need that exists in all of our major cities for slum clearance, and renewal, and that was in 1968, and nothing has been done.

Representative CAREY. They are still there.

Mr. ABEL. The conditions must be much worse today.

Representative CAREY. I can tell you that as I go around New York State it is still there, and it is worse.

Mr. ABEL. That is right.

Representative CAREY. Because the housing stock has been depleted and the private sector has no incentive to invest. In fact, is it not true that the Government is, by going out with the 9-percent money, by this great process called disintermediation, taking out of the savings institutions and the thrift institutions the very resource money we used to use to create housing for the Government, and while it is not creating housing, it is at the same time depleting the money supply that used to be available even for conventional housing. Some think at the summit the new President must see that he has an obligation to get some housing going again. That would certainly help in the unemployment rates that are worst of all in the building trades, and those who use the products of the steel mills. I hope that he would see his way clear to coming forth with a positive housing program.

He mentioned health and he said health, and he said we could get this kind of a bill going, but there is a pending housing act, and I hope that you would use your good offices and your influence with the President, as I will try to do, to make 1974 not only a year for health, but a year for housing. I welcome your recommendations, and I am going to take them with me and try to see if I can convince some of my conferees in the House that we should go ahead with this kind of a program and prompt the President to think about homes for America.

Thank you, Mr. Abel.

Mr. ABEL. Thank you, Mr. Congressman.

Senator PROXMIRE. Thank you. I would just like to conclude, Mr. Abel, by thanking you for superlative testimony, which has been very, very helpful.

I do think, however, there is one caution I would like to give. I would hope that you, with your good advice that you have had in the labor movement, would really consider an anti-inflation program. What you have given us here this morning is most helpful. But I think that the big problem is inflation. You have told us very, very useful things about what to do about the prospect of a serious recession and a depression developing, but we do not have from you, it seems to me, a program that copes with this terrific inflation. You indicate it is likely to go on at an 11- or 12-percent rate, and it is so cruel and it is going to have such an adverse effect and could have even a destructive political effect. In fact, you told me this morning you felt that labor is going to have to ask for the cost of living plus an additional factor for productivity and, therefore, you call for about a 14- or 15-percent wage increase, which would be inflationary. Then you have that terrible cycle of inflationary wages which push up prices, and vice versa.

Now I recognize that labor has been extraordinarily statesmanlike for the past couple of years. But, now if you move ahead and call for that kind of a wage increase and prevail, it seems to me that we do not have much of a chance of avoiding an inflation that is going to last for some time.

Mr. ABEL. Let me again take this occasion to point out to you that our experience here now has proven that wages are not the causes of inflation. They are the result of it. Our escalators, I remind you, are an after-the-fact happening. It is always a quarter late, we are running a quarter late always, and it is a catchup provision, so it is not wages that is the culprit. With respect to your anti-inflation program, I assure you labor is more than willing to cooperate because we know more than anybody else that laboring people are the ones that suffer because of inflationary actions.

Senator PROXMIRE. You see, we are locked into such a dilemma. Here we have never had anything like this. Our inflations in the past by and large have been war oriented, and this is not, and you come along and make some constructive proposals, including proposals for a sharp increase in spending and in a number of areas, public service employment, public works, and you call for that, and that may be necessary and essential. But, unless we have some counteracting spending reduction, we are going to have a serious continued inflation situation, especially if after the excellent behavior from the inflation standpoint of wages, now we get a very sharp increase in wage demands and wage settlements.

I agree it is a result of what has happened in the past, but nevertheless, if you get a 15-percent wage increase——

Mr. ABEL. But as I point out, then even with those kinds of wage increases, we are back to a purchasing power level of 1965.

Senator PROXMIRE. Well, I am not saying you do not have to have a one-time or an increase of that kind. What I am saying is that we have a dilemma here that labor, I hope, will help us begin to solve in some way.

Mr. ABEL. We have a greater interest than anybody else.

Senator PROXMIRE. It would be very helpful if labor would come in very hard and help us crack down on antitrust, for instance. These increases are just outrageous. They cannot be justified and have no relation to cost, these terrific increases in price, and we just have to stop this kind of corporate price fixing, which I think is the root cause, and unless we get labor's support for that, we are not going to be able to have the kind of muscle we need.

Mr. ABEL. I think you will find labor's support will be there.

Senator PROXMIRE. Very good. Thank you very much.

Mr. ABEL. Thank you.

Senator PROXMIRE. The committee will stand adjourned and this concludes the hearing; the record will remain open for a week.

[Whereupon, at 12:40 p.m., the committee adjourned, subject to the call of the Chair.]