690

FINANCIAL AND CAPACITY NEEDS

HEARINGS

BEFORE THE

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FINANCIAL AND CAPACITY NEEDS

TUESDAY, OCTOBER 1, 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. Lloyd M. Bentsen, Jr. (member of the committee), presiding.

Present: Senators Bentsen and Proxmire.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, 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, Carl V. Sears, and Larry Yuspeh, professional staff members; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR BENTSEN

Senator BENTSEN. Good morning. We will come to order and start the first hearing day. Last weekend we completed an unprecedented conference in response to an unprecedented need—rolling back inflation and reversing recession. As the President expressed in his summary remarks on Saturday: "From most summits there is no way to go except down. From this summit we are going to start up. This is not the end, but the beginning of a battle against inflation and waste which will not end until it is won."

I believe that most Americans stand ready to become inflation fighters, but they are watching and they are waiting—with increasing frustration—for a coordinated assault led by the Government against public enemy No. 1. We in Congress, members of the Joint Economic Committee, have already developed "An Action Program To Reduce Inflation and Restore Economic Growth." This report was unanimously adopted by members of both political parties on this committee. It was made available to the President and participants of the Conference on Inflation. The Joint Economic Committee Interim Report on Inflation is a solid initiative and merits the prompt and full attention by the Congress and the Executive.

We recognize, of course, that we are but beginning in this battle against inflation. The committee will complete a more exhaustive investigation of the causes and consequences of inflation by the end of this year. In order to contribute further to our analysis and solutions, I called for this series of hearings on the very serious financial and capacity needs facing our economy.

In my view, we have been rightly concerned with restraint of demand and distributional equity, but we have inadvertently neglected the essential need of increasing production and creating jobs particularly in those basic sectors exhibiting supply shortages. Anti-inflationary policies must do both. We must, for example, institute a viable energy-conservation program and offer some relief to those individuals suffering most from inflation. At the same time, however, we have to make sure that enough money and credit are available to step up investment in productive capacity which triggers productivity increases and builds the bridgework for an expanding economy. Sustained economic growth in those areas where shortages are being experienced is our economy's natural defense against inflation. But increased output in these areas requires adequate financing. While inflation may be enemy No. 1, economic growth with stability is still our No. 1 goal.

Over the next decade, the capital requirements for housing, energy, pollution control, and manufacturing capacity in our country will be enormous. Many perceive a growing long-term imbalance between the demand for investment funds and the adequacy of savings to finance expansion. As one writer has stated, "We may not be able to afford the future," and he was referring not only to inflation but to a basic capital shortage.

We are very pleased to have Henry Fowler, the former Treasury Secretary under President Johnson and presently a partner with Goldman, Sachs & Co. I understand the Secretary has only consented to two or three appearances since he left the Office of Secretary, and he has been very much in demand. He has recently returned from an international conference on inflation in London. He is here this week to participate in the meetings of the International Monetary Fund and the World Bank.

He brings firsthand and immediate knowledge and we are most grateful for his willingness to be with us today.

Mr. Fowler, I know that since you have been out of office you probably do not have as much staff as you might have had in the past and I understand there is a great deal of personal input that went into your prepared statement and we are very grateful for that, the time and the hours you devoted to the public interest, and your concern with these very difficult problems. And knowing of the other demands you have on your time, we would like to lead off with you, and then we will call on the other two distinguished witnesses we have with us.

I also want to say that I am particularly appreciative of Senator Proxmire for letting me chair this hearing before the full committee to deal with this very difficult problem. We have had the interim report on inflation. Senator Proxmire took the President at his word and he said he wanted to have that report available in 6 weeks. Senator Proxmire saw that it was available, and today's meeting will be a further contribution to the final report on inflation in December.

Senator Proxmire.

Opening Statement of Senator Proxmire

Senator Proxmire. Thank you very much, Senator Bentsen.

I want to congratulate you on scheduling these hearings. This was your initiative, your idea, and I think it is most appropriate because

we are all aware of the very, very serious equity problem that we have in this country with the stock market in the shape it is in, with the profound problem that every corporation that wants to raise capital has if they are going to raise it in the equity market, and with recognition that they have to have a balance between equity and borrowed capital, which is extraordinarily hard to achieve now. And, of course, even if they did not have to have that balance, raising money by borrowing it is very difficult. These interest rates are so high and capital is so scarce.

But there is just one point I would like to make with respect to your testimony this morning. One of the things that concerns me about capacity is that all the evidence is that virtually everywhere we are not operating anywhere near capacity. The overall figure is about 80 percent. The basic industry, which has been tight—we are operating at a lower level of capacity now than we were last year, and so inflation seems to be much, much worse.

We have a situation, for example, in steel where we are producing less steel than we were a year ago in spite of the fact that prices have gone skyrocketing—they are up 44 percent, twice as much as in any previous year in our history, an extraordinary increase in price in that industry. And although labor costs are down 30 percent from what they were in 1970, and yet, as I say, they are operating at a lower level of production, they argue that they have to ease off in some of their plants and so forth. But this is very hard to accept in view of the great increase in price and the fact that they have not increased their facilities substantially.

We have something of the same problem in other industries where prices have skyrocketed, yet we have a great deal to say, of course, about the petroleum industry. Of course, everybody has. There is a problem in that industry, too, as to whether they are pricing anywhere near their capacity.

So that we have this dual problem if firms do need more funds—and I am sure they do—they have great problems trying to raise it. But then we have the other problem as to why in this period in which prices have increased so much and profits are so tremendously improved in many areas, why they are not taking advantage of the situation. If thre is a great demand, fulfill that demand by operating closer to capacity.

I want to thank you very much, Senator Bentsen, and once again, congratulations for calling these hearings. You certainly have three of the most distinguished experts in this area that you could possibly get.

Senator BENTSEN. Thank you, Senator Proxmire.

Mr. Fowler, if you would proceed.

STATEMENT OF HENRY H. FOWLER, PARTNER, GOLDMAN, SACHS & CO.

Mr. FOWLER. Thank you, Senator Bentsen and Senator Proxmire. Perhaps in the question and answer session we can be more responsive. That is a very interesting point that you have made, Senator Proxmire, about the paradox we seem to be in.

With your permission, Senator Bentsen, I will file a rather complete and overlengthy prepared statement for the record. I did not have

time to do the necessary revisions and cutting that I would like to have sone, so I will just summarize parts of the prepared statement and leave the rest for the record.

Senator BENTSEN. That will be fine, Mr. Fowler.

Mr. FOWLER. I, too, would like to congratulate the committee on its choice of subject matter for these hearings. I think they will serve to highlight some underemphasized aspects of our current economic dilemma, which is basically how to restore our economy to a long-term pattern of sustained noninflationary growth.

The correction of inadequacies in supply is certainly as important as the moderation of demand to manageable levels in dealing with inflation. My own personel experience, particularly in dealing with mobilization during the World War II and the Korean war, left that as an indelible conviction. And, therefore, I conclude we must treat in our policy formation and action economic growth in its various forms as an ally and not as an enemy in the fight against inflation.

That means practicing as—well, I am not an economist, but I have seen the two able gentlemen behind me, I think they would sall that practicing micro in addition to macroeconomics.

The subject you have particularly raised, stimulating adequate capital formation, removing capacity and production constraints that induce shortages, and identifying and promoting the achievement of specific expansion goals will prove to be essential to any realistic and politically feasible program, particularly a long-term program, to curb the kind of inflation we have been experiencing.

Now you have directed my attention particularly to the international aspects of capital availability and demand and the adequacy of the existing international financial apparatus.

Certainly, the provision of adequate supplies of long-term capital on reasonable terms is indispensable to the restoration of a viable free world economy, including that of the United States, to keep it moving steadily on a pattern of sustained noninflationary growth.

In turn, however, this capital availability will depend on the solution of two very major economic and financial problems that threaten the future of the entire international monetary system and hang over the current atmosphere in Washington in the meeting of the International Monetary Fund and the World Bank like a dark cloud. These problems our Nation shares with the democratic and industrialized countries of Western Europe and Japan and a great deal of the third world, and they are very simply, the familiar ones in today's press: First, the oil and energy supply problem and the exercise of political control over the price and supply of a critical material by the governments of a few countries possessing a predominant share of the world supply; and the second is the now-familiar phenomenon of worldwide double-digit inflation.

It is my strong conviction that the United States will find workable solutions to these problems in the interdependent world in which we live only through greatly intensified international cooperation.

And what I have to say here, Senator Bentsen, is more in the sense of political economics, than economics, as I am sure you will recognize.

What is needed is the constant and persistent thrust of national leadership of the nations at the highest level into the existing institutions for international cooperation, particularly, the International

Monetary Fund, the World Bank, the OECD, and the GATT, and, where necessary, the creation of special bodies to deal with special problems.

Now these organizations, international in character, in my judgment must undertake more and much more responsibility for action beyond the traditional consultation process, important as that process is to international cooperation. They must be agencies increasingly for the pooling of national sovereignties in specially selected areas so that consultation can be translated into international decisionmaking.

Now I realize this is a somewhat striking and perhaps controversial concept to plunge into the present situation, but it does seem to me that this national leadership in the revitalization of international cooperation must seek and secure national sanctions from the relevant legislative and parliamentary bodies for the measures jointly devised and recommended by the experts for collective international action. That is the only way by which the current economic and financial dilemmas that threaten to fragment our free societies can be solved through the democratic processes with due regard to national sovereignty.

And I submit that the Joint Economic Committee, given its purpose, its bipartisan tradition and its unique position in both Houses of the Congress, can make a very major contribution to this process of energizing international cooperation to meet the challenges beyond the power of a single country.

Let me say here, as I will indicate later, it will take an extraordinary degree of teamwork between the executive branch and the Congress, plus an extraordinary amount of initiative on the part of the executive branch, to effect the necessary arrangements and agreements and decisions in the international field with the leaders of other nations that will be required to solve these problems. It will take an extraordinarily skillful but nonetheless affirmative action, following of the pattern, I think, of the late 1940's when we generated some of the great initiatives in the field of international cooperation to pull the present situation back into the pattern of sustained noninflationary growth that we would all like to have.

Now the next pages or so of my prepared statement describe the four basic economic problems in general, the two that have been mentioned, the food and population dilemma, and also now the threat of a worldwide recession.

As I see it these are the four major problems to which international economic cooperation will be addressed. I will omit the reading of those pages and turn to the solution and the role of the Congress, because I really think that is the heart of the matter before this committee at this particular time.

You have alluded to some of the elements of a constructive solution of the problem of the oil price explosion, and that is the first hurdle that I wish to address my comments to, because it is basic in my judgment to an international flow of funds and to a proper functioning of the capital markets to provide the medium and long-term investment that will be necessary for both general growth and particular growth in the special areas where it is particularly needed.

I think it would be fair to say that the solution of the problem of redistribution of international capital that will flow to the oil-

producing countries and be surplus to their needs for goods and services, presents an even more complex challenge to international economic and financial cooperation than the development of the Bretten Woods institutions and the Marshall plan to deal with the postwar economy.

Now, in my prepared statement, Senator Bentsen, I have included a rather—well, my own person analysis of this oil problem and the recycling or redistribution of capital. It is in fairly general terms as I saw the picture last May, and as I see it now. It has not changed very much, and I think it still conforms to the great spate of analysis that the committee has available to it from public reports and from newspapers that I will not indulge in the statistical contours or the analytic contours of the oil problem, but go directly to the questions of solution.

First, it seems clear that the solution of the economic and financial aspects of the petroleum dollar problem includes, among other things, first, a redetermination of an equitable and stable world pricing of oil, fair to user and producer alike. And it seems clear that what has happened in the past year does not represent any fair and reasonable adjustment, but indeed, a great overadjustment of that price of that particular material as it relates to the other materials.

Second, the procurement of maximum quantities from the oil exporter countries who redeploy the maximum percentages of their revenues in the purchase of goods and services from the consuming countries. That will effect an equilibrium in the so-called current account or an approach to equilibrium in the so-called current account to whatever degree the purchases can be channeled in particular countries. Indonesia, Nigeria, Iran, as distinct from, say, the Middle East countries.

Third, an austerity program in the use of oil by the consuming countries until additional conventional and substitute sources of energy are developed in the consuming countries to a degree sufficient to diminish dependence on imports from the OPEC countries.

We have seen some moderation in the rate of increase in oil consumption in the consuming countries, I think, in the last 12 months. But it seems to be rapidly fading and the prospects are for further increase if we fall along the pattern we have been following in the last few months. It seems to me inescapable that one significant thing could be done in dealing with this problem. That would be the resumption of an even more austere patern of utilization of oil and great intensification of efforts to save and conserve oil in industrial processing and in the various uses, and that this must be done on an international basis among the principal consuming countries if it is going to have the impact that is necessary.

Fourth, the development of additional conventional and substitute sources of energy. One need not elaborate on the essentiality of that approach.

Fifth, the effective utilization of private international capital markets (*a*) to finance the additional costs of oil in the interim period while the new conventional and substitute sources are being developed and (*b*) provide channels for the redeployment of all oil revenues surplus to current account needs of the oil producing countries into productive long term investments in real estate, securities, and other assets in the consuming countries.

Sixth, the utilization of the central bank "swap" network for a limited but very appropriate role.

Seventh, the development of the Witteveen IMF proposal for a special IMF facility provided the risks of a failure of repayment by the borrowing countries are borne largely by the oil producing lenders and the regular holdings of the fund are not pledged to make good defaults.

Eighth, the mobilization of concessional aid from the oil producing countries through the international development banks and its synchronized use with bilateral concessional aid to make whole the additional costs of oil to the nonoil producing less developed countries resulting from the recent price increases.

Ninth, some utilization of deferred payment arrangements for 6 to 8 years by the oil producing countries on the portion of sales attributable to the recent price increases, where the lack of credit availability will result in supplies to a given country being reduced substantially below 1973 levels.

Since last winter the existing international economic and financial institutions which include oil producing and oil consuming nations alike—I refer to the IMF and the World Bank particularly—have been striving to minimize temporarily the damage to the world economy and the international trade and payments system resulting from the oil price explosion. The national governments of many of the major oil consuming nations, meeting under the aegis of the ad hoc newly constituted Energy Coordinating Group, have been striving to develop some contingency plans to deal with any new oil boycott or tremendous pulling down of production that might develop. Various national governments of oil consuming countries have embarked upon a variety of separate, independent and uncoordinated measures to develop additional energy resources and conserve the use of oil or cope with the financial fallout.

But a fair appraisal of the pace of progress in both national and international measures in dealing with the consequences of past acts or the danger of future ones by the OPEC would have to return the verdict as of today, inadequate. There could be no other interpretation of the tone of desperation and frustration that characterized the frank and realistic discussions of this problem by President Ford at the World Energy Conference last Monday, September 24, and Secretary Kissinger at the United Nations General Assembly on the same day.

Indeed, all of the problems to which this committee is directing its current efforts, the inadequacies of supply in certain sectors, capital formation, capacity and production constraints, expansion needs, the international aspects of capital availability and demand, the adequacy of existing financial apparatus for achieving noninflationary growth, are all seriously affected by this pervasive energy problem.

The words of the President and the Secretary of State being true, and in my opinion, they involve no overstatement, the course of action for this committee seems clear, given its especial economic role in the Congress.

Its forthcoming report should sound a certain trumpet. That can only mean recommending a decisive pattern of legislation designed to enable the United States to minimize its dependence on imported oil

and to engage in defined programs of international cooperation with other countries, consuming and producing alike. These authorized programs should be designed to achieve defined supply and requirements objectives for the world's energy needs at prices which would provide an incentive to producers but did not disrupt the economies of consuming countries or threaten the maintenance of a workable international monetary system.

My unfamiliarity with the plethora of energy legislative proposals that the executive branch has devised or recommended or that the appropriate committees have initiated does not permit an opinion on whether there is pending legislation that would serve adequately these purposes of internal action and international cooperation.

I do believe, however, that the existence of legislative enactments constituting a clear and unequivocal commitment of the Congress to these policy goals and a credible program for their realization is the heart of the matter.

Accordingly, a report of the Joint Economic Committee setting forth a program of action would be highly decisive and desirable, and I believe somewhat decisive in the current atmosphere.

Within 3 months from the outbreak of hostilities in Korea in 1950 the Congress had devised an enacted the Defense Production Act of 1950. This act, with a related rapid tax amortization provision, resulted in massive expansions to determined goals of the capacity in particular sectors of the economy where the need had been established and the prospects of a shortage were proven. A broad range of certain critical materials that would have been in short supply for defense and essential civilian needs in event of a broader war were provided for. Surely, this Congress can energize comparable accomplishments in the vital but limited field of energy by the same or improved techniques.

Not long before that act the Congress formulated and passed an Economic Cooperation Act that served to implement a Marshall plan. Surely, this Congress working with the appropriate personnel from the executive branch, can place its authority behind executive branch efforts to negotiate meaningful agreements and arrangements with other consuming countries for programs of solidarity and cooperation in the energy field. Indeed, it might define the terms in which Congress would be willing to support negotiations with oil producing and other consuming countries that would induce some of the former to follow a responsible pattern of supplier responsibility as to price and supply in return for cooperation by the latter in promoting the diversified development of the economies of the oil producing countries away from a sole dependence on the sales of oil, which is, I think, their major national concern.

Turning to the other second problem briefly for a few moments, the international aspects of worldwide double-digit inflation, I think something of the same prescription is one that I would commend.

As yet, individual national efforts to halt inflation and return to an acceptable pattern of price stability, without a major recession, seem to be relatively uncoordinated internationally.

In short, there is no program, international in scope and acceptance, by which we can hope to navigate our international interdependent world economy between the Scylla of uncontrolled inflation and the Charybdis of a serious worldwide recession or depression.

It is my belief that the absence of a concrete and credible program for an orderly restoration of sustained noninflationary growth to the international economy adhered to by the major democratic industrialized nations, is the primary cause of the current malaise in the world financial markets.

Now that Senator Proxmire has referred to and I think that is the message that the markets are giving us.

The threat of double-digit inflation on an international scale is not an entirely sudden development on the world scene. At the annual meeting of the World Bank and Fund in Nairobi a year ago, the ministers of finance and central bank governors voiced a common despair at the ever-increasing, all-pervasive worldwide inflation even then prevalent, but at terms roughly half of the present rate.

Inflation in the OECD countries, the developed countries, which was averaging around 7 percent a year ago, a little more than a year ago, is estimated at running at an annul rate of 14 percent now. This acceleration, this doubling in a year, was due in part to the impact of oil price increases, but there are many other contributing factors. Clearly, the most important single cause of this global inflation was that the industrial countries have pursued fiscal and monetary policies which simultaneously, if unwittingly, have been excessively expansionary, patricularly if one takes into account the accompanying inadequacies in efforts to expand supply in key material and product sectors. The resulting excess of global demand has pushed up prices both of industrial products and services and numerous raw materials.

Wage increases substantially in excess of productivity back in the period prior to that, referring to the period before 1972, and really before the action of August 1971, in many of the major countries provided a thrust back even before that time.

Special factors, such as poor harvests in some parts of the world in 1972, have contributed to a steep rise in food prices. And the oil price explosion and echoing forward movement in many commodity prices have added to the pervasive thrust.

An analysis of the causes of inflation is complex. Some people view them as being single and simple and clear. But to my mind this is quite a complicated and quite a unique pattern of inflation and recession, which Senator Proxmire has referred to as a rather paradoxical situation, and we are inheriting much here over the past.

Economists differ greatly on the policy conclusions to be drawn, but I believe most would agree that the international factors are major contributors to national inflations. Imported inflation has become a fact of international economic life, and it does seem clear that the pattern of world trade and investment in the postwar period has begun to create the reality of world markets, with prices of many items that enter into our price indexes set internationally.

It is also clear that interest rates and the flow of capital do not regard national boundaries, at least in the principal capital markets of the world.

And given this kind of a world economy—a happy result of increasing interdependence—one point of view is that while inflation is international, it can be stopped only by national policies.

Another point of view is that restraining demand in one country, even the huge U.S. economy, would not reverse the total world im-

balance between supply and demand and cause prices to stabilize. Indeed, it is contended by some that attempting to do so unilaterally could throw the United States into a severe recession and perhaps cause other major countries to seek to counteract the impact on world economy of a U.S. recession by stimulating their economies even more, or perhaps move them into a competitive deflationary pattern that would spell a serious world economic collapse.

Still another point of view, I think particularly prevalent now in some quarters in Europe, namely, the fear that some of the principal governments may unwittingly be acting in an unduly restrictive manner simultaneously, eventually provoking a collapse in total world action:

Now just to conclude on that point it seems to me that the various points of view can be reconciled only by major democratic industrialized countries acting through their governments, taking concerted action:

(*a*) To achieve a coordinated level of real economic growth in the international economy that will not threaten to exceed available resources and give rise to the demand pull worldwide inflation, which I think occurred in 1972 and 1973;

(*b*) To set in motion those expansions in the supply or conservation in use of particular materials that are contributing or might in the future contribute in a major way to world commodity inflation.

In addition to the scheduled summit meetings transpiring this month in Washington to deal with inflation in the United States, we need an international summit to hammer out a common program of action designed to bring the international economy back to some acceptable norm of price stability without incurring a worldwide recession, and keep it there through the practice of international cooperation.

But, of course, no single meeting or series of meetings will provide the solution. Miracles do not come to pass at international conferences. These meetings can, however, serve as symbols of a common desire and objective and lay the base for a day-to-day, week-to-week, month-to-month, acts of consultation and cooperation that may precede and follow the summit.

A concerted and coordinated program to deal with world inflation, adhered to by the chiefs of state of the major countries, based upon jointly developed recommendations of their ministers of finance, central banks and economic advisers, would carry great weight with legislative assemblies and the public. The electorates are becoming weary and disaffected with increasing inflation, with its distortions, its social injustices and resulting social fragmentation. They are becoming increasingly fearful of a resumption of the boom and bust cycle that marked the breakdown of international economic cooperation in the 1930's when the economies of the world were much less closely interrelated than today.

There is a grave need, then, for a large and giant step in the coordination of national economic policies to reduce inflation.

Now, Senator Bentsen, in my prepared statement I discuss in the pages that follow a good deal about supplementing the problem of demand management with what I think Secretary Kissinger has given voice to in his U.N. General Assembly address on April 15, the importance of international cooperation between consumers and producers

of key raw materials in escaping the cycle of surplus and shortage. I think that may be an even more relevant and an even more important aspect of the problem of controlling inflation over the long pull than perhaps the aspect of reducing demand to meet pressure on demand at a given time. Both approaches, as your hearings signify, are needed.

In the following section of my prepared statement I do deal with the question of these and other factors and the availability of long term capital, and the functioning of our long term capital markets, which both in Western Europe in the Euromarket, and in the national capital markets of Western Europe, and in the United States, is badly defective, as you have, I think, put your finger on in the various hearings before the Senate Finance Committee.

The ability of private enterprise, and, indeed, many sovereign governments and their agencies to raise on reasonable terms the long term capital needed for growth, jobs, increased productivity or necessary public services is seriously jeopardized by these conditions. And the chief cause, it seems to me, of this short supply of long term capital on reasonable terms is inflation and this impact of the oil price explosion.

I will omit that treatment since it is there for the record and conclude by giving you, once again, my recommendations, which are limited to the international aspects of these hearings because these two esteemed former colleagues of mine in Government, Mr. Dusenberry and Mr. Tobin, I know will devote themselves more to the domestic than the capital requirements of supply issue.

My conclusions are, and recommendations, that one, there is a threatened shortage of supplies of long term capital available on reasonable terms to the free world economies sufficient to restore and maintain a pattern of sustained noninflationary growth.

Two, the availability of this essential element in the future will depend upon the solution of at least two major international problems:

(*a*) The international oil price and energy supply situation and the redistribution of capital involved in a manner consistent with the maintenance of a viable international monetary system; and (*b*) Worldwide double-digit inflation.

Three, the United States can find workable solutions of these two problems only through greatly intensified international cooperation for which existing intergovernmental institutions and national practices are woefully inadequate.

Four, national leadership of the major democratic industrialized nations should collectively enable and encourage the existing international institutions for international economic and financial cooperation, particularly the Monetary Fund, the World Bank, the GATT, and the OECD and, where necessary, special new bodies to deal with special problems to undertake much more responsibility for international decisionmaking and action beyond the traditional consultation process in dealing with these two problem areas.

Five, national leadership in the major democratic industrialized nations should seek national authority from the relevant legislative and parliamentary bodies for measures jointly devised for collective action through democratic processes with due regard to national sovereignty.

More specifically, the Joint Economic Committee should recommend to the Congress the prompt enactment of a program of decisive legis-

lation designed to enable the United States to minimize its dependence on imported oil through conservation in use and the development of other sources of energy, and to engage in defined programs of international cooperation with other countries, oil consuming and producing alike. These defined programs should be designed to assure the free world economy adequate and reliable supplies of energy on reasonable terms and restore an international financial equilibrium disrupted by the oil price explosion that permits the restoration of a viable international monetary system.

Seven, the Joint Economic Committee should recommend to the Congress the adoption of a joint resolution urging the President to undertake negotiations with the governments of major democratic industrialized nations looking to the development of concerned programs of action designed:

(*a*) To achieve a coordinated level of real economic growth in the international economy, which while not the same for individual countries, will not collectively threaten to exceed available resources or give rise to worldwide demand pull inflation; and (*b*) To set in motion those expansions in the supply or conservation in use of particular materials and commodities that are contributing or threaten to contribute substantially to world commodity inflation.

Eight, the Joint Economic Committee should stress the need for our Government and the international bodies with which it is associated to place increasing emphasis on increasing rates of private savings and capital generation from them, with a corresponding emphasis on increased development and effectiveness of national and international capital markets.

Nine, more specifically, the committee should advocate the adoption by the Congress of a new national policy and program designed to promote the broad private ownership of equity securities and a viable and effective equity market as an essential part of our national capital markets system.

Thank you very much, Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Fowler.

[The prepared statement of Mr. Fowler follows:]

PREPARED STATEMENT OF HENRY H. FOWLER

Mr. Chairman and Members of the Committee, May I congratulate the Committee on its choice of subject matter for these hearings. They should serve to highlight some underemphasized aspects of our current economic dilemma—how to restore our economy to a long term pattern of sustained non-inflationary growth.

The correction of inadequacies in supply is as important as the moderation of demand to manageable levels in dealing with inflation. My personal experience in dealing with mobilization in World War II and the Korean War left that indelible conviction. We must treat economic growth as an ally, not an enemy, in the fight against inflation.

This will mean practicing good micro as well as macro economics.

Stimulating adequate capital formation, removing capacity and production contraints that induce shortages, and identifying and promoting the achievement of specific expansion goals will prove to be essential to any realistic and politically feasible program to curb the kind of inflation we are experiencing.

You have directed my attention particularly to the international aspects of capital availability and demand and the adequacy of the existing international financial apparatus.

The provision of adequate supplies of long term capital on reasonable terms is indispensable to the restoration of a viable Free World economy, including that of the United States, moving steadily ahead on a pattern of sustained non-inflationary growth.

In turn this capital availability will depend on the solution of two major economic and financial problems threatening the future of the international monetary system. These problems our nation shares with the democratic and industrialized countries of Western Europe and Japan and much of the Third World. They are:

1. The oil and energy supply problem and the exercise of political control over the price and supply of a critical material by the governments of a few countries possessing a predominant share of the world supply.
2. Worldwide double digit inflation.

It is my strong conviction that the United States will find workable solutions to these problems in the interdependent world in which we now live only through greatly intensified international cooperation.

What is needed is the constant and persistent thrust of national leadership of the nations at the highest level into the existing institutions for international cooperation—particularly, the International Monetary Fund, the World Bank, the OECD, the GATT—and, where necessary, the creation of special bodies to deal with special problems.

These organizations, international in character, must undertake more, much more responsibility for action beyond the traditional consultation process, important as that process is to international cooperation. They must be agencies for the pooling of national sovereignity in specially selected areas so that consultation can be translated into international decisionmaking.

Moreover, this national leadership in the revitalization of international cooperation must seek and secure national sanction from the relevant legislative and parliamentary bodies for the measures jointly devised and recommended for collective international action. That is the only way by which the current economic and financial dilemmas that threaten to fragment our free societies can be solved through the democratic processes with due regard to national sovereignty.

I submit that the Joint Economic Committee, given its purpose, its bipartisan tradtion and its unique position in both Houses of the Congress of the United States, can make a major contribution to this process of energizing international cooperation to meet challenges beyond the power of a single country.

In these strange days we see a Free World economy cut loose from its familiar post World War II moorings and adrift on an uncharted sea.

These are days of a raging worldwide double digit inflation of complex causes and a mixed background. It is a strange compound of demand pull, cost push and commodity jump inflation, with the unaccustomed and unprecedented accompaniment of "stagflation" or real or threatened recession. This inflation seems more deep seated than anything previously encountered and is seemingly unresponsive to the normal and simplistic corrective measures traditionally employed.

These are days when a worldwide oil price escalation has created a worldwide disequilibrium in the international balance of payments, with the suddenness of a financial Pearl Harbor. The resulting imbalances do not seem susceptible to any of the normal processes of timely adjustment previously employed in the international monetary system to restore relative stability. This oil price escalation and the resulting disequilibrium threatens to change some of the developed industrialized nations from the practice of an economics of plenty to an economics of scarcity. It divides the less developed nations into two categories: those with substantial oil deposits being converted from hitherto barren plains, deserts and jungles into new centers of money and political power; those without oil threatening to become hopeless pools of stagnant poverty and misery unless they, too, are major producers of a vital raw material also escalating in price to the consuming countries.

These are also days when there is a growing imbalance between the world's food supply and needed reserves and the growth in the world's population, which may be indicative of other imbalances between resources and population growth that are productive of pockets of misery in various parts of the world.

These relatively new and contemporary global economic problem areas are superimposed on one the world has long faced—the massive poverty that still grips two-thirds of the world's people.

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Lurking behind the existing reality of this fearsome triad is a fear—a threat—a clear and present danger of a worldwide economic decline of indefinite dimensions and duration. This "unthinkable", for the first time in a generation, is being seriously and openly discussed in both governmental and private circles as a likely result of a failure to solve the aforementioned problems.

There is a common thread to these existing problems and the threatened danger. They are all international in their pervasiveness; the causes transcend national borders; and, satisfactory solutions require internationally coordinated action by the major democratic industrialized nations in both the governmental and private sectors.

The double digit worldwide inflation and the severe disequilibrium in the international balance of payments which is a consequence of the oil price explosion have given rise to a delicate and strained financial situation which is dangerous and uncomfortable for borrowers and lenders alike, be they public or private. They make the situation unusually difficult for the financial intermediaries and capital markets which are looked to for the capital needed in unprecedented amounts—if the world economy is to continue on a pattern of sustained growth and prosperity.

So let us examine these two problems in some detail.

I.

For the past ten months the world economy has been confronted with a potential blockage of the circulatory system of the world's capital and investment flows that threatens to cause a seizure or a paralysis of the international monetary system of trade and payments that has served the Free World economy so well since World War II.

The root cause of the problem can be put simply: a succession of increases in the posted price of crude oil by the Organization of Petroleum Exporting Countries has caused oil prices f.o.b. exporting countries to be increased four fold since mid 1973.

Estimates of additional cost in 1974 to oil importing countries range from $60 billion to $80 billion.

Assuming that the volume of oil imports in 1974 would be held to 1972 levels, an optimistic assumption, f.o.b. cost to oil importing nations would be $101.7 billion in 1974, an increase of $79.3 billion over the $22.4 billion foreign exchange cost in 1972.

For the U.S. increase in foreign exchange cost from just under $5 billion in 1972 to $20 billion, Western Europe from $11 billion to more than $50 billion, Japan under $4 billion to more than $16 billion, and Developing Countries about the same proportion as Japan.

The essence of the problem created by this sudden and enormous shift in the world flow of funds is how the huge capital accumulation in the oil producing countries can be redistributed throughout the international monetary system so that a healthy readjustment to the new situation can occur.

We should note in passing some of the implications for the world economy in addition to the drastic impact on the world balance of payments structure. For example:

1. The addition of a new cost push and cost of living factor to an already damaging worldwide double digit inflation and the simultaneous reduction in purchasing power in the consuming countries equivalent in economic effect to a massive tax increase.

2. The risk that the whole fabric of international cooperation embodied in the trade and payments system will be shattered by competitive depreciation and the escalation of national restrictions on trade and capital flows in an effort to minimize balance of payments deficits, avoid the exhaustion of monetary reserves and still obtain the necessary supplies of imported oil.

3. The risk that the cumulative effect of the practice of restraint in the consuming countries or production, consumption and growth in an effort to minimize oil imports and excessive balance of payments deficits will bring on a worldwide recession.

Some casualties from the "fall out" of the oil price explosion are already apparent.

The all encompassing international monetary reform, envisaged in the Outline of Reform, issued on behalf of the Committee of Twenty at Nairobi last September, has been deferred. The insuperable difficulties of an early return to a par value system in the shifting tides resulting from the oil price situation

have been recognized as leaving a system of managed "floating" as the only alternative for the near term future.

A second casualty, whose proportions are yet undetermined, is the fate of many of the less developed countries who are not oil producers or exporters. Their development programs are put in jeopardy until and unless some orderly means are devised and put in place by which their current account position may be financed, without jettisoning their development programs.

But this recital does not adequately characterize the longer term difficulties and contours of the problem presented.

The increase of payments of $60–$80 billion by one group of countries to another group in a single year, 1974, is only the tip of the iceberg. It is the difficulty of financing these oil purchases year after year with the resulting debt of consuming countries soaring to cumulative totals of staggering proportions that is the real horror with the unprecedented shifts in national wealth from one group of countries to another.

The unique and unprecedented character of this problem is not even the suddenness and magnitude of the payments shift in a single year. It is the fact that the increased payments of this magnitude, year after year, will be made to a group of countries, many of which are relatively underdeveloped in their capacity to consume and their capability or inclination to make long term investment at home or abroad. This group of countries accounted for about five per cent of the world's imports in 1973.

This makes for a uniquely difficult adjustment process that over time would restore a world balance of payments free from the major deficits that give rise to a problem of effecting a redistribution of international capital of a severity not witnessed since the days of the Marshall Plan.

Of course, the magnitude of this problem over the years can be affected by three factors—the future price movements up or down, the degree to which the consuming countries follow an effective conservation or austerity program in the use of imported oil from OPEC countries, and the degree to which alternative sources of oil in the principal importing countries, either in the form of conventional or substitute energy resources, are developed and utilized in lieu of imports from those oil producing nations which are not likely to use the revenues for the purchase of other goods and services from the oil consuming countries, particularly Saudi Arabia, Kuwait, Libya and the Arab Emirates.

Dr. Witteveen, the able Managing Director of the International Monetary Fund in an address on May 6 to the Economic Club of Detroit, gave the following estimate for the current year:

"With allowance also for certain statistical discrepancies in the estimation of trade flows, the overall surplus of the oil exporting states would perhaps be in the region of $65 billion in 1974, in contrast to a surplus of some $7 billion in 1973."

The other side of the coin—the deficit side—is appraised by the IMF as follows:

"In the past, a satisfactory position for most industrial countries involved a modest surplus on current account, sufficient to cover outflows of aid and capital to the developing world. For the developed countries taken as a group, this current account surplus was running at an annual rate of some $12 billion before the oil price increase. The principal counterpart of this surplus was a deficit of similar magnitude in the developing world, reflecting the natural flow of capital to countries in earlier stages of development.

The situation has now dramatically changed. If oil prices remain at recent levels throughout the rest of this year, the developed countries would be expected to shift to a deficit on current account of $35 billion or more. The deficit of the developing countries other than oil exporters may well rise to over $20 billion."

But these estimates do not tell the whole story. Indeed, they cloak the most serious part of it. It is true that the proceeds of the oil sales being transferred to the accounts of the oil producing countries will, to the extent they do not or are unable to increase their imports, be lent back to the rest of the world.

As put by the London Economist in its March 23 issue:

"If only the oil producers were to lend back to each country exactly what they have levied in the oil tax, there would be no effect on a country's total balance of payments in the short run. But they will not. . . . However, clearly some redistribution or recycling funds among oil consumers will be essential.

The private markets, primarily the Eurocurrency market and the New York capital market, now that it is fully open, have a basic role. They are well equipped

to handle large borrowings, given the acceptance of normal and traditional borrower-lender relationships.

But down the road there is a serious limitation on the utilization of private capital markets which needs to be frankly faced by the oil exporting countries who use these markets as an outlet for surplus funds.

Many of these countries seek primarily short term investments for their surplus funds in the form of bank deposits in a few selected large commercial banks of the U.S., Britain, Switzerland and other industrial countries, on a demand or limited time basis to assure a high liquidity. This puts the risks in the intermediation process on the receiving banks as these deposits are put out on loans of varying maturities. There is the risk of withdrawal in event of political or currency crises. Moreover, the banks will have line limits on the extent to which they are willing to lend to a particular government, its agencies or private institutions. The question arises—who takes the risk—the unwilling oil exporting country or the unwilling bank—in the longer term lending that is essential to any workable redistribution of capital on a sound financial basis. If neither is willing there will be a serious blockage in the redistribution process.

While opinion is divided on this danger, the dominant view is that this is much more of a danger next year or in the years to follow than in 1974.

But there are fears that the deposits, and the need to find lending opportunities for them quickly, will increase far faster than the underlying capital of the banks or their willingness to take the risks of long term loans.

There is also the fear that the failure of attempts of some of the non oil-producing countries to obtain dollar borrowings to defray their rising oil costs might lead to a chain reaction dangerous to economies and creditor banks alike.

There is no authorized lender of last resort for the Eurocurrency market and ad hoc volunteer rescue consortia on a global scale are not very reliable insurance in an era of relatively weak and unstable governments.

It is this kind of apprehension concerning the limitations of the redistribution role of the private sector that gives rise to alternative proposals that dot the financial press from week to week.

The limitation on the ability of the private markets to redistribute the surplus revenues accruing to the oil producing countries on a long term basis is particularly serious when these markets cannot channel funds on reasonable terms to countries whose economic position is precarious.

As Dr. Witteveen, the Managing Director of the International Monetary Fund, sees it:

"The shortcomings of exclusive reliance on short term borrowing through the Euro-currency markets mean that steps must be taken to set up channels of finance more appropriate to the medium and longer term. This implies a willingness on the part of the oil importing countries to open their markets to long term foreign investment and to take the necessary measures to encourage capital flows. For the developing countries, the need is especially for an increase in the flow of aid, particularly of aid on concessionary terms."

Although he notes that there have been some concrete proposals for new mechanisms to meet these needs, the good Doctor is properly skeptical that there will be enough and in time.

So in order to bridge this transition, he has moved to create a special new facility in the International Monetary Fund and solicited borrowings from the oil producing countries for this new facility which have been provisionally committed to the Fund in amounts somewhat in excess of $3 billion at 7 per cent interest.

His proposal provides that for two years, 1974 and 1975, oil importing members of the Fund which have a balance of payments need, and which have difficulty obtaining finance elsewhere, would be entitled to borrow from the Fund an amount related to the higher costs of oil for a period between 3 and 7 years. This would be the subject to an upper limit related to quotas in the Fund, but the facility "should be financed for the most part from borrowing, thus keeping the Fund's existing resources available to meet the other demands of its members."

The immediate objective of the facility—in supplementing the workings of the private international capital markets—is to maintain temporarily the flow of essential imports without having countries resort to undesirable policies.

The reservation of the U.S. Treasury about this proposal is in the words of former Undersecretary Paul Volcker:

"It is not an adequate substitute for dealing with the underlying problem: the redistribution of real resources that the new oil price necessitates, and particularly the pressures on the poorest developing countries."

To conclude on this particular subject it would be fair to say that the solution of the problem of redistribution of international capital that will flow to the oil producing countries and be surplus to their needs for goods and services presents an even more complex challenge to international economic and financial cooperation than the development of the Bretton Woods institutions and the Marshall Plan to deal with the post war world economy.

That solution should include among other things:

1. The redetermination of an equitable and stable world pricing of oil, fair to user and producer alike.

2. The procurement of the maximum quantities from the oil exporters who redeploy the maximum percentages of their oil revenues in the purchase of goods and services from the consuming countries.

3. An austerity program in the use of oil by the consuming countries until additional conventional and substitute sources of energy are developed in the consuming countries to a degree sufficient to diminish dependence on imports from OPEC countries.

4. The development of these additional conventional and substitute sources of energy.

5. The effective utilization of the private international capital markets (a) to finance the additional costs of oil in the interim period while the new conventional and substitute sources are being developed and (b) provide channels for the redeployment of oil revenues surplus to the current account needs of the oil producing countries in productive long term investments in real estate, securities and other assets in the consuming countries.

6. The utilization of the central bank "swap" network for a limited and appropriate role.

7. The development of the Witteveen IMF proposal for a Special IMF facility provided the risks of a failure of repayment by the borrowing countries are borne largely by the oil producing lenders and the regular holdings of the Fund are not pledged to make good defaults.

8. The mobilization of concessional aid from the oil producing countries through the international development banks and its synchronized use with bilateral concessional aid to make whole the additional costs of oil to the non-oil producing less developed countries resulting from the recent price increases.

9. Some utilization of deferred payment arrangements for 6–8 years by the oil producing countries on the portions of sales attributable to the recent price increases, where the lack of credit availability will result in supplies to a given country being reduced below 1973 levels.

Since last winter the existing international economic and financial institutions which include oil producing and oil consuming nations alike—the IMF and the World Bank—have been striving to minimize temporarily the damage to the world economy and the international trade and payments system resulting from the oil price explosion. The national governments of many of the major oil consuming nations, meeting under the aegis of the ad hoc newly constituted Energy Coordinating Group, have been striving to develop some contingency plans to deal with any new oil crisis that might develop. Various national governments of oil consuming countries have embarked upon a variety of separate, independent and uncoordinated measures to develop additional energy resources and conserve the use of oil or cope with the financial fallout from last year's oil price explosion.

But a fair appraisal of the pace of progress in both national and international measures in dealing with the consequences of past acts or the danger of future ones by the OPEC would have to return the verdict—inadequate. There can be no other interpretation of the tone of desperation and frustration that characterized the frank and realistic discussions of this problem by President Ford at the World Energy Conference last Monday, September 24th, and Secretary Kissinger at the United Nations General Assembly on the same day.

In the words of Secretary Kissinger:

"The complex, fragile structure of global economic cooperation required to sustain national economic growth stands in danger of being shattered".

In the opening comments of President Ford:

"Everyone can now see the pulverizing impact of energy price increases in every aspect of the world economy. The food problem, the inflation problem, the monetary problem and the other major problems are linked to the all pervasive energy problem."

Indeed, all the problems to which this Committee is directing its current efforts—the inadequacies of supply, capital formation, capacity and production con-

straints, expansion needs, the international aspects of capital availability and demand, the adequacy of existing financial apparatus for achieving non-inflationary growth—all are seriously affected by this all pervasive energy problem.

The words of the President and the Secretary of State being true—and, in my opinion, they involve no overstatement—the course of action for this Committee seems clear, given its especial economic policy role in the Congress.

Its forthcoming report should sound a "certain trumpet". That can only mean recommending a decisive pattern of legislation designed to enable the United States to minimize its dependence on imported oil and to engage in defined programs of international cooperation with other countries, consuming and producing alike. These authorized programs should be designed to achieve defined supply and requirements objectives for the world's energy needs at prices which would provide an incentive to producers but did not disrupt the economies of consuming countries or threaten the maintenance of a workable international monetary system.

My unfamiliarity with the energy legislative proposals that the Executive branch has devised or recommended or that the appropriate Committees have initiated does not permit an opinion on whether there is pending legislation that would serve adequately these purposes of internal action and international cooperation.

I do believe, however, that the existence of legislative enactments constituting a clear and unequivocal commitment of the Congress to these policy goals and a credible program for their realization is the heart of the matter.

Accordingly, a report of the Joint Economic Committee setting forth a program of action would be highly desirable.

Within three months from the outbreak of hostilities in Korea in 1950 the Congress had devised and enacted the Defense Production Act of 1950. This Act, with a related rapid tax amortization provision, resulted in massive expansions to determined goals of the capacity to produce a broad range of critical material that would have been in short supply for defense and essential civilian needs in event of a broader war. Surely this Congress can energize comparable accomplishments in the vital but limited field of energy by the same or improved techniques.

Not long before that Act the Congress formulated and passed an Economic Cooperation Act that served to implement a Marshall Plan. Surely, this Congress, working with the appropriate personnel from the Executive branch, can place its authority behind Executive Branch efforts to negotiate meaningful agreements and arrangements with other consuming countries for programs of solidarity and cooperation in the energy field. Indeed, it might define the terms on which Congress would be willing to support negotiations with oil producing and other consuming countries that would induce some of the former to follow a responsible pattern of supplier responsibility as to price and supply in return for cooperation by the latter in promoting the diversified development of the economies of the oil producing countries away from a sole dependence on sales of oil.

II.

There are encouraging manifestations of an increasing willingness on the part of the leaders of some of the major democratic industralized nations to seek international solutions of the international oil price and energy supply problem.

But, as yet, individual national efforts to halt inflation and return to an acceptable range of price stability, without a major recession, seem to be relatively uncoordinated internationally.

In short, there is no program, international in scope and acceptance, by which we can hope to navigate our international, interdependent world economy between the Scylla of uncontrolled inflation and the Charybdis of serious worldwide recession or depression.

It is my belief that the absence of a concrete and credible program for an orderly restoration of sustained non-inflationary growth to the international economy, adhered to by the major democratic industrialized nations, is the primary cause of the current malaise in world financial markets. This is the message of the markets.

The threat of double digit inflation on an international scale is not an entirely sudden development on the world scene. At the annual IMF and World Bank meeting in Nairobi a year ago, the Ministers of Finance and central bank gov-

ernors voiced a common despair at the ever increasing, all pervasive worldwide inflation even then prevalent.

In early June 1973, Dr. Otmar Emminger of the Deutsche Bundesbank, who has contributed so much to constructive international economic dialogue, said at Basle:

"Let us first take a glance at the phenomenon of worldwide inflation. The evolution over recent years points to some common cause or causes of world inflation. Indeed, what is particularly striking and ominous in the world economy of today is not only the progressive strengthening, but, in particular, the universal character of the inflationary forces in the industrial countries. Among the OECD countries, the average weighted price increase—measured in terms of consumer prices—was 2.4 per cent per annum in the second half of the 1950s, 2.6 per cent per annum in the first half of the 1960s, 4.2 per cent per annum in the second half of the 1960s, and 5.3 per cent per annum in the three years 1970 to 1972. At present (in June 1973), nearly all industrial countries seem to be marching "in step" at a rate of inflation of 7 per cent or more."

Now, only a little more than a year later, inflation thus far in these same OECD countries is estimated as running this year at an annual rate of fourteen per cent. This acceleration—a doubling in a year—is in part due to the impact of oil price increases. But there are many other contributing factors.

Clearly, the most important single cause of this global inflation is that the industrialized countries have pursued fiscal and monetary policies which, simultaneously, if unwittingly, have been excessively expansionary, particularly if one takes into account the accompanying inadequacies in efforts to expand supply in key material and product sectors. Both our macro and our micro economic policies have been out of phase with reality. The resulting excess global demand has pushed up prices—both of industrial products and services and numerous raw materials.

Wage increases substantially in excess of productivity gains in many of the major countries have added a general inflationary thrust.

Special factors, such as poor harvests in some parts of the world in 1972 have contributed to a steep rise in food prices. The oil price explosion of late 1973 and an echoing forward movement in many commodity prices have added to the pervasive inflationary thrust.

To some the cause of worldwide inflation is single and clear. For example, the July letter of the First National City Bank of New York observed:

"While the precise degree of price increase in any one country proved difficult to predict, the step-up in the worldwide rate of inflation that took place in 1973 and 1974 was predictable in view of the rapid growth that took place in the money supplies of most of the major industrial countries. In 1971 and 1972, the rate of growth in the supply of currency and demand deposits averaged about 27 percent in Japan, 15 percent in the United Kingdom, 8 percent in the United States and 13 percent in Germany. These rates were both well in excess of feasible rates of growth in physical output and at least 50 percent faster than the average rate of money growth in the three previous years."

To other analysts the causes of inflation are multiple and complex.

In a recently published study of U.S. inflation, as analyzed in a June issue of Business Week, economists William Nordhaus of Yale and John Shoven of Stanford depicted the profiles of the inflation in the United States from November 1970 through August 1971—the period preceding the wage-price freeze—only 25 percent of the inflation was due to agricultural prices, 18 percent to imports, while labor costs accounted for 54 percent, with profit margins actually declining over the period.

In contrast, from November 1972 to August 1973 they found that 64 percent of the wholesale price increase resulted directly or indirectly from the increase in agricultural prices which in large measure were responsive to external demand, while imported commodities accounted for 14 percent. Unit labor costs contributed less than 10 percent and rising profit margins 8 percent of the total price rise.

Economists differ greatly on the policy conclusions to be drawn from this type of analysis but all agree that international factors are major contributors to national inflations. Imported inflation has become a fact of international economic life.

It does seem clear that the growth of world trade and investment in the postwar period has begun to create the reality of world markets with the prices of many items that enter into the price indexes set internationally.

It is also clear that interest rates and the flow of capital do not regard national boundaries, at least in the principal capital markets of the world.

Given this kind of world economy—the result of increasing interdependence—one point of view is that, while inflation is international, it can be stopped only by national policies. This school argues that the responsibility for arresting this inflation rests with the larger countries and that the United States should take the lead in the fight against inflation.

Another point of view is that restraining demand in one country, even in the huge U.S. economy, would not reverse the total world imbalance between supply and demand and cause prices to stabilize. Indeed, it is argued that attempting to do so unilaterally could throw the United States into a severe recession and, perhaps, cause other major countries to seek to counteract the impact on the world economy of a U.S. recession by stimulating their economies even more.

Still another point of view, particularly prevalent in some quarters in Western Europe is the fear that some of the principal governments may unwittingly be acting in an unduly restrictive manner simultaneously, eventually provoking a collapse in total demand.

For example, the Highlights from the recent OECD Economic Outlook observes:

"With inflation running well into double figures, the struggle to reduce it takes first place among the aims of most OECD governments. Last year, excessive demand pressures built up rather generally throughout the area. It is only now that it is becoming clear that the recent sharp slowdown in growth, together with the trends forecast over the next twelve months, indicate a substantial reduction of aggregate demand in relation to supply capacity, both for internationally traded commodities and within countries. In most countries supply problems are disappearing and it is probable that excess demand as such is no longer a general problem. There may be some countries where further contractionary action is desirable, but in others the reduction of demand could go too far."

It seems to me that these various points of view can be reconciled only by the major democratic industrialized countries, acting through their governments, taking concerted action:

(a) to achieve a coordinated level of real economic growth in the international economy that will not threaten to exceed available resources and give rise to demand pull worldwide inflation.

(b) to set in motion those expansions in the supply or conservation in use of the particular materials that are contributing or might in the future contribute in a major way to world commodity inflation.

In addition to the scheduled "summit" meetings going on this month in Washington to deal with inflation in the United States, we need an international "summit" to hammer out a common program of action designed to bring the international economy back to some acceptable norm of price stability without a worldwide recession and keep it there through the practice of international cooperation.

But, of course, no single meeting or series of meetings, will provide the solution. Miracles do not come to pass at international conferences. These meetings do serve as symbols of common desire and objective and lay the base for the day to day, week to week, month to month acts of consultation and cooperation that may precede and follow the "summit".

What is gravely needed in dealing with worldwide inflation, in the words of West German Chancellor Helmut Schmidt in an interview reported in the August 25th New York Times, is the "closest personal and almost daily contact between the acting people, between the dramatis personae, in the United States and Germany and Britain and France and Japan."

A concerted and coordinated program to deal with world inflation, adhered to by the chiefs of state of the major countries, based upon jointly developed recommendations of their ministers of finance, central banks and economic advisors, would carry great weight with legislative assemblies and the public. The electorates are becoming weary and disaffected with increasing inflation, with its distortions, social injustices and resultnig social fragmentation. They are becoming increasingly fearful of a resumption of the "boom and bust" cycle that marked the breakdown of international economic cooperation in the Thirties when the economies of the world were much less closely interrelated than today.

There is grave need for a large and giant step in the coordination of national economic policies to reduce inflation. This will involve simultaneous efforts to hold down excessive demand, increase supply of vital materials, assure equitable distribution of these materials on reasonable terms, and avoid a competitive deflation that would risk a world depression.

As the recent Report of the Joint Economic Committee observed: "In 1972 and early 1973 unusually rapid growth in a number of major countries developed into a worldwide boom that contributed to the current inflation. The United States and other industrialized countries should cooperate to avoid excessively restrictive policies that could produce a serious worldwide recession". (See Report of September 21, 1974 at p. 13).

So without international cooperation on the scale, depth and intimacy envisaged above the Free World economy, including the United States, may fall into a recession of uncertain depth and duration.

And without that same international cooperation, the Free World economy can emerge from the current down tick into another worldwide boom of the 1972–73 variety that will bring on an even higher rate of inflation.

But it is not in the field of demand management on an international scale that there may be the greatest rewards for international cooperation in dealing with inflation and recession.

It may well be that concerted efforts to encourage and assure the availability of adequate supplies of the internationally traded commodities at reasonable prices, rewarding to producer and consumer alike, is an even more promising endeavor.

Access to supply as well as to markets may be the most fertile field for international comity and cooperation to plow.

It may be that the notable overture made by Secretary Kissinger to the United Nations General Assembly on April 15 was delivered to the wrong audience. He called for an escape by consumers and producers of raw materials from the cycle of surplus and shortage. He rejected the course of cartels of raw material producers, whether sponsored by governments or private companies, fixing ever higher prices coupled with production restrictions as leading to global inflation followed by global recession "from which no nation could escape". He projected the concept of optimum price—one that can be maintained over the largest period of time at the level that assures the highest real income, noting that "only through cooperation between producers and consumers can such a price be determined." He concluded on an affirmative note urging that an international group of experts be asked to make a comprehensive survey of the earth's non-renewable and renewable resources, including the development of a global early warning system "to foreshadow impending surpluses and scarcities."

If the producing countries prove unreceptive to international cooperation within these guidelines, it will be up to the OECD group to organize their own supply and requirements program, marshalling their technology and skills to develop adequate supplies and substitute materials. As a leading industrial power, the United States can speak as a consumer. As a major producer and exporter of raw materials and foodstuffs, it can see the other point of view. This endowment gives our country both bargaining power and responsibility for leadership in this new but highly important field for international cooperation.

III.

It should come as no surprise that this double digit inflation and the redistribution of capital that is a consequence of the oil price explosion are having a devastating impact on capital formation and, especially, the availability of long term capital and the functioning of our long term capital markets.

The ability of private enterprise, and, indeed, many sovereign governments and their agencies to raise on reasonable terms the long term capital needed for growth, jobs, increased productivity or necessary public services is seriously jeopardized.

The world is confronted by a growing shortage of capital and, particularly, the longer term borrowings or equity needed to assure the sound financing of private business or public debt.

The chief cause of the short supply of this type of capital on reasonable terms is inflation, according to a recent cogent analysis of this factor by Dr. Schaefer, the renowned Chairman of the Union Bank of Switzerland, in an address in London on September 10th. It has many detrimental effects on capital formation.

It balloons the demand, as Dr. Schaefer points out:

"This may be illustrated by the fact that the aggregate GNP of all the OECD nations rose by 351 billion dollars to 2,663 billion dollars in 1972. Of this growth, inflation financing accounted for about 225 billion dollars, whereas the financing of the real growth accounted for only 126 billion dollars."

It weakens the desire to save on a voluntary basis and thus reduces the potential supply of long term capital available. This is particularly true when the rate of inflation exceeds the interest earned on long term funds, a situation which exists today in almost all of the industrial nations and the world's capital markets.

As Dr. Schaefer sees it, the rising level of interest rates, the "negative" interest earned as a resullt of inflation and the distortion of interest rate patterns—the rates for long term investment are lagging behind those for short and medium term funds—have combined to create a reluctance to invest on a long-term basis. Owing to the higher interest rates, the greater flexibility, and the earlier options, savings capital normally available long term is being channeled into short term investments, or a growing portion of savings are providing thrust to a flight into tangibles—land, gold, silver, diamonds, art and the like.

As there is an inadequate supply of long term capital, the private sector particularly is being forced to an increasing degree to finance long term investment with short term funds subject to call. This unsound method of financing is a factor of instability which, if allowed to persist, will lead to increasing liquidity problems and dangers to the enterprises forced to adopt these tactics.

The impact of rampant inflation on the availability of long term capital is being greated exacerbated by the oil explosion. This is constantly draining huge amounts of money from locales where there are functioning capital markets and long term investment is somewhat traditional, to the Arab countries, where there is a distinct preference to invest capital on a short or medium term basis.

Added to both inflation and the redistribution of capital as a result of oil prices, there is the distortion of international capital movements resultant from the system of floating exchange rates to which the international monetary system has been reduced. The large element of risk involved in currency rate changes is also affecting international capital movements, including short term flows rather than long term investment in the international capital markets.

The recent trend in capital availability described above is not theory but fact. As Dr. Schaefer observes:

"The volume of bond issues placed on the Euromarket declined from $6.3 billion in 1972 to $4.2 billion in 1973 and from $2.3 billion in the first half of 1973 to $0.9 billion in the first six months of 1974. In contrast, medium term Euro-credits amounted to $22 billion in 1973, while in the first half of 1974 they have already reached a volume of $19.7 billion."

Both the new issue and secondary bond markets in the so-called Euromarket are relatively dormant. In addition the equity segments in the national capital markets are depressed and unreceptive, leaving the private sector largely dependent on commercial bank short and medium term credit, retained earnings, and the increasing resort to government funds.

My comments on the present state of the U.S. capital market will be brief for several reasons. First, the Chairman of this Committee has already manifest a thorough understanding and full grasp of the situation. Second, the two outstanding economists who will appear before the Committee to-day will undoubtedly cover this area in depth. Third, what has already been said about the Free World private capital markets is generally applicable to the U.S. market, the largest and most important.

But a few especial fatcors in the U.S. situation should be noted.

The most significant is the shrinking availability of equity capital for U.S. industry, having in mind that this source of funds has been the bulwark of the American private enterprise system, as contrasted with a heavier reliance upon debt in some of the other major industrial countries.

What are the salient facts?

Savings are tending to flow into guaranteed savings accounts, life insurance, short term instruments rather than equity securities. Individual stockholders, after increasing steadily for twenty years, have decreased by some 1.6 million in the last two years. Purchases and sales of individual investors now represent less than 30 percent of the daily trading on the New York Stock Exchange.

Stock prices as a multiple of earnings and a percentage of book value have fallen to the lowest level in 30 years. This is not a condition limited to the comparatively small or fledgling company. The average price-earnings ratio of all NYSE listed stocks had dropped to 6.4. Stocks of nine of the twelve largest companies in America are selling at less than 7 times earnings.

The unweighted averages of all NYSE stocks are down 57 per cent since January 1973 and 72 per cent from their record 1968 highs.

Investors in equities are discouraged by high interest rates and yields available in debt instruments which are the consequence in substantial part of the

high rates of inflation, by poor investment results, and by a capital gains tax policy that threatens to absorb ever increasing percentages of any profit that results from risk investment.

What are the results?

The amount of equity capital that corporate business is able and willing to raise is trickling away to an insignificant amount, particularly when measured against the increased requirements of inflationary growth in 1972.

This state of the equity capital market is particularly alarming to the future economic growth of the private enterprise sector of our economy in view of the unprecedented incerases in the cost of borrowed money, whether short or long term, and the limited availability of long term capital on almost any terms to many of the industrial and utility borrowers in the non blue ribbon rated categories of borrowers.

The debt-to-equity ratio for industrial companies has been increasing steadily, according to some estimates from about 25 per cent to 40 per cent in the last decade. Managements will become increasingly reluctant to authorize the increasing levels of capital expenditures that involve a continuing increase in these debt-to-equity ratios or a shrinking coverage of earnings to debt service.

So what is left? Equity or cutbacks of the investment needed for increased capacity, productivity or new jobs. Since equity is not a likely alternative, the prospect is for a curtailment of the needed plant expansion below what it would be if long term capital were available on reasonable terms.

Perhaps, this would be the point for a member of the securities industry to pull out the crying towel about the state of our capital raising machinery and the troubles of Wall Street. But I will spare you this in view of the fact that a member of the current Administration has recently dramatized our plight on national TV and I am not here as a self serving special pleader.

It is sufficient for these hearings directed to the relationship of economic growth to combatting inflation and the role of capital formation, capacity constraints and expansion needs in achieving increased supply to urge this Committee to consider the advocacy of a bi-partisan position that Congress act on the urgent need for a new and vigorous program to create a healthier capital markets system and a healthier securities industry.

Such a program must start with the premise that, as a matter of national policy, the capital markets of our country must continue to be developed and improved; that broad public ownership of equity securities by private individuals as well as institutions should be fostered as an essential element in a thriving industrial democracy that accords a key role to the private enterprise system; that the economic function of the securities industry must be preserved or enhanced; that the securities industry should consist of soundly capitalized independent underwriters, market makers and brokers.

A brief glance at future capital demands for the Free World economy reinforces the impression created by this survey of the supply side—namely, that it is threatened by a severe shortage of long term capital.

One need not rely for this judgment on the long term projections of the economists of General Electric that the cumulative capital investment needs in the United States between now and 1985 are $3.3 trillion, or of Chairman Needham of the New York Stock Exchange whose estimates ran even higher.

To get a closer and more near term look at just one sector of this market I asked Mr. Richard Worley, one of the principal economists at our firm for his outlook on 1974 as compared to 1975.

He estimates that in 1974 U.S. non-financial corporations will probably raise approximately $38 billion dollars of long term capital—corporate bonds, mortgages and equity issues, but that in 1975 these same non-financial corporations will need to raise as much as $60 billion of long term capital.

This $22 billion increase results in part from a $12 billion widening of the gap between long term capital expenditures and internal cash flow—primarily due to an estimated decline in corporate profits and the fact that depreciation allowances have not kept pace with the inflation in capital plant and equipment prices. The remaining $10 billion of additional long term capital will be needed for a larger increment to net working capital to rebuild corporate liquidity which is as strained today as in 1969–70. This is quite understandable when one views the abnormal levels of quarterly short term borrowings by non-financial corporations in the form of bank loans and commercial paper which have characterized the last two or three years.

Nearly a year ago I had occasion to make an analysis of the outlook for capital requirements of the Free World economy. This was before the days of worldwide double digit inflation and oil price explosion.

My conclusions then are my conclusions now, only intensified by the events of the intervening year. They are:

An analysis of the economic growth prospects and investment requirements of both developed and developing countries, and in some special areas of economic activity such as the supply of energy, suggest a substantial increase in both worldwide capital requirements and the scale of activity on capital markets needed to meet those requirements for the remainder of the decade.

It also suggests the grave need for governments, international bodies, and the private sector to lay increasing stress on increased rates of private savings and capital generation with the corresponding emphasis on increased development and effectiveness of national and international capital markets.

It also suggests that unless there is an intensive effort to bring under control and into tolerable limits the global inflation that threatens to engulf, if not submerge, the world economy, attempts to stimulate savings and generate private capital on a scale adequate to meet prospective capital requirements may be frustrated. One consequence will be retarded growth inadequate to provide a rapidly expanding world population with either an increased standard of living or an improving quality of life. Another would be to lessen hope for the future for nearly a billion people sunk in absolute poverty. Another result will be increasing dependence for capital on the public printing press and a tendency for the state to become the primary generator and conductor of economic activities.

The outlook for worldwide capital requirements suggests a continuing disproportion between the national capital markets in both countries and regions. This factor plus the greatly increased flows of international trade in raw materials, finished and intermediate products, and services will enhance the importance of functioning international capital markets.

The existing capital markets in their current state are likely to prove unequal to the burdens these capital requirements will place upon them. Unless governmental and inter-governmental policies are designed and implemented to increase levels of savings, improve and enlarge national capital markets, and enable the international capital markets to play their indispensable role, capital shortages could adversely affect increasing prosperity in the industrialized countries and the processes of economic development in many of the less developed ones.

This is not the place nor is there time to deal definitively with the many dire consequences of a failure to deal with global inflation. But, surely one will be a failure to stimulate savings and private capital generation on a scale adequate to meet the rising tide of capital requirements. The active appliction of fiscal and monetary policies and related measures to curb inflation to levels conducive to the accumulation of savings is, therefore, the first and fundamental measure. The utilization of regularized "monetary adjustment" procedures, utilized in Brazil to stimulate savings in the face of inflation rates that might otherwise be prohibitive is an interesting but "second best" approach, acceptable only as a transition device from a period of excessive inflation to reasonable price stability.

Clearly, a great deal more must be done by national states, encouraged and assisted technically by international bodies, to develop internal capital markets that are capable of marshalling internal savings and channeling them to meeting capital requirements.

Much more support and emphasis needs to be given, particularly in the less developed countries, to the encouragement of a developing institutional fabric that is capable of accumulating individual and collective savings and putting them to work in organized national capital markets.

The pioneering work in this area of the International Finance Corporation affiliated with the World Bank, is to be commended and should be greatly expanded and intensified.

My conclusions and recommendations, as was the case with the foregoing analysis, will be limited primarily to the international aspects of the subject of these hearings.

They are:

1. There is a threatened shortage of supplies of long term capital available on reasonable terms to the Free World economy sufficient to restore and maintain a pattern of sustained non-inflationary growth.

2. Availability of this essential element in the future will depend upon the solution of at least two major international problems:

(a) The international oil price and energy supply situation and the redistribution of capital involved in a manner consistent with the maintenance of a viable international monetary system.

(b) Worldwide double digit inflation.

3. The United States can find workable solutions of these two problems only through greatly intensified international cooperation for which existing intergovernmental institutions and national practices are woefully inadequate.

4. National leadership of the major democratic industrialized nations should collectively enable and encourage the existing international institutions for international economic and financial cooperation—particularly the IMF, the World Bank, the GATT and the OECD and, where necessary special new bodies to deal with special problems—to undertake much more responsibility for international decisionmaking and action beyond the traditional consultation process in dealing with these two problem areas.

5. National leadership in the major democratic industrialized nations should seek national authority from the relevant legislative and parliamentary bodies for measures jointly devised for collective action through democratic processes with due regard to national sovereignty.

6. More specifically, the Joint Economic Committee should recommend to the Congress the prompt enactment of a program of decisive legislation designed to enable the United States to minimize its dependence on imported oil through conservation in use and the development of other sources of energy, and to engage in defined programs of international cooperation with other countries, oil consuming and producing alike. These defined programs should be designed to assure the Free World economy adequate and reliable supplies of energy on reasonable terms and restore an international financial equilibrium disrupted by the oil price explosion that permits the restoration of a viable international monetary system.

7. The Joint Economic Committee should recommend to the Congress the adoption of a joint resolution urging the President to undertake negotiations with the governments of major democratic industrialized nations looking to the development of concerted programs of action designed—

(a) To achieve a coordinated level of real economic growth in the international economy, which while not the same for individual countries, will not collectively threaten to exceed available resources or give rise to worldwide demand pull inflation.

(b) To set in motion those expansions in the supply or conservation in use of particular materials and commodities that are contributing or threaten to contribute substantially to world commodity inflation.

8. The Joint Economic Committee should stress the need for our government and the international bodies with which it is associated to place increasing emphasis on increasing rates of private savngs and captal generation from them, with a corresponding emphasis on increased development and effectiveness of national and international capital markets.

9. More specifically, the Committee should advocate the adoption by the Congress of a new national policy and program designed to promote the broad private ownership of equity securities and a viable and effective equity market as an essential part of our national capital markets system.

Senator BENTSEN. Gentlemen, we have a vote on the floor of the Senate; Senator Proxmire has gone over and then I am going. We will do this in relays.

I know Mr. Tobin has a plane to catch. We will ask Mr. Tobin to testify next, who I think is one of this Nation's outstanding economists, a man who has served on the CEA; past president of the American Economic Association, and has particular expertise on monetary policies and price stabilization.

Senator PROXMIRE [presiding]. Mr. Tobin, it is an honor to have you here today. Why do you not go right ahead.

STATEMENT OF JAMES TOBIN, STERLING PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. TOBIN. Senator Proxmire, the announcements of these hearings describes their subject as "methods of easing a financial shortage that is driving up prices and aggravating unemployment in construction,

farming, and other basic U.S. industries." The financial shortage is, of course, related to the conjoined problems of inflation and stagnation that currently beset the American economy. The hearings are meant to provide information for the final Joint Economic Committee report on inflation. I have expressed some views on the sources and remedies of the "stagflation" and their financial implications in three papers which I take the liberty of submitting for the record. The papers are, first, "There Are Three Types of Inflation; We have Two," from the New York Times, September 6, 1974; second, "Monetary Policy in 1974 and Beyond," from the Brookings Papers on Economic Activity; and third, "Inflation, Interest Rates, and Stock Values," from the Morgan Guaranty Survey, July 1974.

Senator PROXMIRE. The papers will be incorporated in the record at the end of your statement.

Mr. TOBIN. Thank you.

I would say that there is no mystery about how to ease a financial shortage. A shortage of money is, unlike a shortage of food or fuel, not an act of nature or of God. Nor is it an act of OPEC. Financial stringency is the result of the policy of our own government—specifically the Federal Reserve System—and it can be relieved whenever the System chooses to change its policy. The Fed can inject new reserves into the banking system, thereby increasing their lending capacity, lowering interest rates, restoring the flow of funds into thrift institutions, reversing the decline in securities prices. By such action the Fed can end the depression in residential construction, encourage business investment, increase employment, and start the American economy growing again. It can be done. The real questions are whether it should be done and whether the Fed will do it.

Parenthetically, I think that until a year or so ago I would have objected to the notion that the financial shortage is driving up prices. Standard doctrine is that high-interest rates curtail demand, and that curtailing demand pushes prices down, or at least retards their rate of increase. There is no doubt about the first link in the chain. Tight money curtails demand, and the shambles of the residential construction industry is only the most obvious and immediate indication. As for the second link, however, prices in most of the nonagricultural economy of the United States are determined by marking up costs. The most important costs of American industry are costs of labor and of materials imported from abroad or from nonindustrial sectors of our economy. But the practice of raising the markup to reflect higher borrowing changes, routine in regulated utilities, may well have been spreading to other sectors in recent years.

However that may be, the main point is that restriction of demand acts very, very slowly either to retard cost inflation or to diminish markups. Once entrenched in habits and expectations, the wage-price-wage spiral has a strong momentum of its own. Employers raise prices to cover costs. Workers want to keep up with increases in cost of living, and with the pattern of wage increases other workers have been receiving. Employers wish to stay in line both with their competitors and with other employers in their labor markets.

In one of the papers I have submitted for the record, a report given to the Brookings Panel on Economic Activity last April, I tried to estimate how long it would take to reduce the rate of inflation to 4

percent per year, by following monetary and fiscal policies which stabilized the growth of GNP, in current dollars, at 8 percent per year. On the most optimistic assumptions, I estimated that it would take 3 years, 3 years of steadily rising unemployment, eventually exceeding 7 percent of the labor force. And on less optimistic assumptions, about the speed of adjustment of wages in response to unemployment, it would take much longer. According to the press, similar conclusions were presented by Otto Eckstein and David Grove to the pre-summit conference of economists. The unpleasant fact of life is this: Inflation gives way terribly slowly even when the economy stagnates and unemployment steadily rises.

Forecasters agree that prospects for the next four to six quarters are for zero or negligible growth in real output and for a substantial rise in unemployment, to the neighborhood of 7 percent. I remind you that the economy is normally capable of a sustained 4 percent per year growth of output, and that unemployment rises when the actual growth of production falls short of this potential.

Current business forecasts assume continuation of present monetary and fiscal policies, and the authors of those policies do not dispute the forecasts in any significant degree. In other words, present policies are deliberately intended to keep the economy stagnant through 1975, or longer. They are deliberately designed to increase unemployment, even though the payoff in diminished rates of inflation is trivial.

Now it is true that administration economists and Mr. Arthur Burns of the Federal Reserve have offered, as I understand it, you, the Congress, and us, the public, a change in the mixture of monetary and fiscal policy. If fiscal policy is tightened, by cutting expenditures or raising taxes, then the Fed will ease money and interest rates enough to offset the fiscal restriction of aggregate demand. Indeed, administration economists have been arguing that the proper compensatory easing of interest rates will occur naturally, even if the Fed does not increase the rates of growth of bank reserves and money supply.

This may or may not be so, but it seems to me to be beside the main point. The main point is that the administration and the Fed are not proposing, as far as I can see, to avoid the stagnation and rising unemployment now forecast. They are simply proposing to achieve the forecast scenario by a different mixture of policies. The change would be welcome to home buyers, homebuilders, and construction workers. But their relief would come at the expense of the incomes and jobs of others.

The losers will be people who pay higher taxes or people who receive benefits and employment now from Federal programs that would be curtailed by fiscal stringency. Maybe this redistribution would be an improvement in equity and in resource allocation. But we do not—certainly you in Congress do not—have to acquiesce in the administration's premise that stagnation is the only acceptable path for the economy. The idle resources in the construction industry can be put to work without depressing production and employment elsewhere.

Lower interest rates are certainly to be desired, not for their own sake but for their contribution to economic recovery. The Federal Reserve can and should give us low-interest rates without waiting for budgetary economies.

Indeed, the economy can actually stand some stimulus from the side of the budget. It is heartening that the administration now seems to be contemplating tax relief for low-income families. I have advocated giving the relief via a progressive reduction in the payroll taxes, with the objective of moderating wage demands and labor costs by providing gains in take-home pay through tax remission instead of at the bargaining tables.

I do not propose a reckless expansion. I accept somewhat reluctantly that in present circumstances we cannot prudently aim at unemployment rates much below 5 percent. If monetary and fiscal policy keep unemployment around 5 percent, there will be no excess demand inflation; indeed there will not be significantly more upward pressure on wages and prices than there is now from the side of demand. Under the strategy I propose, normal year-to-year growth of national production would be resumed; in fact, probably we could do a bit better than 4 percent in the first couple of years. Not only is unemployment currently well above 5 percent, but productivity figures suggest that the currently employed labor force is capable of significantly more output than firms are now producing.

In comparison, the administration scenario, with output stagnating and unemployment rising, will gain very little on the anti-inflation front, but will cost the country $50 to $60 million in lost production over the year ahead.

The Subcommittee on Economic Growth is concerned with economic growth and with the adequacy of future investment and saving. You, Senator Bentsen, have reminded us that prices depend on supply as well as on demand. That is a good reminder, but it is a fact that must be used with some caution. Experience around the world does not suggest that rapid growth in productive capacity is either the cure for inflation or as sometimes alleged the cause of it. Some rapidly growing economies, like Japan and Brazil, have had high rates of inflation; West Germany has grown fast with very little inflation.

I think Professor Duesenberry some years ago studied the question whether there was a correlation between growth rates and inflation rates, and concluded that there was not much evidence of any connection, positive or negative.

Faster growth in productivity is, of course, a disideratum for its own sake. But the reason we cannot expect generalized productivity gains to temper inflation, except temporarily, is that employers and employees will eventually scale up their annual wage increases to include productivity gains.

There is, however, one way in which supply augmenting policies may moderate the average inflationary trend. Specific bottlenecks and shortages have a ratchetlike effect on the average rate of inflation. The reason is that the price-and-wage-setting institutions of our economy have an inflationary bias. That is, prices and wages rise more readily and sharply in sectors where there are shortages than they fall in sectors where there are surpluses. The fuel, food, and materials shortages of the last 2 years have illustrated how large adjustments in relative prices almost inevitably mean large increases in overall price indexes. Anticipating and avoiding bottlenecks can, therefore, help to moderate the inflationary trend.

I turn now to some general observations about capital accumulation in the U.S. economy, since that is one of the emphases of the subcommittee.

The subcommittee is correct, I believe, in its premise that sustained investment of a substantial share of the Nation's productive capacity is essential for sustained growth of productivity. In addition to the normal capital requirements of a growing economy, we have to make up some shortfalls of capacity in basic materials, meet the shortage of energy and the strategic and geopolitical needs of Project Independence, and protect the natural environment. Professor Duesenberry, I believe, is going to give you his estimates of capital requirements for the rest of the decade. As I understand it, they are large, but they are by no means unfeasible for the economy to meet. He has measured investment requirements against the potential of the economy to generate the savings to match them. I would like to emphasize a somewhat different aspect.

Capital accumulation can be limited either by the saving capacity of the economy or by the willingness of firms, households, nonprofit institutions, and governments to undertake investment projects and to use the savings available. When the economy is operating and growing at its potential, capital accumulation is limited to the new saving of businesses, households and governments. However, some domestic saving may go overseas, as it has in the past in the United States, or alternatively, domestic capital accumulation may be augmented by borrowing abroad. The recycling of oil receipts is potentially an important source of finance of investments in the U.S. economy. Professor Duesenberry's calculations concern the adequacy of domestic saving to meet capital requirements at full employment.

Incidentally, I have been a little puzzled by the reaction to the recycling problems throughout the Western World and the United States. Of course, the explosion of oil prices is a great blow to all of our economies, but given that it seems that we might actually prefer that those countries lend us the money than insist on immediate delivery of goods and services to pay the higher price for oil.

In times like these, full employment saving potential is not the operative constraint on investment. Prospective buyers of new homes are depressed by shortage and expense of mortgage finance and by the disappointing resale market of their existing homes. Nonresidential investment is depressed or may become depressed, and it has been rather stagnant because business firms are depressed about future prospects for sales and profits and because financing is difficult to find and very costly if it is found. Interest rates are high, and the story of equity prices is one nobody wants to hear. Businesses have been borrowing short-term at unprecedented rates, but there are obvious risks in covering long-term capital commitments with short-term debt. Long-term debt floated at present market rates will burden earnings for years to come, and for many corporations the consequences of additional long-term debt will be to lower the market value of their stock issues. Clearly no company whose directors have any sense of responsibility to their shareholders would dilute their equity by selling shares in the current market. Indeed, one might think the best thing that they might do for their shareowners in the present market would be to buy back some of their stock, if they had any funds available.

At the same time, rosy reports of gains in corporate profits give an exaggerated impression of the ability of American business to finance new investment with internal funds. Sheer replacement frequently requires more funds than original-cost depreciation provides, and the

strange attachment of many businesses to first-in, first-out inventory accounting means in inflationary periods that a significant part of reported profits have to be used just to replace inventories. Paradoxically, the strong demand for business loans earlier this year may have been a sign more of weakness than of strength in the economy. When sales lagged, businesses had to find a way to finance more high-cost inventories than they really wanted to hold.

In any case, the securities markets have judged that the capital equipment of American corporate business is worth a lot less than its replacement cost. In 1965 and 1966, the market value of the long-term debts and equity shares of American companies was 160 percent of the replacement cost of their plant and equipment. A year ago this quarter the ratio had declined to 111 percent. And the last figure I was able to obtain on this calculation was 89 percent, but the market has been going down since then, so it is probably a good bit lower than that now. And in this financial environment, why should a company spend a dollar on new plant and equipment when the market will pay only 89 cents for the paper claims to that capital? As said before, the company might be kinder to its shareholders, if it had money to pay it out in dividends or to buy back its own shares.

At the beginning of this year, nonresidential fixed investment was considered the bright spot in a generally gloomy business outlook. But actual outlays are falling short of intentions expressed in earlier surveys. And after price changes are eliminated, both actual investment and recently expressed intentions look pretty flat. With the present monetary policy and economic outlook, real investment will probably decline. If the economy stagnates for several years, we will lose a lot of investment, and Professor Duesenberry's requirements for 1980 will become more difficult to achieve. For example, if we miss in 1975 the 4 percent real growth of which the economy is capable—some $50 to $60 billion of output—we will lose $10 to $15 billion of savings and capital investment.

As capital accumulation lags in a sluggish economy, Congress will be importuned, I feel sure, to make further tax concessions and subsidies for saving and investment. I think that you should be very skeptical of such proposals. A generous investment tax credit is already on the books—Secretary Fowler and I had something to do with putting it there in the first instance—but there is nothing wrong, I think, with investment incentives in this economy that would not be remedied by a revival of confidence in future growth and by the restoration of a salubrious financial climate. In the absence of those fundamental remedies, I fear that tax concessions, further tax concessions, will serve mainly to tilt the distribution of the income of a stagnating economy in favor of profits, at the expense of the majority of taxpayers, workers, and other citizens. Before we conclude that our present system cannot generate the savings and investment we need for growth of capacity and productivity, let us give it a fair try.

Thank you very much, Senator Bentsen.

Senator BENTSEN [presiding]. Thank you very much, Mr. Tobin.

[The papers referred to in Mr. Tobin's statement for the record follow:]

[From the New York Times, Sept. 6, 1974]

THERE ARE THREE TYPES OF INFATION; WE HAVE TWO

(By James Tobin)*

NEW HAVEN, CONN.—Three decades of experience tell us that inflation is endemic to modern democratic industrial societies. Fortunately the same record indicates that these economies are nonetheless capable of yielding their citizens substantial gains in well-being decade after decade. But hysteria about inflation may lead to policies that keep economic progress well below its potential.

The United States inflation of 1973–74 is a complex and difficult case, unique in our history. In general we may distinguish three types of inflation: a) excess demand inflation, popularly summarized as "too much money chasing too few goods," b) the wage-price-wage spiral, and c) shortages and price increases in important commodities. Our current inflation is a combination of b) and c). But public discussion generally ignores these distinctions and identifies every inflation, including the present case, as the classical type a). From this diagnosis, mistaken in my opinion, follows the classical remedy, the "old-time religion" of restricting aggregate demand by tight monetary policy and by fiscal austerity.

With some oversimplification, we can say that the U.S. suffered a severe case of excess-demand inflation a) in 1966, when President Johnson and Secretary of Defense Robert McNamara piled war demands onto an economy already operating close to its capacity, and ignored their economists' pleas to raise taxes. Re-enforced by a lesser dose of excess demand in 1968, the 1966 outburst left in its wake a surprisingly stubborn case of inflation type b), the wage-price-wage spiral. Attaining a momentum of its own, this inflation first accelerated and then abated somewhat under the deliberately recessionary policy of 1969–71, assisted by Phases I and II of the controls introduced in August 1971.

At the end of 1972 the ongoing wage-price dynamic was producing over-all inflation of 3½ per cent per year, down from 5 per cent in 1969 and 1970. However, it was obvious, as events confirmed, that some of the improvement was transient window dressing which would not survive relaxation of controls and completion of the recovery from recession.

Some observers view the 1973 expansion of the American economy as another case of excess demand and blame the Federal Reserve and the Nixon budget for overheating the economy once again. But unemployment never fell below 4.6 per cent, and the Government cooled off the boom pretty quickly after mid-year. In any case, the underlying wage-price-wage dynamic was proceeding at year-end with wage increases of 7 to 8 per cent, which with normal productivity gains would mean price inflation in the neighborhood of 5 per cent per year.

But meanwhile the United States was hit by a severe type c) inflation, a spectacular increase in commodity prices. For the first time since the Korean war, external events sharply increased the prices facing American producers and consumers. Everyone knows about the world shortages of food and energy, and about the aggressive new policies of the oil-producing nations, who have in effect imposed an excise tax of $10 to $15 billion a year on American consumers of their products. What may be less well understood is the role of the 16 per cent depreciation of the dollar in foreign exchange since 1970. Working precisely as the architects of the policy hoped, dollar depreciation made imports about $10 billion a year more expensive to Americans. Combined with booms in Europe and Japan, depreciation also increased foreign demand for U.S. products, notably basic agricultural and industrial commodities. Foreign demands for our exports created shortages and price increases for American buyers.

Now there are two important differences between types b) and c) inflation. First, the wage-price spiral keeps going of its own momentum. Wage increases are covered by price boosts, and subsequent wage settlements respond both to past wage patterns and to price inflation. The type c) commodity price increases, however, are once-for-all adjustments to new supply-demand situations; those prices won't necessarily fall, but all that is needed to improve the rate of inflation is that they stop rising.

Second, the wage-price-wage spiral does not of itself impose any collective loss on the nation or on the urban nonagricultural sector of the economy in

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which it occurs. One man's price is another's income; when buyers pay more, sellers receive more. The inflation may proceed unevenly, so that some workers, consumers, and property owners lose while others gain; such relative distributional changes are always occurring, inflation or no inflation. But it is simply vulgar nonsense—no less for constant repetition by economists, politicians, bankers, and journalists—to say that an internal self-contained inflation causes per se a loss of economic welfare in aggregate.

The commodity price increases are a different matter. They are symptoms of a real national economic loss to urban wage-earners and consumers. In current circumstances, we are paying more for oil and other imports. We're not just paying more dollars but more work and resources; under our new foreign exchange rate policy we can no longer buy foreign goods with paper dollar i.o.u.'s. We are also paying more, about $25 billion a year gross, to our own farmers. Recorded declines of real wages are the painful and unavoidable consequences. To attribute them indiscriminately to "inflation" is superficial and misleading.

The economy is currently in recession, and the prospects are for abnormally slow growth in output and for rising unemployment. The Federal Reserve is administering the classical medicine for excess demand inflation a), because that is the only medicine it has. Some of its spokesmen, supporters, and critics regard every inflation, almost by definition, as the excess demand type—on the ground that, whatever the proximate origins of inflation, it could be avoided by sufficiently resolute restriction of demand. The idea is that the wage-price-wage spiral will unwind if enough slack—idle capacity and unemployment—is created. Extreme advocates of the old-time religion even argue that determined disinflation of demand could have yielded big enough reductions in prices of other goods and services to offset or average out the recent price increases of food, fuel, and basic materials.

The trouble with this prescription is that it will not succeed without years of economic stagnation, high unemployment, and lost production, with much more severe consequences for real economic welfare than the inflation itself. Experience shows that the wage-price-wage spiral is extremely resistant to unemployment, recession, and economic slack. The unpleasant fact of life is that the wage- and price-setting institutions of our economy, and of every other non-Communist economy, are based toward inflation. Wages and prices rise when and where demand is strong much more readily than they decline when and where demand is weak. While the classical medicine would have prevented the Vietnam burst of inflation, it will take much more time and pain than its advocates admit to overcome the wage-price-wage inflation now built into our economy.

The main inflationary threat this year is that the temporary inflation of type (c) will be permanently built into the ongoing wage-price-wage spiral. The setbacks to real wages reflected in higher prices of food, fuel, and other commodities cannot really be reversed. General attempts to "catch up" by escalated wage settlements will simply be defeated by accelerated price inflation. So Washington is right to be alarmed by this year's wage settlements.

But there is very little the Federal Reserve can do about them, even if the Fed provokes a full-blown recession. The settlements are already in the works, and they depend much more on the recent history of wages and prices than on the current strength or weakness of demand. The budgetmakers of the Executive and the Congress are in much the same position. They too can be nobly and resolutely austere, pretending they are fighting a classical type (a) inflation. But the results of budget cutting will be measured more in lower unemployment and production statistics than in wages and prices. Present anti-inflation hysteria may well yield policies that bring us the worst of several worlds.

Is there a more promising and less costly way to confront the unique inflationary problem of 1974? If ever there was a time for what the Europeans call "incomes policy," the time is now. It may be that the Nixon experiment with wage and price controls was never a good idea, and the stop-and-go alternation of phases certainly didn't help. But the total abandonment, in April of this year, of every legal or informal restraint was incredibly untimely.

What was needed was Presidential leadership—in open, candid understanding with business, labor, agriculture, and consumers—to establish realistic moderate guideposts for wages and prices. We still need what some of us have called a new social contract for the economy, along the following lines: (1) Monetary and fiscal policy would be geared, not to increase unemployment, but to keep it from rising, and to achieve, not to thwart, the 4 per cent a year growth in production of which our economy is capable. (2) Workers' take-home pay would be increased by cutting Social Security payroll taxes and by making the structure of those taxes more equitable and progressive. This tax cut would provide part of the demand stimulus needed under (1). (3) Labor, for its part, would consent to a general wage guidepost of 8 or 9 per cent, and Washington would expect and exact comparable moderation in business and agricultural price-setting.

The hour is late. But the long national nightmare is over. Our new President has the trust and goodwill of the American people. If the economic problem he confronts is unique, he also enjoys a unique opportunity to seek a new direction.

[From the Brookings Papers on Economic Activity, 1 : 1974]

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Monetary Policy in 1974 and Beyond

WHAT SHOULD BE THE AIM of monetary policy in 1974? One answer is the fulfillment of the administration's forecast for the year. As explained in the President's *Economic Report*, the forecast is also the target; according to the Council of Economic Advisers, it is the best feasible path for the economy. I personally do not agree with this policy, nor do I believe it carries out the mandate of the Employment Act of 1946. But accepting it, one can ask what kind of monetary policy is likely to fulfill the forecast.

The expected and approved path appears to be quarter-to-quarter rates of growth of real gross national product in 1974 of roughly −0.5, 0, 1, and 1 percent, with unemployment rising to about 5.6 percent in the second quarter and remaining there the rest of the year. The rate of price inflation would fall sharply in the second quarter, but rise slightly toward the end of the year.

The target forecast of January does not differ radically from more recent forecasts made by private economists. Table 1 reports George Perry's latest guesses. (A difference of semantic and political significance, but of no economic import, is that Perry's trajectory qualifies as a "recession.")

What monetary policy will achieve this outcome in 1974? The council suggests a year-over-year increase of 8 percent in M_2, about the same as the projected gain of nominal GNP. A unitary income elasticity of demand for M_2 is historically consistent with one of about 0.7 for M_1. On this basis, the 1973–74 increase in M_1 would be 5.6 percent. The *Economic Report* provides few clues to interest rates in 1974. But the council's monetary tar-

Table 1. Alternative Forecasts for Selected Economic Indicators, 1974, by Quarter

Dollar amounts in billions, seasonally adjusted annual rates; annual rates of change from previous period in percent

	Perry							*CEA*	
	Real GNP		*GNP deflator*		*Nominal GNP*			*Real GNP*	
Year and quarter	*Amount (1958 dollars)*	*Growth rate*	*Index (1958 = 100)*	*Growth rate*	*Amount*	*Growth rate*	*Unemployment rate (percent)*	*Amount (1958 dollars)*	*Growth rate*
Actual									
1973:4	844.6	1.6	158.4	8.8	1,337.5	10.5	4.7	...	...
Projection									
1974:1	838.6	−2.8	161.9	9.1	1,358.0	6.2	5.3	840	−2.0
2	833.5	−2.4	165.0	7.7	1,375.3	5.3	5.9	840	0.0
3	841.8	4.0	166.8	4.4	1,404.1	8.4	6.0	848	4.0
4	853.0	5.3	169.0	5.3	1,441.3	10.8	6.0	857	4.0
Actual									
1973	837.4	...	153.9	...	1,289.1	...	4.9	...	...
1974 Projection									
Perry	841.7	0.5	165.7	7.6	1,394.7	8.2	5.8	...	...
CEA	846	1.0	164.5	6.8	1,390	7.8	5.5	...	...

Sources: Actual, *Survey of Current Business*, Vol. 54 (March 1974), pp. 12, 13, 15, S13. CEA data are from, or are based on data from, *Economic Report of the President together with the Annual Report of the Council of Economic Advisers, February 1974;* Perry forecasts are from George L. Perry, "The Economic Outlook for 1974," tabulation (Brookings Institution, March 1974; processed).

Table 2. Required Annual Rates of Increase of M_1 and Time Deposits to Effect Various Movements in Interest Rates, 1973:4 Actual and Projections for 1974, by Quarter
Percent

Interest rate and monetary variable	*1973:4 Actual*	*1974 projection, by quarters* First	Second	Third	Fourth
		Slow decline in interest rates			
Rate on commercial paper	9.0	8.3	8.0	7.7	7.4
Growth rate					
Currency plus demand deposits, M_1	3.9	8.5	7.2	5.1	7.2
Time deposits	5.3	7.4	6.7	5.2	8.2
		Moderate decline in interest rates			
Rate on commercial paper	9.0	8.2	7.7	7.2	6.7
Growth rate					
M_1	3.9	8.6	7.5	5.5	7.8
Time deposits	5.3	7.6	7.4	6.4	9.8
		Substantial decline in interest rates			
Rate on commercial paper	9.0	8.1	7.4	6.7	6.0
Growth rate					
M_1	3.9	8.7	7.8	5.9	8.4
Time deposits	5.3	8.1	8.2	7.7	11.6

Sources: Based on Stephen M. Goldfeld, "The Demand for Money Revisited," *Brookings Papers on Economic Activity* (3:1973), pp. 577–638; and Perry, "Economic Outlook for 1974."

get and its judicious balancing of factors raising and lowering rates both suggest that no significant changes are expected or desired. If interest rates remain stable or rise during the current (growth) recession and recovery, this will be a unique episode in business cycle annals.

Stephen Goldfeld recently reported some carefully estimated econometric equations of demand for money.[1] Table 2 shows rates of increase of M_1 needed, according to his preferred equation, for three alternative paths of interest rates in 1974. In each case Perry's forecasts for real GNP and prices from Table 1 were used. These estimates take off from 1973:4, when demand for money was unusually high, in the sense that there was a large positive residual from the systematic part of Goldfeld's equation.[2] The

1. Stephen M. Goldfeld, "The Demand for Money Revisited," *Brookings Papers on Economic Activity* (3:1973), pp. 577–638. Hereafter, this document will be referred to as *BPEA*, followed by the date.

2. I am grateful to Professor Goldfeld for these estimates, which are based on the specification in equation (4), ibid., p. 582.

1974 projections carry this residual with gradually diminishing weight. The residual for 1973:4, reflecting a shift of asset preferences toward money, is scarcely surprising. The same uncertainty and failure of confidence have been painfully evident in the stock market.

Goldfeld also has an equation for the time deposits component of M_2, but it is not as successful over the sample period as his M_1 equation. Using this equation, I calculated annual rates of increase in demand for time deposits for the four quarters of 1974, for the same three hypothetical paths of interest rates. These are also shown in Table 2.

I conclude that the standard forecast—the administration target—will not be met without rates of monetary growth that will (a) exceed the recommendation of the council, and (b) draw screams from monetarists.

I am very skeptical that the standard GNP scenario can be staged without declines in interest rates at least as sharp as those shown in the third panel of Table 2. My skepticism has three sources.

First, one act of the play is a revival of residential construction in the second half of the year. Indeed, February figures suggest that the worst may already be over. But the current interest rate structure does not induce large flows of savings into thrift institutions. Such flows will not occur, the record suggests, until open market rates dip below 7 percent. Meanwhile, during the current slump, mortgage rates have continued a steady rise that has scarcely been interrupted since mid-1971. Although nonmonetary measures—advances from the Federal Home Loan Banks and purchases by the Federal and Government National Mortgage Associations—are billed as remedies to ease the mortgage market, they have not yet lowered rates. Tight credit conditions continue in a housing market weakened by the energy crisis. Prospective home buyers are doubtful about suburban or exurban locations and uncertain about house size and design.

Second, consumer demand looks weaker than the standard forecast assumes. Perry's forecast puts personal saving rates in 1974 below the 7.3 percent of 1973:4—at 6.5, 6.0, 6.1, and 6.4 percent in successive quarters. The most recent University of Michigan survey of consumer attitudes is the most pessimistic ever, by far. Independently of this information, Tom Juster has tried to estimate the influence of expectations and uncertainties about inflation, jobs, and incomes on the personal saving rate.[3] For 1974

3. F. Thomas Juster, "Savings Behavior, Uncertainty and Price Expectations," in *The Economic Outlook for 1974*, Papers presented to the Twenty-first Conference on the Economic Outlook, 1973 (University of Michigan, Research Seminar in Quantitative Economics, 1974), pp. 49–70.

his equations predict rates in excess of 8 percent of disposable income. A third factor lowering the propensity to consume is the transfer of income to sellers of food and fuel at home, as well as abroad. A fourth is the decline in auto sales because of the gasoline scare. Given the heavy use of installment finance in auto purchases, most of the money that would normally be spent for cars will be saved rather than spent on other goods.

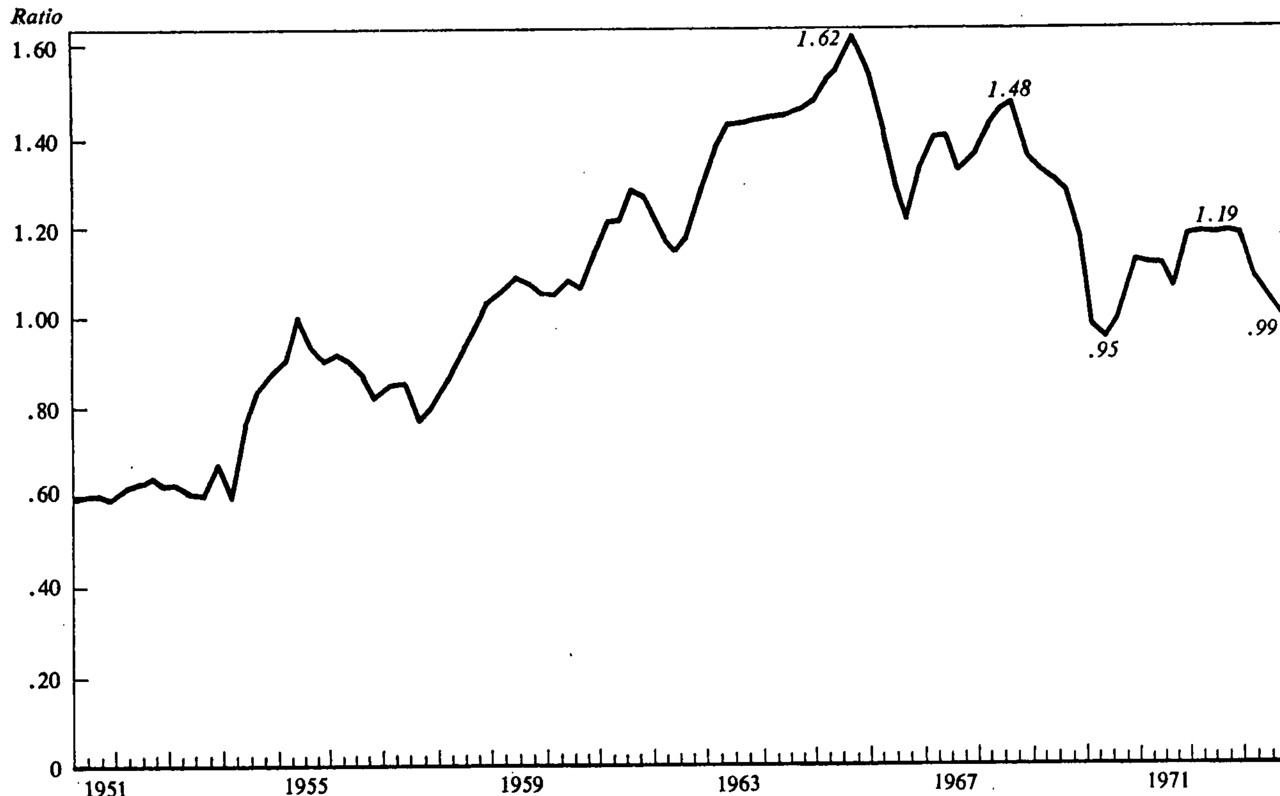
Finally, optimism about the prospects for recovery later this year depends principally on the strength of nonresidential investment in 1974, as registered in surveys of anticipations. The survey reported in March by the Commerce Department indicates that business anticipates spending 13 percent more for investment in plant and equipment in 1974 than was spent in 1973. Yet there is an underlying weakness in the financial climate for corporate investment, the high cost of capital relative to expected earnings. If this is not corrected, it may retard investment later in 1974 or in 1975. In the plans for this year, three types of investment play an unusually large part: increases in energy-producing capacity; capacity additions in materials and other bottleneck sectors; and defensive investments to adapt to new scarcities and higher costs. These kinds of investment are probably relatively insensitive to interest rates and capital costs, but a sustained and broadly based investment boom will depend upon an improvement in expected earnings relative to costs of finance. I turn to this topic in the next section.

Is the Real Rate of Interest Really Low?

Figure 1 shows the quarterly time series of Q, the ratio of the valuation of corporate physical capital in the stock and bond markets to its estimated cost of reproduction at current prices of goods. The ratio is now below 1, for the first time since 1970:3 and only the third time since 1958. A high value of Q is favorable to investment, since a corporation can sell paper claims to physical capital for more than the capital costs. A low value of Q, on the other hand, means that the rate of return required in the market by current and potential share- and bondholders is high relative to the marginal productivity of capital. As Keynes has said,

> [The] daily revaluations of the Stock Exchange, though they are primarily made to facilitate transfers of old investments between one individual and another, inevitably exert a decisive influence on the rate of current investment. For there is no sense in building up a new enterprise at a cost greater than that at which a similar existing enterprise can be purchased; whilst there is an inducement to spend on a

Figure 1. Estimated Ratio of Market Valuation to Replacement Cost of Corporate Capital Stock, 1951:2 to 1973:4



Source, Derived by John Ciccolo: Federal Reserve Bank of New York, and used with his permission.

new project what may seem an extravagant sum, if it can be floated off on the Stock Exchange at an immediate profit.[4]

Figure 2 shows I/K_{-1}, gross investment as a percentage of the lagged capital stock (both in 1958 dollars), over the same time period.[5] John Ciccolo has also computed a regression of I/K_{-1} on K_{-1} and eight lagged values of Q. From this regression can be calculated projections of 1974 nonresidential fixed investment, in 1958 dollars, assuming that Q remains at its 1973:4 value of 0.995.

As I stated above, I have no doubt that special factors will be favorable for investment in 1974, and, of course, it is possible that the stock market will pick up. Table 3 is meant to show that in the absence of special factors or a stock market recovery, investment demand might be weak.

Table 3. Alternative Forecasts of Nonresidential Fixed Investment, 1974, by Quarter

Year and quarter	*"Q" forecast (billions of 1958 dollars)*	*Perry forecast*	
		Billions of current dollars	*Billions of 1958 dollars*[a]
Actual			
1973:4	94.5	141.8	94.5
Projection			
1974:1	93.7	145.8	96.0
2	92.6	147.0	95.6
3	91.7	153.5	98.6
4	91.4	158.0	100.2

Sources: The "Q" forecast (explained in the text) was calculated by John Ciccolo. Other data are from Perry, "Economic Outlook for 1974."
a. Assumes investment deflator rises at 5 percent per year.

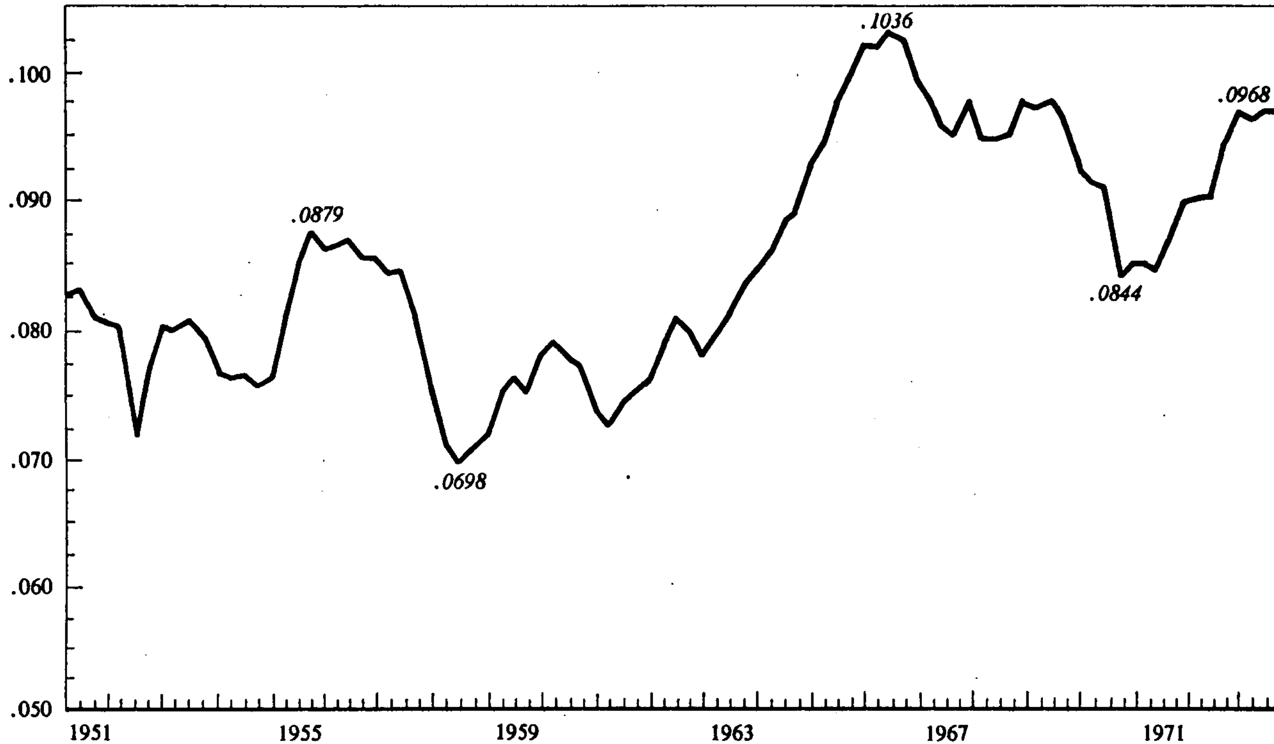
Further evidence is provided by William Nordhaus' calculations, in his article in this issue, of the internal after-tax rate of return on corporate capital. This rate reached its post-1950 high of 10.0 percent in 1965 and fell to 5.4 percent in 1973. Standardized cyclically to an average unemployment rate of 4.5 percent, the rate was 10.0 percent in 1965 and 5.6 percent in 1973. The profit squeeze is not a myth. In these circumstances, real rates of interest as high as those that prevailed in the 1960s are not an appropriate target for the Federal Reserve.

4. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Macmillan, 1973 ed.), p. 151.

5. I am indebted to a former student, John Ciccolo, now of the New York Federal Reserve Bank, for the calculations of Q and I/K_{-1}.

Figure 2. Ratio of Real Gross Investment to Gross Capital Stock, 1951:2 to 1973:4[a]

Ratio



Source: Derived by John Ciccolo.
a. Computed from investment and capital stock in 1958 dollars.

In my opinion, it is a fallacy to conclude that real rates of interest are low simply because current rates of inflation are high compared with nominal market interest rates on dollar-denominated assets. The important thing, as I have argued above, is the comparison of earnings prospects and interest rates. This is the comparison the stock market makes, and it is hard to argue that real rates have declined in any meaningful sense after price-earnings ratios have declined by a third over the year.

The rates of increase of price indexes do *not* represent operational investment opportunities; it is not possible to acquire and hold for future sale the consumer price index's market basket or a share of gross national product. Anyway, recent increases in price indexes have large one-shot components; rational savers and investors would not extrapolate those rates into the future. Inflation premiums are not immaculately added to interest rates. They are put there by market forces and monetary policy. Inflationary expectations do not force bond rates up unless they induce borrowers to float bonds and investors to shift into other assets. One would expect equities to rise in value. When inflationary news makes *both* bonds and stocks fall in price, the explanation, I think, is that these markets know that the Federal Open Market Committee reads the papers too and will react by making policy more restrictive.

I have lately been reading how money markets react adversely to news of high rates of growth of the stock of money. Perhaps the market is full of convinced monetarists. More likely, the market, knowing that the Fed sets targets and limits for growth in the money stock and is sensitive to monetarist criticism, anticipates that the FOMC will act restrictively to reverse "excessive" growth of monetary aggregates. This game is an unfortunate consequence of the Fed's adoption of money-stock criteria in making policy and of the market's use of these criteria in interpreting policy. But it does not mean that the Fed is impotent to reduce interest rates if it really aims to do so. Expectational markups of interest rates will not be sustained unless real live borrowers appear to take all the funds available, and this will not happen unless the Fed confirms the expectations by contracting bank reserves and supplies of loanable funds.

The Recommendations of the "Shadow Open Market Committee"

The press recently reported that the "Shadow Open Market Committee" advises the Fed to set the growth of M_1 at a constant rate of 5 to 5½ per-

cent per year.[6] Just as Milton Friedman did in his letter of February 20, 1974, to Senator William Proxmire, the shadow committee blamed the Fed for the major part of current inflation. Friedman likewise urged the Fed to slow down monetary growth. Advocates of this position rarely tell the public the costs of the policy they espouse. Friedman does say ". . . there is literally no way to end inflation that will not involve a temporary, though perhaps fairly protracted, period of low economic growth and relatively high unemployment."[7]

In one sense the Fed can be held responsible for all inflation that occurs. If the Fed were willing to starve the economy for liquidity, regardless of the consequences for real output and employment, presumably price indexes could be held down even when unit labor costs are rising or even when special factors raise the prices of internationally traded goods like oil and grain. But the Fed is not responsible for the structural features of modern industrial economies that give them an inflationary bias even at reasonable rates of utilization. Nor can the Fed be blamed for unwillingness to accept the "temporary, though perhaps fairly protracted" costs of trying to cure structural inflationary bias by deflation of aggregate demand.

We already know that these temporary costs *can* be fairly protracted. In 1970 Andersen and Carlson simulated their St. Louis monetarist model for steady rates of monetary growth in the period 1970–80.[8] With 6 percent monetary growth, unemployment stayed above 5 percent until 1976 and above its natural rate of 4 percent until 1978. With 4 percent monetary growth, consistent with long-run price stability, unemployment was above 6 percent in 1971–75 and above 5 percent until 1978, and it had not reached 4 percent by 1980.

In a monetarist spirit I have made some similar calculations for the present context. I assume that the shadow committee's proposal for M_1 means an 8 percent annual rate of growth of nominal GNP. I also assume that the normal rate of growth of potential output is 4 percent per year and, for the sake of argument, that the natural rate of unemployment is 5 percent.

6. The Shadow Open Market Committee is a private group of economists who meet occasionally to recommend monetary policies to the Federal Reserve.

7. "Letter on Monetary Policy," *Federal Reserve Bank of St. Louis Review*, Vol. 56 (March 1974), p. 23.

8. Leonall C. Andersen and Keith M. Carlson, "An Econometric Analysis of the Relation of Monetary Variables to the Behavior of Prices and Unemployment," in *The Econometrics of Price Determination*, Conference Sponsored by Board of Governors of the Federal Reserve System and Social Science Research Council, 1970 (FRB, 1972), pp. 177–81.

The rate of increase of the GNP deflator each quarter is the sum of two components. One is a weighted average of the eight preceding quarterly increases, the weights summing to one. The other is a correction depending on U_{-1}, the unemployment rate for the previous quarter: the correction is positive if U_{-1} is less than 5 percent; negative if it exceeds 5 percent.

The specific form of the second component is $(b/U_{-1}) - (b/5)$. I have used two vastly different values for b. The first is 13.32, which comes from the Phillips curve of the old Fed-MIT-Penn model as reported by de Menil and Enzler in 1970.[9] This is an optimistic view of the efficacy of unemployment in slowing down inflation, for it implies that the difference between 6 percent and 5 percent unemployment is a reduction of 0.4 percentage point each quarter in the annual percentage rate of inflation. This is surely overoptimistic for the purpose, since the de Menil-Enzler Phillips curve has no natural rate and attributes variations in wage inflation predominantly to variations of unemployment. The second value of b is 4.0, from an Eckstein-Brinner wage equation (reestimated by Gordon),[10] in which full feedback of past price changes accounts for the lion's share of explained variance of wage inflation. On this basis, unemployment of 6 percent cuts down the annual rate of inflation only by 0.13 percentage point each quarter.

The simulations, displayed in Figure 3, assume that the Perry forecasts are realized in 1974 and that the monetarist recommendation takes hold in 1975:1. From then on, nominal GNP grows at an annual rate of 8 percent. In the optimistic version, unemployment rises to 6.9 percent in 1978:2 and finally gets down to 5 percent in 1982:4. In 1978:2 the rate of price inflation crosses its long-run equilibrium value of 4 percent. That is why unemployment begins to decline. But by 1982:4 the rate of price inflation is only 2 percent, so unemployment overshoots and continues to decline. Eventually the rate of inflation accelerates again, and so on. I stopped the cycle at the end of 1985, assuming that the Shadow Open Market Committee might have had another meeting by that time.

The second version is even worse, as might be expected in view of the weak effect of high unemployment on wage inflation. Unemployment rises steadily for eight years.

9. George de Menil and Jared J. Enzler, "Prices and Wages in the FR-MIT-Penn Econometric Model," in ibid., pp. 277–308.

10. Robert J. Gordon, "Wage-Price Controls and the Shifting Phillips Curve," *BPEA* (2:1972), pp. 385–421.

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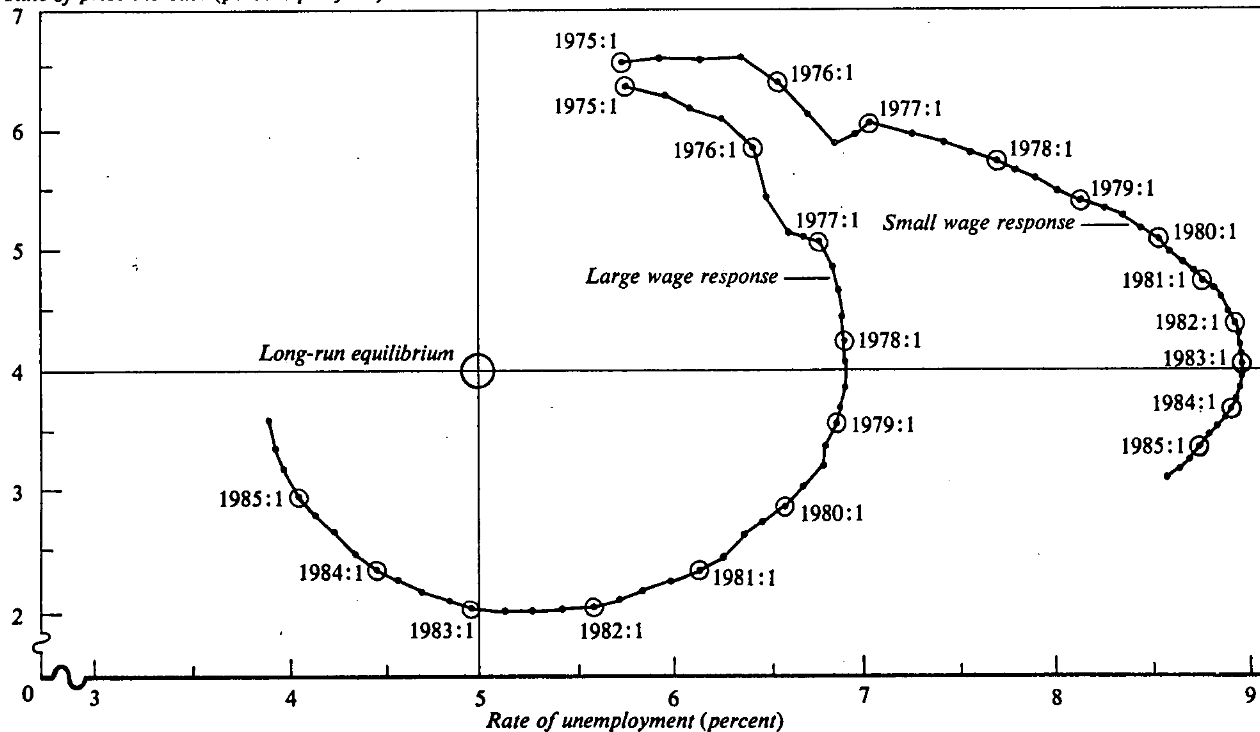
Figure 3. Simulations of Inflation and Unemployment with Constant 8 Percent per Year Growth of Nominal GNP, Alternative Wage Responses to Unemployment, 1975:1 to 1985:4



Source: Derived by author. See text discussion.

The Old Dilemma Once More

The recommendations of the shadow committee and of Friedman raise once again the big and terribly uncomfortable issues of macroeconomic policy. So, for that matter, does the CEA at the beginning of its 1974 Report:

> . . . while continued rapid inflation is not inevitable, the course of unwinding it will be long and difficult . . . to hope that we can "wring the inflation out of the system" by the end of some short period is to assure disappointment. Whoever undertakes now to fight inflation must be prepared to stay the long course. We think it is necessary to do this, and also to recognize why we must do it. Experience extending over almost a decade teaches us that if we do not fight inflation effectively it will accelerate. . . .
>
> [The facts of our prosperity over the past eight years] do not relieve us of the need to bring inflation under control, and to accept the cost of doing so for the sake of avoiding the greater costs of an accelerating inflation.[11]

This statement makes me wonder what macroeconomic scenario the administration has in mind for 1975 and subsequent years.

In the fight against inflation, the urgent matter in 1974 is to keep the fuel-food bulge in prices from escalating the rate of wage inflation. From the record so far, one can be moderately hopeful, and there are reasons why one would not expect rising commodity prices to pull wages all the way up after them. These price increases do not improve the bargaining power of most employees. They do not inflate the profits of employers or the value of labor to them; in many instances the opposite is true. They do not distort the pattern of relative wages and provoke another round of wage-wage spiral. Still, with George Meany talking 12 percent, no one would underrate the problem.

But I doubt that the wage outcome this year will depend appreciably on whether the unemployment rate is 6 percent or 5.5 percent or 5 percent. As I have already noted, wage equations that assign high coefficients to past price experience do not assign a strong influence to unemployment. The short-run Phillips curve is flat at high rates of unemployment. Since it is steep at low rates, a much longer time is required to unwind an inflation than to generate one.

In the circumstances, neither monetary policy nor aggregate-demand

11. *Economic Report, February 1974*, p. 21.

policy in general is a useful tool. As Arthur Okun has observed, if there really is a danger that a one-shot bulge in particular prices will be permanently incorporated in general wage and price inflation, and if the damage of such acceleration is as great as the CEA suggests, then all kinds of preventive measures—controls, subsidies, rollbacks—would be justified, in spite of their temporary allocational costs.

Should not a real effort to negotiate a social treaty with George Meany and other labor representatives be the first order of business? I suspect that American consumers, wage earners, union leaders, and businessmen are quite capable of understanding that scarcities of food and fuel make it impossible for their real incomes to grow at the accustomed pace. Workers might accept wage guideposts for 1974 and 1975 that recognize this fact of life. But they would have to regain confidence that the sacrifices will be equitably shared. Indeed, wage guideposts might be more acceptable if workers were assured that the burdens of layoffs and short time were not piled on top of the inescapable burdens of commodity scarcities.

The abiding problem will be with us whatever happens in 1974. My views and values respecting unemployment and inflation are not shared by all economists. I do not agree that inflation, or even acceleration of inflation, is *ipso facto* evidence of excess aggregate demand. I do not agree that all unemployment up to the "natural" rate compatible with zero or steady inflation is *ipso facto* voluntary. Anyone who does agree to those propositions would have no qualms in aiming monetary and fiscal policy at the single target of zero inflation.

For the rest of us, the tormenting difficulty is that the economy shows inflationary bias even when there is significant *in*voluntary unemployment. The bias is in some sense a structural defect of the economy and society, perhaps a failure to find and to respect orderly political and social mechanisms for reconciling inconsistent claims to real income. Chronic and accelerating inflation is then a symptom of a deeper social disorder, of which involuntary unemployment is an alternative symptom. Political economists may differ about whether it is better to face the social conflicts squarely or to let inflation obscure them and muddle through. I can understand why anyone who prefers the first alternative would be working for structural reform, for a new social contract. I cannot understand why he would believe that the job can be done by monetary policy. Within limits, the Federal Reserve can shift from one symptom to the other. But it cannot cure the disease.

[From the Morgan Guaranty Survey, July 1974, published monthly by the Morgan Guaranty Trust Co. of New York]

Inflation, Interest Rates, and Stock Values

The following article was written by James Tobin, who is Sterling Professor of Economics at Yale University.

THESE days "inflation" is the catchall scapegoat for all economic evils—energy crisis, the troubles of Con Ed, world food shortage, even recession and unemployment. It is also popularly blamed for high interest rates and for the sag in equity prices.

Is it in fact true that interest rates have been pulled up to double digits primarily by double-digit inflation? Or is a substantial part of the rise in interest rates due to Federal Reserve policy? Has Arthur Burns tightened credit relative to realistic opportunities to invest in homes, plant and equipment, and inventories?

In the main I believe the answer can be found in restrictive monetary policy. Indeed, I shall argue that the behavior of the stock market this year confirms that the recent run-up of interest rates is not just inflationary froth but has real substance.

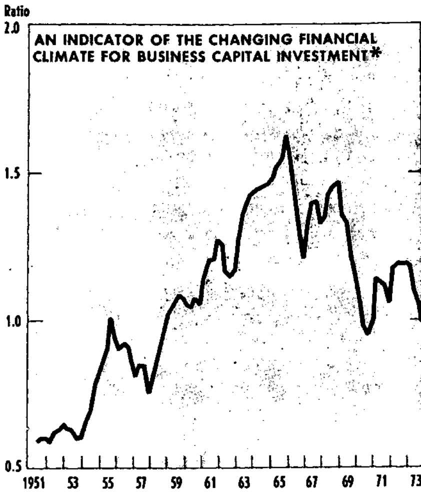
The performance of the securities market clearly is evidence that the financial climate for capital investment in the United States has deteriorated. Since 1966 aggregate market valuations of corporate securities (bonds and stocks) have not kept up with the replacement cost of corporate inventories and fixed capital. The chart shows for the years 1951-1973 the ratio of the securities market valuation of U.S. nonfinancial corporations to the replacement cost of their tangible capital. A high value of this ratio means that the market thinks well of the earnings capacity of the capital assets and/or applies a low discount factor to future earnings. A low value means that the market is pessimistic about future profits and/or discounts them heavily.

During the 1950s and early 1960s this ratio was generally increasing. For corporations this meant that funds for expansion and investment were easy to come by, and also that managements were generally doing their shareowners a favor by reinvesting profits. The decline in the ratio since 1966 indicates a worsening of the financial climate for business capital investment. In 1974, obviously, equity financing has become a laughable idea, internal funds are scarce, and companies are risking their shareholders' future by undertaking huge fixed-interest commitments.

One reason for the worsening climate, no doubt, is the well-known profit squeeze. William Nordhaus estimates that corporations' after-tax rate of return on replacement cost has fallen from 10% in 1965 and 1966 to 5.4% in 1973.* To have maintained the same climate for investment and growth, it would have been necessary for real after-tax financial interest rates—that is, market rates corrected for inflationary expectations—to have declined correspondingly. That has not happened.

It is true that inflation has something to do with the profit squeeze. Taxable profits are swollen by fictitious inventory gains and by reckoning depreciation at historical cost. Partly in response to the capricious tax penalties of inflation, increasingly favorable treatment of depreciation has been provided for in the tax laws. But, despite such relief, the effective tax rate on true economic income, as estimated by Nordhaus, rose from 38% in 1965 and 1966 to 42% in 1972 and to nearly 49% in 1973. Significantly, however, this rise in the effective tax rate accounts for only a part of the steep fall-off in the rate of after-tax return since the mid-1960s. Had

* *Brookings Papers on Economic Activity*, 1974:2.



* Ratio of the aggregate market valuation of the bonds and stocks of U.S. nonfinancial corporations to the replacement cost of their tangible capital. I am indebted to Jack Ciccolo of the Federal Reserve Bank of New York for the calculations.

the rise in the effective tax rate not occurred, the after-tax rate of return on replacement cost would have been 6.5% in 1973 rather than 5.4%. Thus, a substantial part of the decline from 10% remains.

Profits before taxes have been depressed in recent years of recession and "stagflation." The sluggish economic climate was not the automatic or natural result of inflation. Rather it was deliberately engineered by Washington policymakers to control inflation.

Yet the decline in profitability exceeds what might be expected on cyclical grounds. Among other possible explanations are: price controls; foreign competition; increased relative costs of materials imported from abroad or purchased from the non-industrial sector of the U.S. economy; environmental controls; slowdown in productivity growth; diminishing returns to the heavy capital accumulation of the long investment boom of 1946-1966.

The main point is that the facile and complacent assertion that inflation is the culprit for the trauma of the stock market is a dangerous exaggeration. It is dangerous because it gives the impression that the conquest of inflation by restrictive monetary policy is both necessary and sufficient to revivify the stock market. It is dangerous not because strength in the market is a goal per se but because weakness indicates a general financial climate unfavorable to investment needed for recovery and growth. And it is dangerous because it diverts attention from the role of current monetary policy and interest rates in perpetuating that unfavorable climate.

A related strand of the new conventional wisdom is the theory that market interest rates fully reflect inflationary expectations. Interest rates, it is commonly argued, are not high in any real sense if they do not exceed the contemporary rate of inflation. Why have commercial paper rates risen from 5% to 12% since 1965? A widely accepted explanation is that price indexes, which were then rising at less than 3% per annum, are now rising at 10% per year.

In 1896 in his book *Appreciation and Interest* Irving Fisher formalized the theory that the nominal interest rate (dollars yielded by dollars) is the real rate (commodities yielded by commodities) plus the anticipated rate of inflation. Fisher's insight, long neglected, enjoyed spectacular renaissance in the 1960s. Monetarists in particular have seized upon inflationary expectations as the principal source of variations of nominal interest rates, both the upward postwar trend and shorter-term fluctuations around it. The premise, usually tacit, is that the real rate moves little and slowly. The conclusion is that a rise of nominal interest rates simply to mirror height-

ened expectations of inflation is neutral, i.e., not a meaningful rise of rates in any real economic sense.

Applied to the current American scene, the two theories—that inflation is responsible for the stock market decline and that increases of interest rates have been neutral reflections of inflation—are in logical conflict. If observed increases in market interest rates simply mirror general expectations of inflation, why do equities fall in value?

A correctly anticipated general inflation, *neutrally* embodied in interest rates, would not change equity values. Upward corrections in interest rates to allow for general inflation would not drain money from the stock market; they would simply maintain the attractiveness of bonds relative to stocks. The real value of equities would reflect real economic conditions, independent of price levels and rates of inflation. As time and inflation marched on as anticipated, equity prices would rise in step with commodity prices. The charted statistic on page 5, the ratio of the securities market valuation of companies to the replacement cost of their tangible capital, would remain stable. When, as has been true in recent years, the ratio of paper claims to capital goods declines in value while the goods themselves rise in price, we must conclude that actual and expected inflation is a very inadequate explanation of events in financial and capital markets.

A principal concern of these markets is to anticipate future government policies: monetary, fiscal, wage-price control. Why is inflationary news deflationary these days? Not because of the effects of inflation per se but because of the anticipated anti-inflationary responses of the federal government. As experience since 1971 has taught, these responses may include price freezes and controls. They may include new taxes that restrict consumer demand and business profit. They may include restrictions on foreign trade and capital movements, or new exchange rate policies.

But perhaps the market's most consistent concern is the response of the Federal Reserve to inflationary developments. The market knows that Arthur Burns, an announced, determined enemy of inflation, reads the newspapers too. News of more inflation is taken as a signal that the Fed will further and longer restrict the growth of the economy, with uncertain impact on inflation but obvious damage to the real earnings prospects of American business. News of increased interest rates—to which the market has become acutely sensitive—is read as a signal that the Fed is in fact pursuing a strongly restrictive policy.

Making the wind

The acute sensitivity of the stock market to interest rates is a relatively recent phenomenon. Before 1966, stock and bond prices frequently moved in opposite directions. Booms and expectations of booms pulled up stock prices but raised interest rates; recessions did the opposite. Firmness in interest rates was a signal of prosperity to come, reflecting strength in business loan demand more than restriction of credit supply. The Fed's practice, well understood, was to "lean against the wind." The Fed did not generally tighten strongly enough in booms to nullify the improvement in the climate for earnings and investment. Nor did it ease credit so drastically as to overcome the pessimism about profits induced by recession. Now, however, stock and bond prices move together. Interest rate movements drive the stock market, both because high yields on dollar-denominated assets attract funds and because they signal the intentions of the authorities to make the wind, not just lean

against it.* This market behavior is strong evidence that the interest rate variations we have been experiencing have real bite; they are not simply Fisher-like adjustments for expected inflation.

It is not really surprising that current interest rates can be low and high at the same time—low relative to contemporaneous inflation in general price indexes, high relative to operational investment opportunities. The explanation is two-fold. First, recent price indexes contain dramatic one-shot price increases in fuel, food, and—thanks partly to the depreciation of the dollar since 1971—internationally traded goods. Rational investors would not expect recurrent shocks of equal magnitude. Second, much recorded inflation, especially in consumer prices, occurs in items in which net speculative investment is impossible or very costly—services, perishable goods, imports, taxes, even interest rates themselves. Many recent price increases have added to corporate costs but not to corporate revenues. Although business loan demand has been strong during the 1974 slowdown, it seems to reflect more the scramble for liquidity to carry out existing commitments and plans at higher prices than the financing of real economic expansion. The inflation of 1973-74 has affected asset values unevenly. For some categories of reproducible assets, it has merely trickled through. But it has strongly favored nonreproducible assets—mineral deposits, agricultural land, precious metals, old coins, objets d'art. The prosperity and progress of the United States economy, however, is crucially dependent on financial incentives for the accumulation of reproducible productive capital.

* To substantiate the point, here are some correlation coefficients computed on quarter-to-quarter changes of the indicated variables:

	1951:II to 1965:IV	1966:I to 1973:IV
Stock prices (S&P 500) and corporate bond rate (AA new issues)	+0.11	−0.43
Stock prices and prime rate	−0.04	−0.53
Dividend yield (S&P 500) and corporate bond rate	−0.06	+0.49
Dividend yield and prime rate	+0.21	+0.57

Too much complacency

That is why I think the Federal Reserve, and the articulate voices of the business and financial community, are much too complacent about today's double-digit interest rates. The Fed, of course, is not responsible for the very real economic difficulties besetting the nation—the shortages of food, fuel, and materials; the apparent decline in the productivity of capital investment; the strains of the international monetary system; the crisis of confidence in political and economic institutions. But these are maladies which tight money does not cure but only aggravates. The stock market's weakness, the recession in residential construction, and the general sluggishness of the economy are warnings of the dangers in our present course. I realize that the objective of the policy is to weaken aggregate demand enough, and long enough, to reduce significantly the rate of inflation. Experience does not, I think, justify much optimism about the success of this policy, but I have not argued that point here. I have only tried to indicate that the policy contains more bite and cost and risk than one might suspect from superficial comparisons of interest rates and rates of inflation.

Senator BENTSEN. We are also fortunate to have with us Mr. James Duesenberry, who is coauthor of a forthcoming book on capital claims and resources in the 1970's. I know you can shed some fruitful insights for us on this country's investment needs in years to come.

Mr. Duesenberry served on the Council of Economic Advisers in the Johnson administration, he knows Washington, and I know he can translate economic analysis into a policy framework.

Mr. Duesenberry, please proceed.

STATEMENT OF JAMES S. DUESENBERRY, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. DUESENBERRY. Thank you, Senator Bentsen.

My testimony now is a summary of capital requirements from now until 1980, which was conducted by the Brookings Institution, and Mr. Barry Bosworth is associated with me in the study. He is from California; he does not appear today, but he has done a very large part of the work on this study.

In the years since the Second World War, our economy has produced a volume of savings and provided for continuous upgrading and renovation of industrial and commercial capital as well as for new facilities for an expanding work force. In the public sector the demands of a vastly expanded educational system have been met with little strain, while 40,000 miles of interstate highways were being built.

Nonetheless, our capital requirements, far from being satisfied, are greater than ever. The demand for industrial capital is intensified by our new energy requirements, by capacity shortages in many raw materials processing industries, and by the need for pollution abatement facilities. Widely accepted national housing goals require the construction of 26 million new homes in a decade. In the public sector large amounts of capital will be required for pollution abatement and mass transit.

The simple addition of all the capital which will either produce a profitable private return or appear high on someone's social priority list during the next decade or so yields sums which run to over $2 trillion. Such calculations suggest that as one writer put it, "We may not be able to afford the future."

Senator Bentsen read the same financial writer.

The inference drawn by some capital market Cassandras is that we are faced with a capital shortage on a large scale which will require high real rates of interest, sharp increases in tax rates and a scaling down of programs for improvement of social capital in such fields as housing and pollution abatement.

Some of the resulting gloom is readily dispelled when we annualize the capital requirements calculations and taken into account the fact that in a growing economy our capacity to produce and to save will grow by 50 percent in a decade. Moreover, while new capital demands have appeared, capital requirements in some areas are declining. The classroom shortage of a few years ago is gone. The Interstate Highway program is nearing completion. Those observations do not prove that there is no problem, but they do suggest that the dimensions of the problem can only be understood by a careful analysis of the bal-

ance between the growing demand for capital and the growing resources of our economy.

The prepared statement reports the results of a study done before the energy crisis of the probable demand for capital—public and private—in the period 1974–80 and of the potential supply of capital. Can we provide industrial capital for an expanding economy, provide for new sources of energy, meet the national housing goals, and carry out our commitments for public and private expenditures for pollution abatement and transit facilities? Or must we expect higher tax rates, underfunded programs and congested capital markets? Our answer is that we can afford the future, but just barely.

Our estimates indicate that with normal growth our economy will be capable of meeting the capital demands that can be reasonably projected for the remainder of the decade without unusual sacrifices. At the same time, they indicate that very careful fiscal management will be required if we are to avoid a capital markets crunch or a renewal of inflationary demand pressures, on top of the cost push inflation which is likely to persist for the remainder of the decade. A substantial full employment surplus will be required. The size of the required surplus depends partly on future decisions with respect to revenue sharing and in part on the target level of unemployment.

A substantial surplus will be required if we choose a 5 percent unemployment target; a much smaller surplus would be consistent with 4 percent unemployment. Because inflation tends to increase Federal tax revenues faster than costs, due to the "bracket effect," the Federal budget will automatically tend to show a surplus. That is good news. But it will be necessary to hold at least a part of that surplus. In our view it will be necessary to resist demands for tax reductions and expenditure initiatives, and that will be difficult to do while maintaining a surplus. Moreover, our estimates of expenditures for social capital are realistic projections of what is likely to happen given present legislation. They fall considerably short of the higher estimates of "needs" which some people have generated. In the upshot, then, we do not foresee any capital markets catastrophe, but we do foresee that very careful resource management will be required for the rest of this decade and beyond. Excessive spending initiatives or tax reductions will lead to renewed inflationary demand pressures or an extremely tight monetary policy with substantial increases in interest rates or both.

The result of our study suggests that the United States would be needing to devote a significantly greater amount of resources to capital formation in future years. Many areas of primary public concern such as housing, pollution abatement, and increased energy reserves are highly capital intensive. In addition, some sectors of the private economy such as raw materials processing, which have suffered from excess capacity in the past, are now fully utilizing the available capital stock and higher levels of investment will be required in the future. However, after adjusting for increased resource availability the magnitude of the investment needs is not overwhelming.

The text seems to be somewhat out of line with the figures because it turns out that the share of public and private investment of total GNP will have to rise only about a half percent—to 18 percent—over the 1974–80 period compared with 17.5 percent in the first years

of the decade. The expansion of business investment is partially offset by a lower share of GNP going to residential construction and State and local governments' capital formation.

I should note that that results not from a decline in the rate of housing construction but from the fact that the projections for the housing targets require a fairly flat level of housing, not at the present rates, but at rates of a year or so ago, a flat level of somewhat over $2 million; and that will involve a steadily smaller share of total GNP.

The goal of 25 million housing units over a 10-year period as set forth in the 1968 Housing Act appears to be within reach and consistent with needs. Because of increased estimates of household formation, the goal does not seem to be as far above normal demand as some studies initially implied. The costs of the program have been reduced by a shift in homebuying patterns toward less costly mobile homes and apartments. That is either good or bad, depending on how you feel about that.

State and local government capital formation will need to rise sharply for the remainder of the decade after several years of declines in real terms, if legislated standards for water pollution are to be met. But some of the pressure on their capital financing has eased because of a sharp slowing of demand for educational services. Private spending for pollution abatement will also be substantial, but the required increase above present spending levels appears to be moderate.

Recently, forecasts of very large amounts of capital investment have been put forth for the U.S. effort toward greater self-sufficiency in energy. When expressed as 15-year cumulative totals, these numbers do appear to be overwhelming, but when they are reduced to annual rates and compared to an ever-growing aggregate GNP they are far less awesome. The growth of public utility investment is projected at a rate only slightly above that of the 1960's. The major increases are in the domestic production of fuels, but the industry is not large enough relative to the rest of the economy to cause significant aggregate problems. There may be problems for the individual industry associated with such a rapid growth, but the concern is not a shortage of resources. Some offset to the growth of investment in energy and raw materials can be anticipated from reduced capital requirements in the consumer finished goods industries.

Some moderation of the growth of State and local governments spending outside of pollution abatement can be anticipated. The impact on education of the postwar baby boom has largely passed. In addition, the growth of welfare program costs has begun to slow and the Federal Government is assuming a larger proportion of the financial burden. By shifting a larger share of their revenue to the personal income tax, these governments are also in a better position to keep up with cost increases without resorting to tax rate increases. Nonetheless, State and local governments are likely to have difficulty in making ends meet. They must either obtain additional grants in aid—or general revenue sharing—raise tax rates or severely limit improvements in service levels.

We have made some calculations on the position of State and local governments, and our conclusion is that after allowing for the borrowing which would be consistent with their normal behavior in regard to borrowing against capital programs meeting their debt

requirements, their debt retirement requirements, and allowing for the normal financial offset accumulation by State and local governments, we conclude that State and local governments will have a shortfall of financing of $25 to $30 billion if they are to keep their tax rates constant and at the same time meet the capital requirements that I have already mentioned and continue the trend of improvements in the quality of other services. That means that some resumption in the growth of Federal transfers to State and local governments will be required; otherwise, State and local governments will be forced to either raise their taxes or cut back the quality of their services.

We have projected Federal expenditures and transfer payments on the basis of existing legislative commitments—except that in the case of defense we have assumed the adoption of the administration's defense posture as outlined in the 1973 budget.

At this point we can cast a trial balance to determine the fiscal policy implications of the calculations just made. For each year we begin by assuming that the GNP is the one required for the target unemployment rate.

We have two calculations, one for 4 percent unemployment and one for 5 percent unemployment.

We then allocate the income side of the GNP accounts to households, corporations, State and local and Federal revenues, assuming we are producing the output that goes with the stated unemployment figure. To do that we have used existing tax rates and transfer payment legislation and have used historic relationships for the patterns of capital consumption allowance, corporate profits, dividends and retained earnings. We then apply a simple consumption function to obtain an estimate of consumer expenditures. To these we add the earlier estimates of residential construction expenditures, business fixed investment, inventory investment, and net exports. Finally, we add projections for government expenditures at all levels, based on existing legislation—with the exception of the defense program—and compare the total with the assumed GNP figure.

The result of that calculation I summarized in the table of the prepared statement, which is labeled "table 15." And to get the central figure, the figures that are almost at the bottom under the heading "unallocated resources," what we have done is to make the calculations I have just noted and find that the expenditures which we have taken into account add up to somewhat less than the projected GNP at either 4 or 5 percent unemployment. The amount is $19 billion in the case of the 5-percent target; $43 billion in the case of the 4-percent target. That amount is the amount of additional Federal expenditures for goods and services or transfers of payment, which could be made consistently with meeting that target.

Now, those figures are in the 1980 prices as we estimated them, with an aggregate inflation of about 5 percent over the next 6 years—which I am afraid is a bit optimistic. But if you brought them down to 1973 prices, then you would bring the $19 billion figure down to about $14 billion and the other one down to about $30 billion. Now those seem like rather large amounts, but in fact if you visualize that what that calculation says is that if we are to come out even at the unemployment targets we have suggested, if we are to hold to a 5-percent target, then only about $50 billion of new expenditure initia-

tives is possible in the whole period between now and 1980. If we adopt a 5-percent target—which I am afraid is the more realistic one—and that compared to the scale of most Federal programs is really a very small amount.

Now, the rest of the data fallout, so to speak, from the same calculation. Consistent with the implied Federal expenditure program is actual surpluses of $18 billion in the case of 5-percent unemployment; $13 billion in the case of 4-percent. Full employment surpluses, which would be also $13 billion with the 4-percent target, but $32 billion with the 5-percent target.

That is another way of looking at the degree of fiscal restraint which is required.

And I should emphasize that we have allowed for a very substantial increase in effective tax rates because of the effect of inflation on the average tax rate that is paid.

Now these same calculations indicate the amount of saving by households, by businesses, through attained earnings and depreciation allowances, by retirement funds of State and local governments. And the corresponding investment figures—and, of course, the figures for the Federal Government are calculated in such a way that the Federal Government's surplus would be almost exactly equal to the excess of private investment over private savings, so that if the whole calculation proved to be correct and the fiscal policy which we have indicated were carried out, then we would have a global balance in the capital market.

And I think the central message is that if we are to achieve a reasonable balance in the capital markets, it will be necessary to limit new spending initiatives very severely in the coming years.

Now, let me say then, just a few words about the long-term financial aspects of these calculations.

In making our calculations on private investment we assumed that the real rate of interest would be about 4.5 percent. Now at present the real rate of interest is probably lower than that, but what we have assumed, really, is that if there is some retardation in the rate of inflation, so that we drop down to say a 5 percent rate, we would then have long-term rates perhaps just about at their present level or somewhat below, and public AA utilities are now 10.5 percent or thereabouts. This would allow for getting them down to a 9.5 percent. It would also imply that short rates would be significantly below those long rates. And our whole calculation assumes that the Federal Reserve pursues a monetary policy which supplies the system with enough reserves to put short rates into that position and permit the decline in the long-term rates.

Now, in that event, the thrift institutions should not have great difficulties, but they will still be in a very marginal position if the rate of inflation remains as high as 5 percent throughout this period and the rate structure is one of, say, 9.5 percent for long rates and say 8 percent for short rates on the average, thrift institutions would be just marginally viable, is one way to put it. Their earnings are rising because the mortgages which they have been writing for some years have been relatively high rates and so that their position will improve some, but they would be just barely in an effective, competi-

tive position. If we could get the rate of inflation down to about 3 percent by the end of the period, then you could mark down all those figures by a couple percent, and the position of the thrift institutions would be much stronger.

Now, there may also be some liquidity problems because peculiarly enough if we were to run substantial Federal surpluses, we would then be retiring some Federal debt, and the Federal debt has been a steadily declining proportion of financial assets for many years.

I made a calculation a little while ago which shows that the amount of debt in domestic private hands—not a Federal debt, but in domestic private hands—is just about the same now as it was in 1946. So there is a much smaller percentage of anything than it was. This would cause—you have Federal surpluses; there would be even greater decline and that would create the necessity for additional private liquidity sources and those involve some additional risks.

That is the second problem in the financial sector which might occur even if we succeed in achieving overall balance in our capital markets by an appropriate fiscal policy.

Now unfortunately, I think there is a little gap between our short-run position and our long-run position. I think I agree with almost everything that Professor Tobin said. His remarks were addressed to the immediate future, and I think the one point that I would like to make is that in attempting to get a pickup in the rate of growth of the economy in the near term—and I think that while some slow growth for the next year or so may be appropriate, then I think it is also appropriate to move gradually toward a positive rate of growth and a rate of growth which will allow us to gradually reduce unemployment from the high figures which it is going to reach. Now in doing that I think we have to be very careful that the fiscal programs we adopt are such that to be either consistent with our view of the savings and investment picture of 2 or 3 years ahead or that they are of a temporary or reversible nature rather than to get ourselves into a situation where in the short-term action to stimulate growth we adopt policies which will then give us great difficulty later on by overcommitting our resources.

To summarize, then, in just a couple of words, we do not feel that the capital market Cassandras who have told us that we are faced with a terrible capital shortage are correct. We think they are overdoing it. On the other hand, it is also clear that there is a real problem, and it is simply that the real problem has been simply exaggerated in some of the financial press and that there will be a need for us to conserve our resources and to guide our fiscal programs very seriously in the next few years.

Now my text has a great many caveats in it. After all, these are projections; they are based on the best analogies we can get from past experience, but we know and you know that that kind of projection is subject to very considerable error. So take this only as a rough sketch indicating the dimensions of the problem and recognizing that we have to steer in the short term by responding flexibly to problems of the day, but at the same time trying to recognize that in view of these

projections that we should try to avoid permanent commitments which will string our resources at future times.

And I will stop there.

Senator BENTSEN. Thank you very much, Mr. Duesenberry.

[The prepared statement of Mr. Duesenberry follows:]

PREPARED STATEMENT OF JAMES S. DUESENBERRY

CAPITAL REQUIREMENTS OF 1980

(By James S. Duesenberry and Barry Bosworth)

During the postwar period the American economy has demonstrated an unparalleled capacity to produce goods and services of all kinds. In spite of periods of inflation and occasional recessions, living standards have risen almost continuously. At the same time the volume of saving has provided for a continuous upgrading and renovation of industrial and commercial capital as well as for new facilities for an expanding work force. In the public sector the demands of a vastly expanded educational system have been met with little strain while 40,000 miles of interstate highways were being built. Nonetheless, our capital requirements, far from being satisfied, are greater than ever. The demand for industrial capital is intensified by our new energy requirements, by capacity shortages in many raw materials processing industries, and by the need for pollution abatement facilities. Widely accepted national housing goals require the construction of 26 million new homes in a decade. In the public sector large amounts of capital will be required for pollution abatement and mass transit.

The simple addition of all the capital which will either produce a profitable private return or appear high on someone's social priority list during the next decade or so yields sums which run to over 2 trillion dollars. Such calculations suggest that as one writer put it; "we may not be able to afford the future." The inference drawn by some capital market Cassandras is that we are faced with a capital shortage on a large scale which will require high real rates of interest, sharp increases in tax rates and a scaling down of programs for improvement of social capital in such fields as housing and pollution abatement.

Some of the resulting gloom is readily dispelled when we annualize the capital requirements calculations and taken into account the fact that in a growing economy our capacity to produce and to save will grow by 50 percent in a decade. Moreover, while new capital demands have appeared capital requirements in some areas are declining. The class room shortage of a few years ago is gone. The interstate highway program is nearing completion. Those observations do not prove that there is no problem, but they do suggest that the dimensions of the problem can only be understood by a careful analysis of the balance between the growing demand for capital and the growing resources of our economy.

This paper reports the results of a study, undertaken before the energy crisis, of the probable demand for capital—public and private in the period 1974–1980 and of the potential supply of capital. Can we provide industrial capital for an expanding economy, provide for new sources of energy, meet the national housing goal, and carry out our commitments for public and private expenditures for pollution abatement and transit facilities? Or must we expect higher tax rates, underfunded programs and congested capital markets? Our answer is that we can afford the future, but just barely.

Our estimates indicate that with normal growth our economy will be capable of meeting the capital demands that can be reasonably projected for the remainder of the decade without unusual sacrifices. At the same time, they indicate that very careful fiscal management will be required if we are to avoid a capital markets crunch or a renewal of inflationary demand pressures (on top of the cost push inflation which is likely to persist for the remainder of the decade). A substantial full employment surplus will be required. The size of the required surplus depends partly on future decisions with respect to revenue sharing and in part on the target level of unemployment. A substantial surplus will be required if we choose a 5 percent unemployment target; a much smaller surplus would be consistent with 4 percent unemployment. Because inflation

tends to increase Federal tax revenues faster than costs (due to the "bracket effect"), the Federal budget will automatically tend to show a surplus. That is good news. But it will be necessary to hold at least a part of that surplus. In our view it will be necessary to resist demands for tax reductions and expenditure initiatives, and that will be difficult to do while maintaining a surplus. Moreover, our estimates of expenditures for social capital are realistic projections of what is likely to happen given present legislation. They fall considerably short of the higher estimates of "needs" which some people have generated. In the upshot then we do not foresee any capital markets catastrophe, but we do foresee that very careful resource management will be required for the rest of this decade and beyond. Excessive spending initiatives or tax reductions will lead to renewed inflationary demand pressures or an extremely tight monetary policy with substantial increases in interest rates or both.

Our objective in this paper is not so much to forecast what will actually happen as to provide a basis for judgments of the implications of the fiscal and monetary policy decisions which will have to be made in the next few years. In particular we want to provide a basis for judging whether the extensive investment programs and the existing public expenditure policies have already overcommitted our resources. Our procedure begins with an examination in Chapter II of the sources of potential output to 1980. In subsequent sections, special attention is directed to the basic factors affecting the growth of housing demand, public and private investment in the physical environment, and investment in energy. We also survey the prospective growth of state and local expenditures, the demand for business investment and the implications of existing Federal expenditure commitments. Finally, we estimate private consumption on the assumption of no change in tax rates. These pieces are then drawn together to produce estimates of private savings and investment and of the amount of Federal surplus required to balance the excess of private investment over private savings. That leads finally to estimates of the amount available for Federal tax reduction on new expenditure initiatives.

The problems of financing the projected levels of investment are reviewed in Chapter III. The magnitude of borrowing requirements for residential construction, state and local government capital formation, and business investment are derived from the nonfinancial projections of the previous chapter. These are combined with savings flows of the remaining sections in order to determine the composition of credit market obligations by issuer and holder for a specific set of fiscal and monetary policy assumptions. The chapter concludes with a brief examination of some of the potential implications for U.S. capital markets of the sharp rise in the world price of oil.

Long-term economic forecasting is a notoriously inaccurate undertaking. As the recent unexpected shortages in fuel and some foodstuffs (with commensurate price rises) have demonstrated, long-term projections cannot hope to reflect the sudden surprises which periodically beset the economic system. Yet as often as our economy has suffered from these jolts, it has paid the costs of ignoring the future implications of current policy decisions. The long lead times involved in many of our capital expenditure decisions dictate that we at least attempt to examine some of their consequences.

The projections which follow should not be viewed as a forecast of what will happen, but rather as the future costs of current government program commitments, the continuation of historical trends for private spending plus a set of specific goals in the areas of housing, the environment, and energy. Even within the private sector the projections frequently are based on estimated "needs" rather than on expectations of actual spending trends. For example, the projections of private investment include the estimated costs of meeting public goals in the areas of pollution abatement and energy without maintaining that these goals will be realized.

The estimates of current-dollar costs are particularly uncertain because of the arbitrariness of the assumed price increases. Inflation, however, affects the estimates of both the availability of, and the claims on, resources in a roughly proportionate fashion; while it raises expenditures it also increases income. We have incorporated a specific inflation assumption into the projections because of our interest in examining the nature of the problems that might develop in the financial markets.

Our projections of resource availability are equally hazardous. The estimates of the growth of real full employment GNP are based on widely accepted but, nonetheless, uncertain estimates of labor force participation rates and productivity growth. The current dollar GNP estimates, of course, reflect our inflation assumptions.

The resources available for public and private capital formation depend very largely on the revenues withheld from private consumption by the tax system and on gross corporate profits. For our baseline projections we have arbitrarily assumed no changes in tax legislation. The corporate share is estimated by econometric relationships based on past experience. The estimates of tax revenues are significantly influenced by the assumed inflation rates because Federal revenues increase more than proportionately to current dollars GNP. State and local revenues increase somewhat less than proportionately mainly because Federal Grants in Aid are projected to rise relatively slowly.

Our estimates of resource availability are also significantly affected by the unemployment target. Most of our estimates have been based on a 4 percent target because many estimates of Full Employment revenues (including the Brookings "Setting National Priorities" estimates to which our own are linked) are based on this assumed rate of resource utilization. But it is doubtful whether the inflation rate can be pushed down to 3 percent, as we have assumed, with an unemployment rate as low as 4 percent. Accordingly after developing the baseline projections on a 4 percent basis we show adjustments to a 5 percent unemployment rate basis. The change makes a good deal of difference. A one percentage point difference in the unemployment rate will reduce real GNP by around 2 percent or by about $50 billion in 1980 prices.

The results of this exercise suggests that the U.S. will need to devote a significantly greater amount of resources to capital formation in future years. Many areas of primary public concern such as housing, pollution abatement, and increased energy reserves are highly capital-intensive. In addition, some sectors of the private economy such as raw materials processing which have suffered from excess capacity in the past are now fully utilizing the available capital stock and higher levels of investment will be required in the future. However, after adjusting for increased resource availability the magnitude of the investment needs is not overwhelming. As a share of total GNP private and public investment would average about 18 percent over the 1974–80 period compared with 17.5 percent in the first three years of the decade. The expansion of business investment is partially offset by a lower share of GNP going to residential construction and state and local governments' capital formation.

The goal of 25 million housing units over a 10-year period as set forth in the 1968 Housing Act appears to be within reach and consistent with needs. Because of increased estimates of household formation, the goal does not seem to be as far above normal demand as some studies initially implied. The costs of the program have been reduced by a shift in home buying patterns towards less costly mobile homes and apartments.

State and local government capital formation will need to rise sharply for the remainder of the decade after several years of declines in real terms, if legislated standards for water pollution are to be met. But some of the pressure on their capital financing has eased because of a sharp slowing of demand for educational services. Private spending for pollution abatement will also be substantial, but the required increase above present spending levels appears to be moderate.

Recently, forecasts of very large amounts of capital investment have been put forth for the U.S. effort toward greater self-sufficiency in energy. When expressed as 15-year cumulative totals, these numbers do appear to be overwhelming, but when they are reduced to annual rates and compared to an evergrowing aggregate GNP they are far less awesome. The growth of public utility investment is projected at a rate only slightly above that of the 1960s. The major increases are in the domestic production of fuels, but the industry is not large enough relative to the rest of the economy to cause significant aggregate problems. There may be problems for the individual industry associated with such a rapid growth, but the concern is not a shortage of resources. Some offset to the growth of investment in energy and raw materials can be anticipated from reduced capital requirements in the consumer finished goods industries.

Some moderation of the growth of state and local government spending outside of pollution abatement can be anticipated. The impact on education of the post-war baby boom has largely passed. In addition, the growth of welfare program costs has begun to slow and the federal government is assuming a larger proportion of the financial burden. By shifting a larger share of their revenue to the personal income tax, these governments are also in a better position to keep up with cost increases without resorting to tax rate increases. Nonetheless, state and local governments are likely to have difficulty in making ends meet. They must either obtain additional grants in aid (or general revenue sharing), raise tax rates or severely limit improvements in service levels.

We have projected Federal expenditures and transfer payments on the basis of existing legislative commitments (except that in the case of defense we have assumed the adoption of the administration's defense posture as outlined in the 1973 budget.)

At this point we can cast a trial balance to determine the fiscal policy implications of the commitments just made. For each year we begin by assuming that the GNP is the one required for the target unemployment 5 per rate (as noted above, alternate projections are made for 4 percent and 5 percent unemployment rates). We then allocate the income side of the GNP accounts to households, corporations, state and local and Federal revenues. To do that we have used existing tax rates and transfer payment legislation and have used historic relationships for the patterns of capital consumption allowance, corporate profits, dividends and retained earnings. We then apply a simple consumption function to obtain an estimate of consumer expenditures. To these we add the earlier estimates of residential construction expenditures, business fixed investment, inventory investment, and net exports. Finally, we add projections for government expenditures at all levels and compare the total with the assumed GNP figure.

Our estimates indicate that with present tax rates and expenditure commitments the Federal budget will tend to show an increasing surplus at high levels of employment. The tendency for Federal revenues to outrun expenditures results from the high elasticity of Federal revenues to price and wage increases due to the "bracket effect." A part of this potential surplus may have to be transferred to state and local governments, but even if we take all governments together it appears that they would tend to show a surplus at high levels of employment if present tax rates and expenditure commitments were to remain unchanged. Another part of the potential surplus must be retained to offset the deficit (excess of investment over saving) of the private sector. The remainder constitutes unallocated resources which may be used for tax reduction or expenditure increases beyond those included in our projections:

Present commitments for public expenditures and the requirements for private investment will absorb almost all the savings, public and private, generated by a GNP corresponding to a 5 percent unemployment target with the present tax system. Only about $30 billion—less than 1 percent—of GNP would be available for new spending initiatives or tax reduction.

Moreover, the Federal budget will have to be managed so as to produce a surplus on the order of $19 billion at a GNP corresponding to 5 percent unemployment (measured against the 4 percent this would be recorded as a full employment surplus of $35 billion).

This surplus will have to be retained in the face of the fact that: the "bracket effect" of inflation will have raised effective federal personal income tax rates by 34 percent, there will be strong demands for additional expenditures in a number of areas, and 5 percent unemployment will be unacceptable to many people.

With a 4 percent target there will be considerably more leeway:

The resources available for tax reduction or new spending initiatives will be twice as large—around $43 billion, and

The required full employment surplus would be much smaller—$13 billion against $35 billion in the 5 percent case—(at 4 percent the actual surplus would be the same as the full employment surplus).

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TABLE 15.—SAVING AND INVESTMENT BY MAJOR SECTOR 1660, 1973, 1980 (PROJECTED)

	Actual		Projected—1890, unemployment rate of—	
	1960	1973	4 Percent	5 Percent
Households (+)	4.8	33.5	60.4	58.9
Personal saving	17.0	54.8	88.0	86.5
Retirement credits from savings and loans, Governments [1]	2.2	8.4	15.0	15.0
Capital consumption allowances [2]	5.3	10.4	13.4	13.4
Residential home purchase [2]	19.7	40.1	56.0	56.0
Business (+)	−3.6	−37.4	−71.3	−70.3
Retained earnings	13.2	42.7	70.9	68.2
Inventory valuation adjustment	.2	−17.3	−4.5	−4.5
Capital consumption allowances [2]	38.1	99.2	176.3	175.0
Gross domestic investment [2]	55.1	162.0	315.0	309.0
Governments (+) [3]	1.6	3.3	5.2	10.7
Federal surplus	3.5	1.2	13.2	18.7
State and local government general fund [1]	−1.9	2.1	−8.0	−8.0
Net foreign investment (−)	1.7	2.2	−3.1	1.9
Statistical discrepancy (+)	−1.0	2.9	2.5	2.5
Addenda:				
Unallocated resource [3]	0	0	43.5	19.0
Full employment Federal surplus [4]			13.2	31.7

[1] NIA surplus of State and local governments is adjusted to exclude retirement funds which are shifted to the household sector.
[2] Residential home purchase and capital consumption on homes have been shifted from the business to the household sector.
[3] Federal surplus in 1980 is adjusted to include unallocated resources and the financing gap of State and local governments from table 15 as expenditures.
[4] The full employment surplus in 1980 differs from the actual surplus of the 5 percent unemployment case because it is calculated on the traditional basis of revenues associated with a 4 percent unemployment rate.

Sources: U.S. Department of Commerce, "Survey of Current Business," February 1974; Board of Governors of the Federal Reserve System, "Flow of Funds Accounts;" and authors' estimates.

Senator BENTSEN. I will not take too long so Senator Proxmire can get his questions in.

Mr. Fowler, I was interested in your proposals. I think they are constructive. I noticed in your prepared statement you talk about the international role that we have as a major producer as well as consumer of raw materials and food stuffs, that that gives our country bargaining leverage with the OPEC nations.

But is it really effective? How can we bargain with them over oil in relationship to two prices when we have so many competitors around the world who can move in and supply the needs of the OPEC countries?

Is there any real muscle in this?

Mr. FOWLER. Well, my reference there to bargaining power really has its antecedent in our leading industrial power position, our technology, our engineering capacity, if you will, to plan and execute major projects in many fields that are relevant to their long-term needs. It seems to me that the trading possibilities on a cooperative basis, you might say, would be for not only the United States, but the United States in particular to try to lend itself to helping them—through its technology and its engineering capability, and its skills in that area—to achieve some of their long-term goals. One of their long-term concerns is where they will be when the oil runs out if they have not built up viable economic systems when that happens 10, 20, 30 years from now. They will just go back, as it were, to the desert again. I think the

leaders in those countries do have a concept now of trying to use this wasting resource, you might say, or this resource in their oil over a timespan and use the fruits of that in such a way that they can translate it into a part of prosperous world economy. That is very clearly the goal of Iran and I think it becomes clear, the more we hear about it, as being the goal of Saudi Arabia.

Kuwait's future seems to be that of largely becoming a major world investment bank because of the limited amounts of other alternative development in petroleum and also in amounts of population.

Senator BENTSEN. You make another point about the oil-producing countries working through the IMF special facility for loaning money to some of these countries, and that the producing nations take the risk on the loan.

Now, we have been doing that for a long time in this country with some of our soft-credit lending which many of us felt, from time to time, were actually grants.

Do you think that is feasible with these OPEC countries? Some of them do not belong to GATT, they do not belong to the OECD, or other international organizations. Are they prepared to make this sort of commitment?

You talked about the Marshall plan and the great maldistribution of capital at the end of World War II, and we are approaching something along those lines today where these massive flows of currency, of petrodollars, do you think we can get OPEC to do something like we did almost 30 years ago?

Mr. FOWLER. I do not see any current evidence that they are—that these countries are stepping up to the challenge of concessional lending to the less-developed countries who are nonoil producing and who are bearing, I would say, the most serious brunt of this oil-price explosion. Certainly they are not stepping up to their responsibilities in anything like the order of magnitude that will be required.

However, there are some currents of movement. In Kuwait, for example, there has been established a development fund which is in the order of magnitude now of around $3 billion, earmarked to assist development in other countries outside Kuwait, for which they have political or ethnic or religious affinities.

Mr. Witteveen has been able to prevail on those countries to provide, I think, around $3 billion, but that is not concessional aid. Those are funds provided, as I understand it, at around 8 percent, to be re-lent to the less-advantaged non-oil-producing, less-developed countries at an equivalent, or a rate at perhaps a slight additional margin.

What those countries need to replace, to compensate for the impact of the increase in oil price is not commercial lending. They need concessional lending, and the most serious problem in this whole picture is, I think, if you heard President McNamara yesterday at the meeting, to develop the same sense, you might say, of participatory responsibility in a viable system that marked, I think, our own conduct at the time of the Marshall plan.

Now, whether that is at all feasible, given the state of development in those countries, one can only conjecture. I think it would be useful to try to induce it.

Senator BENTSEN. I will agree with that.

Mr. FOWLER. They have something of a benefit to be achieved by participating in an overall pattern of cooperation.

Senator BENTSEN. If there is a self-interest involved.

Mr. FOWLER. Precisely as it was with us because at the time of the Marshall plan this was not just beneficient charity on the part of the United States out of the goodness of our hearts. We felt at that time, rightly I think, that the future of security and of prosperity in the world as we saw it and as we saw ourselves a part of it, would be served by the revival of the industrial economies of western Europe and Japan, and that that would serve our self-interest. I think there may be also elements of self-interest that can be touched in this present situation which would induce them or might induce them to participate more responsibly.

Senator BENTSEN. Is this government fund of Kuwait's, is it a significant amount?

Mr. FOWLER. A little over $3 billion I think as of now, and there are other bilateral arrangements being made; so the situation is not without some encouraging signs—one has to approach it country by country and leader by leader.

Senator BENTSEN. Mr. Duesenberry, your comments are encouraging to me. I am not sure I have quite as much optimism as you do in regard to adequate capital. You talk about the liability of the savings institutions. It seems to me that liability only continues if you have some reduction in interest rates and certainly some curbing in inflation. I look at savings and loans with their long-term investments and their short-term savings and the increasing sophistication of the saver of disintermediation funds, and you talk about the turnover in mortgage, and increased yield in mortgages. On 25-year mortgages, it takes you about an average of a 12-year turnover before you have that money to reinvest.

Mr. DUESENBERRY. Well, Senator, the turnover in practice is a facet in there. I think the average life of a mortgage is about 8 years, since houses are frequently resold.

Senator BENTSEN. I was in the business about 4 years, and believe me, they are faster than they used to be.

Mr. DUESENBERRY. But I think the central point is that unless we can get both the rate of inflation and the structure of interest rates down, they are in trouble, and the most optimistic I can get is to say that they are marginally viable on a 5-percent inflation rate. They would be home free with a 3-percent inflation rate, but I think it is a little optimistic to assume that we will actually achieve that, certainly in the near future. We might conceivably reach it by 1980.

Senator BENTSEN. I must say that I agree. When you look at the demands for capital in total they look a little staggering. If you spread them out year by year and relate them also to what has been true in the past, they are a little more digestible.

Again I look at the amount of capital that should be available out of cash flow to corporations and out of their profits, and then I look at the inflation factor that one of you was bringing up, showing on FIFO with the accounting practice that is utilized how much of that cash flow is actually going to be needed just for replacement. It is at substantially higher cost, and I wonder how much net increase of capital is really left.

Mr. DUESENBERRY. Well, of course, we have the present rate of inflation. If they were to continue for any time, this whole calculation goes out the window.

Senator BENTSEN. I see. So it is predicated, obviously, on curbing inflation.

Mr. FOWLER. I would just like to say, Senator Bentsen, as an observer from the capital market area, I think that the most exciting thing in Professor Duesenberry's presentations are these two assumptions: One, that our fiscal policy is going to provide a surplus to plough back into in a sense debt repayment and provide that source of funds to the capital market; and second, that the rate of inflation he assumes is one that could or would permit a more normal deployment of savings into medium- and long-term investments, whereas today under present rates with the abnormal yield curves, most of the savings are obviously going into the very short-term investments, and it is those two assumptions which would excite, I think, and delight anybody in the business of trying to bring back and revive an equity market or to bring back a more normal pattern of utilization of medium- and long-term funds.

Senator BENTSEN. Let me say, Mr. Tobin, since you have to get away, Mr. Burns has said that he is not going to allow a credit crunch, and he says this from time to time. I obviously am having a little difficulty in defining what a credit crunch is because when I talk to people in the housing industry, certainly you have a depression going there, and I see public utilities having a very difficult time getting financing now. We have had a substantial amount of disintermediation of funds. We have seen savings institutions with an outflow of funds as savers try to find higher rates of return elsewhere.

Do you think we have a credit crunch?

Mr. TOBIN. Yes; I would call it a credit crunch. The symptoms of credit crunch in the past have been the creation of depression in the housing industry. That is the main economic impact of the crunch, and it seems that we have that now.

We have also an unparalleled depression of the stock market, brought about I think by monetary policy, by high interest rates.

Senator BENTSEN. Well, I would agree, Mr. Tobin, and the other thing you talk about, a company buying their own stock when it is selling at three or four times earnings, you are not going to find investments that would yield that much, and I understand that and the reasons for doing it, to increase the actual earnings per share. But at the same time, they face the problems of contracting their capital when they do that, with capital awfully hard to raise.

Mr. TOBIN. Well, that was just a dramatic form of expression to bring home the point that the position of the stock market is a real deterrent to capital investment right now. It is not that I am recommending that firms repurchase their shares. I am just pointing out that with present equity prices, real investment is just not an attractive proposition. If you are going to meet Professor Duesenberry's targets by the end of the decade, we have to get the stock market out of its present shortrun situation.

Senator Proxmire.

Senator PROXMIRE. Mr. Fowler, I understand that Secretary Simon has just given a speech, just released a few minutes ago, in which he said the following, and I would like to ask whether or not you agree

with him. It was an address to the IMF World Bank. He said, "I do not believe the international financial market is about to collapse. I do believe the situation can arise in which individual countries may face serious problems in borrowing to cover oil and other needs. For that reason we must all stand prepared to take cooperative action if the need should arise."

Do you agree with the statement, the international financial market is not about to collapse?

Mr. FOWLER. Yes. I do not consider the present situation as being one of collapse. As I have said in my prepared statement, I characterize the present condition of financial markets as being quite depressed, quite inadequate to deal with the financial problems of both markets that Mr. Duesenberry has been referring to and also business, certain types of businesses, and also certain countries are sadly deficient in their ability to draw on the capital markets. But I would not want to characterize the present outlook as one of collapse.

Senator PROXMIRE. I want to make sure that you feel firmly that the international market will not collapse.

Mr. FOWLER. No, no, no one is going to go that far, Senator Proxmire, and peer into the future. I'm just trying to say——

Senator PROXMIRE. Well, the present Secretary, the Secretary did say, "I do not believe the international financial market is about to collapse." Now, he did not further qualify it, but he made that clear, unqualified statement.

Well, let me follow up by asking you this. What steps do you think we can take to protect other countries that are affected by this situation, other countries, not talking about this country?

Mr. FOWLER. Well, one is always tempted, as I was on the occasion of this hearing, to come in with one's own prescribed plan, and I think there are many variants of various plans for the relief of the present situation floating around the Sheraton-Park Hotel. You can almost throw a pebble, and anybody that you would hit would have his own plan.

I wanted to put my emphasis in coming here today not on any particular prescription but on the responsibility I feel that the Congress and the administration, acting together, have to put forward a credible position indicating that the United States is ready and willing not only uptown but downtown, not only the executive branch but at the congressional level, to authorize our negotiators to proceed with the negotiation from all the variety of alternatives that might be available.

Now, I would think that to get any kind of advice on the specific type of program that should be authorized or should be contemplated maybe by a joint resolution such as I think characterized the action in 1948 which preceded the Marshall plan legislation, would be to call Secretary Simon to come down and to explore the various options that have perhaps arisen in the various private discussions. Rather than come in with some pat prescription of my own which would be without reference to these discussions, I prefer to put my emphasis where it is.

Senator PROXMIRE. All right.

Now, Mr. Tobin, I, of course, have not followed everything that has been said by everybody in recent days, there have been so many things said by so many economists with respect to the inflation situation, with

respect to monetary policy, but you may be one of the first, and you are certainly an eminent expert in this area, to indicate that you think that present monetary policy, restraining policies may actually be driving prices up. This is a position, as you know, that has been taken for many, many years with great consistency, perhaps with too much consistency, and under all circumstances, by the chairman of this committee, Congressman Patman. It is a position that has been taken with great emphasis and vivid rhetoric by former Vice President and present Senator Hubert Humphrey.

A great number of people in the Congress feel this way, and I think perhaps the majority of the people in the country feel this way. But economists by and large have not felt that restraining monetary policy, whatever the effect may be on mortgage rates and whatever the effect may be on the cost of capital borrowing by corporations which in turn is passed on in higher prices, that overall because of the demand impact the effect must be, in the views that I have heard by economists, to restrain demand sufficiently to overcome the other elements and result in a net anti-inflationary effect.

Did I understand you correctly to say you think under present circumstances it has been pushed so far that the net total consequence is that prices are going up because of tight money?

Is that right?

Mr. TOBIN. No, no.

Senator PROXMIRE. I am glad to be corrected then.

Mr. TOBIN. No; I did not mean to say that.

At the most what would happen if prices were marked up to get a higher rate of return as a result of higher interest rates, there would be a one shot markup. However, the demand-restricting effect of the interest rate restraint would be a continuing damper on inflation.

What I did point out is that the demand restraint works quite slowly. But it is a continuing thing, whereas the markup effect, to the extent it occurs, would be a one-shot effect for any particular rise in interest rates.

What I did want to emphasize more than that is the following: I have the impression that pricing in a good part of the American economy is going on more and more independently of the demand situation, independently of the market situation in large sectors of the economy. Prices are being set at what the firms or industries making the decisions regard as the prices that will cover their normal costs, both materials and labor, and get them the rate of return that they think is appropriate given monetary conditions and interest rates. Once prices are set in this way, the effect of demand, either up or down, in causing firms to deviate would act very slowly.

Senator PROXMIRE. That is very helpful.

I think that that may be the case. It may be, however, it is conceivable—maybe it is not and I would like to ask you, as a distinguished monetary economist, to tell me—it seems to me it is perfectly conceivable that you could arrive at a situation where—you would prefer to feel that we have not arrived at it yet—the effect of monetary policy might be to exacerbate rather than ease inflation.

Let me give you this scenario. We seem to have a situation where demand has been easing for a long, long time, production in the economy has gone down, retail sales in real terms are down, hours of

work are the lowest that they have even been in this history of the country—they have never been below 37 hours a week and they have been below that consistently all year— indicating that we are not using our work force fully. We are working at less than capacity operation in industry after industry. Unemployment is increasing, although much more slowly than anticipated, but all these things together indicates that this enormous increase in prices is the biggest increase we have ever had in peacetime, and perhaps the biggest ever.

It is all occurring at a time when we have a soft economy and where we have tight money and where we have extremely high interest rates.

Is it conceivable to you that we may be moving into a time when interest rates and tight monetary policy may be counterproductive or not?

Mr. TOBIN. Well, I think they are counterproductive now, but not because——

Senator PROXMIRE. They are counterproductive in terms of the ultimate effect on prices.

Mr. TOBIN. I would not say they are counterproductive in terms of the ultimate effect on prices. I think that if it were politically possible and socially possible for the Federal Reserve to stick with its tight money policy for a very long, long time, for several years, they would in fact eventually bring down the rate of inflation of both prices and wages. They would provoke enough stagflation, enough unemployment, enough slack in the economy so that the inflation rates of prices and wages would gradually fall. It would be very slow, very slow, and it would be very damaging and very costly. I do not think the main point is to argue about how much of actual increases in prices are the direct result of raising interest rates. The big question is whether the costs of that policy of long attrition, that seige of the economy, is worth the benefit in terms of reduced inflation, or whether some other course should be taken.

Senator PROXMIRE. Now, Mr. Tobin, in your statement, you say, "Rosy reports of gains in corporate profits give an exaggerated impression of the ability of American business to finance new investment with internal funds."

I am sure that the business people are very sincere when they come in and say that these profits are exaggerated, and when you take out the inventory and profits, as you indicate, with the FIFO inventory analysis that you have here, that you may not have such an immense increase.

Now, this is a place where it seems to me we have got to be specific and name a particular industry. Certainly when an industry increases its prices, as steel has, by 40 percent, or as oil has, by 80 percent, or as industrial chemicals have by 60 percent, it is hard to argue that that colossal increase in prices for that industry is not likely to exceed any conceivable cost increase that that industry is suffering.

I mean, you take steel. Their labor costs are stable, and they say so, they admit it. They are so integrated that the labor cost is a big element in their overall costs. They have to buy some scrap, but they own their mines, they own their transportation system, they have control over a great deal of their operations, and they are producing steel now at 30 percent less than they were in 1970 in terms of man-hours, 30 percent less man-hours, so that when you take these industries, that

industry and some others, is it not true that there are likely to be some industries where profits are sufficient to more than take care of any future costs which they have to anticipate, either in equipment or in inventory?

Mr. TOBIN. I am sure that is true, Senator, but if you look overall at what has happened to the profitability of capital stock of American corporations, and calculate it free of the distortions because of the depreciation accounting, and free of the fictitious inventory gains and so on, you do find that there has been a decline in the real after-tax return on capital investment.

Senator PROXMIRE. Are you not making a big assumption. Is not the assumption that you are making that the price increase is a one-time increase? If they have that price increase next year and another similar proportionate price increase the following year——

Mr. TOBIN. I am not making a projection. I am just saying that between 1966 and 1973, it appears that the after-tax rate of return, real rate of return on investment capital declined from about 10 percent to about 6 percent.

Senator PROXMIRE. We are just looking at different periods, then. I am looking at a much shorter period.

Mr. TOBIN. I do not doubt that a number of industries are, now that they are free of price controls, seeking target pricing which will restore rates of return that were damaged——

Senator PROXMIRE. And they are succeeding in doing so.

Mr. TOBIN [continuing]. In the period that I was talking about. Some of them are in a position to raise markups because they are well situated with respect to the current demand situation.

Senator PROXMIRE. My time is up. Thank you.

Senator BENTSEN. I do want to question you on one point that you made where you cited some figures showing the amount of inflation attributable to the cost of agricultural commodities. I, for one, am not at all sure that is going to recur for a while. A good part of that came from some bad crop harvests and bad weather, but I am also convinced that these high prices for commodities are going to bring on a great deal more production and the world is capable of a great deal more production in agricultural products.

I met with the trading minister from Australia and some of these other countries, talking about what they are doing in the way of increased investment in agricultural products, and I also read last year that the Agriculture Department told us, because of an increased standard of living, people around the world, and a greater desire for protein, how much the consumption was up for beef, and how the price of beef was going to continue to stay up, and yet I know today the price of beef has taken a very substantial drop around the world, and that you are seeing Australia and you are seeing the European Common Market, people like that, with a great surplus of beef. We are seeing it in this country even though it is still not reflected in the supermarket. But to the producer itself it has.

I think the same thing can and probably will happen to grain, and there you have a situation where competition actually does set the price, and I feel that that is one factor that is not going to continue to increase inflation without some curtailment of prices.

Mr. FOWLER. I think I would agree with that. I think the problem in the field of food is that you escape not only from the occasional

cycle of shortage, but quite often escape from the cycle of surplus, of excessive surpluses, and therefore a great deal of, in a sense, indicative planning, which I would hope would be somewhat contemplated at the World Food Conference that is coming up in November, would be involved because the problem with food is not one always of shortage. You can have, as we have seen in our own national experience at various times, the problem of excessive surpluses, and I again in this field cannot escape from the feeling that a good deal of international cooperation between governments in terms of their food and food pricing policies, is going to be in the best interests of the producer and the consumer alike.

Senator BENTSEN. No question, Mr. Fowler. We have done great things with R. & D. in the past in food production. We doubled production of corn, you know, in 10 years, per acre, and all that, and so if we support the technology of food production and we convince some of these developing nations it is important that they feed their people as much as having steelplants, I think we could do some good in that regard.

You were talking, Mr. Tobin, about the shortage of money being man-made, and I agree with that, but how do we relieve that shortage without fueling inflation? How do we take care of the disparities or the disproportionate effect on our economy in housing and that type of thing, and still not fuel inflation?

Mr. TOBIN. Well, if the Federal Reserve engaged in a massive injection of reserves and expansion of credit and money supply, which would take the economy into another boom, and reduce unemployment well below 5 percent, down to our previous targets of 4 percent or something like that, then I agree that there would be a significant danger of sustaining the inflation, of strengthening the internal sources of inflation, the wage-price-wage spiral. I think we have to distinguish between two components of inflation. One, the wage-price-wage spiral is endemic to the nonagricultural, industrial, and services sector of the American economy, the sector where there is wage bargaining and administered price setting. The other component of the inflation that we now have is external in origin. It is due to the extraordinary series of events in oil and food throughout the world. It is also due to the devaluation of the dollar, whose effects we are still seeing in import prices and export prices.

Now, what we do with domestic monetary policy does not have an awful lot to do with the second source of inflation, the commodity inflation. It does have to do with the strength of the underlying endemic American wage-price-wage spiral, and if we accelerate too fast in our demand policy, our monetary policy, we can make that underlying inflation worse than it is now. But if we must move to 5-percent unemployment and if we just restore normal growth to the economy—in real terms, 4 percent a year—I do not think we will change very much the strength of the underlying endemic inflation, the wage-price-wage spiral in the United States.

Now, it has seemed to me all year that the biggest problem of the anti-inflation policy in the United States was to try to prevent the commodity inflation from being built into the more permanent, underlying wage-price-wage spiral. The spiral is very resistant to any kind of remedy once it gets built in. But it does not seem to me that our

present policies are going to prevent it. It may not happen to any large degree anyway, because our wage earners and their unions are not bargaining with Faisal and with farmers whose prices are the ones that they are worried about. The employers with whom they are bargaining do not have the ability to give them wage increases to compensate for recent increases in oil and food prices. But, nevertheless, there is a danger here, and it is one that the Government ought to be seeking to prevent.

But the way to prevent it is not a tight monetary policy, but some kind of incomes policy. We should attempt to give to workers some increases in take-home pay, and to employers some moderation of labor costs, through tax reductions. I particularly have in mind payroll tax reductions. The President should try to get a general understanding of the need for wage restraint with the major segments of the economy.

For that reason, I welcome the establishment of the Wage and Price Stability Board, and I have some hopes for the Labor-Management Committee that the President has just set up.

Senator BENTSEN. Well, Mr. Tobin, we are in concurrence with that.

Do you think we can further implement it by some selective credit restraints? I see that the Fed—I had made a recommendation earlier in that regard, and the Fed is trying to do that with some guidelines, and that is not really a new idea. We had it in the Korean war, and to some extent in 1966.

Do you think we can get some help in trying to channel funds into particular industries that are in serious trouble now?

Mr. TOBIN. I think that I would have more enthusiasm for selective credit constraints if we were really operating a tight economy such as we were in the Korean war, where there was a genuine shortage of savings and a genuine need to allocate it to priority uses.

Here I think that many of the problems which are giving rise to the call for selective credit restraints, selective credit controls, would be relieved by a general expansion in credit within prudent limits, within the prudent limits for the economy that I sketched a minute ago.

Now, there is a particular problem for the housing sector, which is a chronic one. It is one we have every time tight money recurs, and it requires some structural reforms in the thrift institutions. I think that there are some reforms that could make the housing sector less vulnerable than it is now to periods of extreme tightness of credit. I think right now, I was just speaking to Professor Duesenberry while you gentlemen were voting, and that even right now it would be possible to relieve some of the stringency in the thrift institutions by a rise in ceiling rates.

Eventually I think we ought to move to a situation where we do not have to have those ceiling rates at all.

Senator BENTSEN. I think that is probably right; where you get flexible rates on mortgages by the extension of the maturity problem, perhaps more than the payment. Some of the savings and loan people have resisted that very much. They thought if you took rates completely off savings, that the more irresponsible institutions would get all the savings was their argument. But I think if they are going to be a viable institution they are going to have to work toward that end.

Let me ask you, Mr. Duesenberry, for the last decade it seems from the figures I have seen this Nation of ours has been one that has put practically the smallest percentage of its GNP back into fixed capital investment in trying to build up the productive capacity of manufacturing. I understand that we are becoming more and more a service-oriented society. But obviously if we are going to keep up the balance of payments, be able to keep up the defense effort, we cannot do that just by taking in other people's washing.

Now, I looked at the numbers, and I think it runs 1968 to 1973, we were putting about 14 percent of our GNP, next to us, in low amounts, the English, and then we look at others like the Japanese whose investment rate is substantially higher. Senator Proxmire referred to the production percentages, the capacity utilization of some of our industries, and he mentioned a figure of something, I think around 80 percent.

But we have a number of our basic industries that are running at about 90 percent of capacity, as I understand, like paper and fertilizers and steel.

Is there anything that the Government can do in that regard to try to take care of or anticipate those kinds of disparities and be of help?

Mr. DUESENBERRY. Let me go back to your original point. I think we have to take great care in these international comparisons of percentages of GNP going into capital formation. After all, we are a very high technology economy, with a very large amount of capital per worker, the highest amount of capital per worker already; and since our GNP is relatively high, any given percentage means actually more dollars worth of additional capital. So what we really have to ask ourselves is, are there investments which would yield a worthwhile rate of return, which industry is not able to make? And I think that looking at it as a long-term problem, it has not been the case that there has been a great surplus of worthwhile investment opportunities which have not been met. However, it is true that in a number of industries, mostly at the raw material processing end of things which you mentioned, there have been some cycle in both the prices and the building of capacity. But a number of those industries had overcapacity for some time. They built up capacity during the 1950's, and the 1960's suffered from overcapacity, and then relatively low returns for a while. Eventually the demand caught up with their capacity, and they swung over to the other side. But that takes a long time to build those plants.

Now, in addition, in some cases, as in steel, there have been some very substantial changes in the import-export balance, owing partly to the devaluation and partly to the relative rates of growth of other countries, so that we have had suddenly—and I do not know whether there is anything more than coincidence to it—a number of industries which ran into capacity bottlenecks more or less at the same time. Of those who say, if you take the whole of the average for the whole economy, in spite of those few industries that are bottlenecked, the capacity generally is not especially high. That seems to me to be a temporary situation, which we will have to work out of, and indeed I think we will work out of, just because of the slow growth that we have. So that I do not see that there is a basic role for Government here.

It is conceivable that we should do better on anticipating the capital needs of a particular industry, but the people in those industries spend a great deal of effort on trying to do it, so that I do not have an obvious contribution there. And I think I do want to emphasize what Professor Tobin said about the investment incentives picture; that it seems to me to be very odd to be simultaneously having recommendations for further incentives for investment, while at the same time we are operating a monetary policy with very high interest rates. The best incentive that you could give for investment right now would be to get those interest rates down, and since that, particularly when we talk about long-term rates, takes a long time, we ought to be starting as soon as possible. Because we want to reap the reward from the short rates in terms of long rates for probably an extra year after that movement has taken place.

Senator BENTSEN. I have a question about an hour long that I would like to ask, concerning some of these things. But I am going to let Senator Proxmire ask the concluding questions.

Mr. FOWLER. I would just like to make a comment on what Professor Duesenberry said. I do not think I would agree with him. If the comment had to do, let us say, with the new sources of energy that we need, in terms of gasification of coal and that sort of thing, I think there you have got an entirely different problem, in which you do have to fix some expansion goals. You do have to provide some kind of take-or-pay contracts, and you have to provide some kind of incentives, or I do not believe you are going to get out of a general recovery in the economy.

The application of longer term investment in that particular sector, which is a very acute sector—I do not known whether there are others—it would take a good deal of study, which I do not have the benefit of. But I do have a conviction that we are not going to come out of this energy problem with the additional sources of supply and energy in this country on the traditional financing patterns. I do think something comparable to what we did in the Korean war will be necessary.

Senator BENTSEN. Senator Proxmire.

Senator PROXMIRE. Now, Mr. Duesenberry, your message is, as I understand, while we cannot relax on capital needs, you foresee no serious shortage overall. I think you have a very useful analysis, in which you point out the fact that we probably do not need or should not put as much resources into highway building, for example. Our classrooms are probably adequate for the time being. At the same time, you indicate that we may have problems, and we have to be careful about husbanding our resources. We cannot commit ourselves to any new, big programs.

Well, you have observed the Congress, and so have I, over a time. While we have a new Budget Act that may be helpful, nevertheless there is a tendency to move ahead ambitiously, and there are some good, strong, social programs that command our resources. Health, certainly, is going to command a great deal of resources, and I think we probably are continuing to move toward even higher transfer payments. I do not know how it will affect investment capital. A guaranteed income of one kind or another seems on the horizon, housing allowances, all of these areas are tempting. And then we have projected by industry;

Business Week reported that their survey indicated that industry would need something like $800 billion investment over the next few years.

Now, what concerns me about this whole situation is, if we simply relax and let nature take its course, what we are likely to have is not only inflation, but continued exacerbation of the housing situation, because the method of channeling resources there is so weak. Under these circumstances, what would you think of providing for—not allocation of credit, because that has a bad ring—but doing the same thing to other financial institutions that we do with savings and loans; in other words, require that a certain proportion—in some cases, it can be rather small, but your total results would be big—a certain proportion of the resources of financial institutions would be required to be invested in housing. As I say, we do this with savings and loans. We could extend this to commercial banks. We could extend this to insurance companies, even pension funds, perhaps, because the Federal Government does provide services, protections in those areas, and that would be quid pro quo.

Mr. DUESENBERRY. Well, I think we have great difficulties with doing that on any substantial scale. I think our experience with attempting to manage from outside the portfolios of financial institutions—we did have some experience in the episodes of the ceilings on the negotiable CD's, when we attempted to force banks to limit banks' resources—we found that there was some tendency for financing to escape from the channels which have been built up, and really to drive business out of the regular commercial bank into the holding company subsidiary.

I think that while—you know, if it is done in very small amounts—perhaps it can be kept at the level where it does not produce a big reaction, if you tried to allocate financial resources, you find they are very, very fluid, and there would be a strong incentive for people to move some of their business out of the kind of business you regulate, then you have to go reguluate that, and keep pursuing them from one place to another. Now, I think there are two kinds of suggestions. There are a number of improvements in the mortgage markets and thrift institutions which could be made.

I believe I mentioned some of them when I testified here in August; namely, the direction of getting more direct channels for the mortgage market into the bond market by further development of Jennie Mae bonds, by linking the liabilities of the thrift institutions. But in addition, I think that we are bound to have a certain amount of subsidized housing programs. Aside from housing allowances, we will have subsidies tied to particular buildings, and I think it would not be inappropriate to have direct budget financing of those items, even those on a loan basis, and make use of the Federal Government's channel, rather than to try to chase the private investors.

Senator PROXMIRE. I just wanted to have as light a hand by Government as possible on it. As I say, we do, in effect, mandate a certain proportion, a big proportion, of the resources of the savings and loans into housing. They are not allowed to go into other areas. They cannot make many business loans. They are not allowed to invest, except for a limited proportion in Government obligations, and so forth. Why cannot we extend that principle to a lesser degree and make these other resources more readily available?

Now, you have instead of that a request on their part for tax credits. They want tax credits now for savings, and as you know, in savings and loans, that has a lot of support. The administration may support it at the summit conference, and a lot of people thought that would be an ingenious proposal. As Mr. Fowler, I am sure, recognizes, everybody wants a tax credit, and if you begin to weaken our tax system much more, it results in loopholes that create great inequity. Even if you allow only $1,000, which is the most popular amount at the present time, that means you have to have $20,000 in savings in the savings account to take full advantage of it. Now, who is able to do this? You have to be a relatively wealthy person to have that much in a savings account. A lot of people have substantially more than that, but if they do, it is in equity on a home, or something of that kind.

So that any way that you look at this, it is not pleasant. But it seems to me that something like that would leave the decision as to what mortgages to buy and under what circumstances and what terms for the private sector. But to receive that, you would have an automatic allocation of a substantial amount of resources to housing, which has been so badly neglected.

Mr. DUESENBERRY. Well, I should note that we have given concessions to the thrift institutions in return for their restriction to mortgage financing, and I say I think that the other financial institutions have a great deal of flexibility. I would fear that people would reduce their liability for this by inventing other types of financial institutions. I would certainly not like to lose momentum in basic reforms in the thrift institutions and the mortgage markets by pursuing the allocation route. I would be happier to see the allocation proposal as the last step in the total program for reorganizing the mortgage and thrift institution markets.

Senator PROXMIRE. Let me move into another area. Unfortunately, I am going to have to leave in a couple of minutes. We are going to have to terminate the hearings, because there is another vote on the floor. But, Mr. Duesenberry, in your prepared statement, you stress the need to sustain a full-employment budget surplus. Now, some economists have argued that we should index taxes. In other words, if because of the difficult impact on people with rising money incomes but declining real incomes, or stable real incomes, we ought to index taxes to provide inflation protection for taxpayers.

I gather you would oppose such indexing. Is that the case? As you know, they do have something like that in Canada now.

Mr. DUESENBERRY. Yes. What it comes to, if we were to index taxes so as to eliminate the bracket effect, we would then find we would have to raise the rates. Given the present fiscal commitments, we are in the situation where we have an automatic, built-in tax increase, and the more democratic way to do it would be to index the taxes, and Congress would face the facts of life.

Senator PROXMIRE. More democratic, but politically less—well, effective? As you know, we have elections every 2 years, and as you know, it is very hard to increasae taxes during elections.

Mr. DUESENBERRY. Yes. I think, as a practical matter, we should just stay with what we have.

Senator PROXMIRE. Would you support—Mr. Tobin would, or maybe the administration would—tax relief for low-income people right now?

If so, would you balance that with tax increases elsewhere, and if so, where?

Mr. DUESENBERRY. I think that in the present situation, we could, of course, benefit from some temporary tax relief for low-income groups. Given the longrun picture, I do not see that we have much to give away. So that leads me to the conclusion that you want to offset it by tax increases elsewhere, and I would be perfectly happy to recommend a shift, so that there was——

Senator PROXMIRE. Something like a reduction in payroll taxes and surtax on incomes over, say, $15,000 to $20,000?

Mr. DUESENBERRY. I would buy that, even though I would not be on the end of receipts, and even though my employers are in no position to keep up with inflation and rising prices.

Senator PROXMIRE. Do you think that Government should directly subsidize thrift institutions, rather than continue to penalize the small savers by regulations holding down interest on small deposits?

Mr. DUESENBERRY. I know it is an inequitable situation, but I hate to go down the road of building a permanent system of subsidies in order to remove that inequity. I think we would remove some of it by getting market interest rates down some as soon as possible.

I also think that there is some room for an increase in the rate ceilings right now. Earnings of the thrift institutions are gradually going up as the mortgages roll over, and there is room for some increase in their rates right now. As market rates would come down, we could close the gap and reduce the inequities somewhat, although it would not completely eliminate them. And I would hate to get involved in a long-term program of that sort, and I do not think if would be a temporary one.

Senator PROXMIRE. Very good, gentlemen. I want to thank you so much. It has been a very, very useful panel. You have been most generous and helpful in your advice, and we deeply appreciate it.

The hearings will reconvene in this room at 10 o'clock tomorrow morning.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, October 2, 1974.]

FINANCIAL AND CAPACITY NEEDS

WEDNESDAY, OCTOBER 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. Lloyd M. Bentsen, Jr. (member of the committee), presiding.

Present: Senator Bentsen.

Also present: Courtenay M. Slater, senior economist; Michael J. Runde, administrative assistant; Carl V. Sears, professional staff member; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR BENTSEN

Senator BENTSEN. The hearing will come to order. We are experiencing an economic phenomena known as "stagflation"—declining production and rising prices. This condition affects all members of our society causing loss of jobs, loss of real income, and hardship for millions of Americans. The Government through its regulatory, taxing, purchasing, and borrowing authority exercises enormous influence on the growth of our economy. It bears a special responsibility in the battle against inflation and the fight for social equity. In a situation like this one we are trying to fight inflation and recession at the same time. We try to put a damper on inflation without at the same time pushing this country over the brink into a severe economic recession.

There is a growing commitment in the Congress and the executive to hold expenditures in this fiscal year at or below $300 billion. This action is essential but we cannot expect it to be a panacea. I don't think it will resolve all of our problems.

The conduct of monetary policy in recent months has been restrictive. The money stock has risen at an annual rate of only 2 percent in the last 4 months, considerably slower than in the previous 8 months. Over the past year the rise in the money supply rose about 6 percent, much lower than the rate of the previous 2 years.

Tight money policies mean that banks have limited amounts of credit available to lend among competing claims. When interest rates are at historical highs many vital sectors of our economy like housing, small business, agriculture, and enterpreneurs are readily priced out of the market for financing. They are often the productive groups hit hardest by inflation and recession, and by insensitive Federal policies to combat these economic disorders.

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What is a recession for most is a virtual depression for specific sectors. Housing starts have declined over 50 percent since the peak in 1972. Higher construction costs and the unavailability of loans for builders and buyers have made owning a home the preserve of the affluent. As one man put it, "I never thought I could live in a more expensive neigborhood without moving." In the background today we know that a large part of the productive capacity of the housing industry lies dormant or even worse is disintegrating as skilled construction workers move into other trades because they can't make a living.

For agriculture the costs of farmland, fertilizer, and other production inputs have soared, straining the financial resources of one of America's most productive industries.

For the small businessman and the enterpreneur who have been the true competitors and innovators of our free enterprise system financing through equity is nonexistent. The stock market hit a 12-year low yesterday. I have put practically all of my estate into a blind trust. And I sure hope those bankers are doing a good job. But in this day and time I don't know how anyone could do a job in equity. At present values why should a company spend a dollar on new plant and equipment when the market will pay only 89 cents for paper claims to that capital?

Even though we are not in a financial collapse the conclusion seems inescapable that we are experiencing a credit crunch. I listened to Mr. Burns say that he is not going to allow a credit crunch to come about. But I don't know what else you could call what is happening today. The malfunctioning of our capital markets is being exacerbated by the man-made shortage of money. We must bring interest rates down especially for those productive loans that create the greatest general benefit.

Today, we are very pleased to welcome Mickey Norman and Michael Sumichrast of the National Association of Home Builders; Ed Jaenke, Governor of the Farm Credit Administration; Reed Powell, Chairman-elect of the National Advisory Council to the Small Business Administration; and Ralph Landau, president of Halcon International.

Gentlemen, we are delighted to have you. We appreciate your attendance.

Mr. Norman, why don't you start?

STATEMENT OF J. S. NORMAN, JR., FIRST VICE PRESIDENT AND LEGISLATIVE CHAIRMAN, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Norman. My name is J. S. Norman, Jr. I am a home builder from Houston, Tex. At the present time I am also serving as first vice president and legislative chairman of the National Association of Home Builders. Sitting with me is Mr. Michael Sumichrast, staff vice president and chief economist of the National Association of Home Builders.

Although we are both officials of NAHB, it is my understanding that we have been invited to appear before you today in our individual capacities and not necessarily on behalf of NAHB. I will attempt to

give you my own impressions as to the impact of the present mortgage money crisis on myself and other homebuilders around the Nation. Mr. Sumichrast, I understand, will give you his analysis of the nature of the cyclical availability of mortgage money and its effect on homebuilding.

These hearings today deal with the credit claims and needs of certain vital sectors of our economy—small businesses, agriculture, firms dependent on venture capital and housing. While I cannot speak with familiarity about the needs of agriculture and those other businesses dependent upon venture capital, I believe that I can speak with great familiarity about the needs of both small business, in general, and homebuilding. The great bulk of homebuilders in this country are small businessmen. The average homebuilder constructs well less than 50 housing units a year and is heavily dependent upon outside sources of capital to finance both his construction operation and for his buyer to purchase his product.

Today, this small businessman homebuilder finds himself almost completely excluded from the capital market. This is because funds are not available at all in many cases, and, when available, are available only at interest rates so high that neither he nor his customers can afford them. Unfortunately, for the homebuilder who has been able to survive, this situation is not new, since our industry has found itself increasingly subject to sharp cycles in the availability of capital in the form of both construction and permanent financing. This present situation; however, is the worst that we have ever experienced in my 28 years as a homebuilder. And there seems to be no end in sight. It must stop!

Mr. Sumichrast will tell you in detail about the lengths of the several cycles we have experienced since the Second World War and the overall effect that this has had on our industry's ability to provide, at a reasonable cost, homes for the American people. He will tell you about construction money costing between 15 and 18 percent and permanent mortgage money costing between 10 and 11 percent and these can be well attested to. They are common in my area and, I understand, elsewhere as well.

I will leave the statistics, however, to Mr. Sumichrast. I would like to discuss the philosophy of government that permits one industry, the homebuilding industry, to bear so great a share of the Nation's efforts to fight inflation; the philosophy of economists and money managers that treats the housing needs and aspirations of the American people as postponable and subject to wild swings in the availability and cost of financing.

This is a philosophy I believe to be very wrong. It is a philosophy which callously subjects the over 75,000 members of NAHB, who produce more than 70 percent of the housing and have made America the best housed of any nation, to the real possibility of losing the fruits of a lifetime of work and the capital built up as a result of that work. Many more people than homebuilders are affected by this philosophy. It threatens the livelihood of over 2 million skilled workmen in the building trades who builds the houses. It further jeopardizes the ability of millions of families to obtain the American dream of a home of their own.

This we believe to be unjust and we believe that the laws that permit this to occur are unjust. If one accepts the fundamental tenet that our Nation is one governed by laws and not the whims of man, and that the purpose of law is to establish equity and justice among the governed, the effect of present laws governing our economic system is unjust since the burden of fighting inflation is borne primarily by a few and not all on an equitable basis.

Some will say that the homebuilders' present pilght is a result of the basic laws of economics. Unfortunately, this analysis ignores the impact of Government actions upon such allegedly basic laws through control of the money supply and other equally important controls. While striving to support the principles of free markets and private enterprise, our system, like other industrial nations, is a mixed economy, regulated in many ways, both to prevent unfair competition and to achieve stated national objectives such as full employment or our national housing goal, for example.

To say that the so-called laws of economics must apply to the homebuilding industry but not to other industries is nonsense. This Nation's economy functions under regulations prescribed pursuant to the laws enacted by the Congress intended to serve our objectives as a Nation of free men. The situation in which we as homebuilders find ourselves today is a direct result of the application and administration of these laws in such a fashion as to impact most directly upon us.

In the past, when the laws of the Nation governing the control of our economy have proven to need adjustment, both in the interests of equity and to serve our national purposes, this has been done. It is now time to take another look at those laws because, as they are being applied in the Nation's present fight against inflation, the brunt of the burden is being borne inequitably and unjustly by the homebuilder, the construction worker and the homebuyer.

No other segment on the production side of our economy has paid the heavy price these are paying in the name of fighting inflation. They are paying this inordinate price because the homebuilder and his buyer are small economic entities and cannot compete for the shortage of available funds. Government action must be taken to rectify it. It is totally inequitable that in the name of fighting inflation, one segment of our economy must face disaster while others enjoy record earnings.

While I do not pretend to have all the answers, I do know first hand what the principal problem is. It is a scarcity of capital funds at an affordable price. Neither I nor my buyer can afford to compete for scarce capital funds with a General Motors, a United States Steel, or an Exxon. A better way has to be found to fight inflation, a fight which I and all other homebuilders believe must be won, than to place the bulk of the burden on the small user of capital such as the homebuilder and the homebuyer.

I believe that it is essential that laws be enacted, if necessary, to spread this burden equitably and justly through all segments of the economy—to the big as well as to the small economic entity. To the extent that this cannot be done, then I believe it is necessary for the Government to provide special assistance for those who otherwise would bear an inequitable share.

While I realize that the Joint Economic Committee does not act on individual legislative proposals, it does play a very important role in spotlighting economic problems and injustices and recommending means of dealing with these problems and injustices. I would hope that as a result of these hearings the glare of the committee's spotlight will help illuminate for all Members of the Congress the need to make overdue adjustments to those laws which govern the regulation of our economy and whose present application have brought about the injustices I have discussed here today. I also hope that the committee will recommend and endorse specific proposals to deal with today's very serious situation.

I should like to mention a few such recommendations for the committee's consideration. These are recommendations which the National Association of Home Builders has strongly endorsed as going a long way toward rectifying present inequities. They deal primarily with the problem of assuring an adequate supply of mortgage funds at reasonable rates.

For example, the Nation's thrift institutions have historically played a predominate role in providing long-term mortgage money. Today, confronted with massive outflows of funds seeking the higher yields made possible because of the Federal Government's high interest rate policy, they are unable to continue to fulfill this role. I believe that one sure way to reverse this outflow is to make it more attractive for the small and medium saver to put and leave his funds in a thrift institution. This can be done by providing an exemption from Federal income taxation of some portion of the interest earned annually on savings accounts in thrift institutions. This will increase the yield to the saver while at the same time permitting the institution to relend the funds at a rate that can be afforded by the homebuyer.

Another means of assuring a greater supply of mortgage funds is to redirect the resources of pension funds into residential mortgages. Today these funds, which are the fastest growing reservoir of savings in the Nation, practically ignore the residential mortgage market. Instead, they have invested heavily in the stock market, perhaps contributing to the speculative fever which until recently beset that segment of the economy. They certainly are reaping its whirlwind, as the values of almost all stocks have fallen drastically over the course of the past several months. Legislation requiring pension funds to invest, say 25 percent of their assets in residential mortgages would not only meet a high social goal, but also provide a greater protection to those who look to their pensions for economic safety after retirement.

These and other measures, such as special assistance funds through Government intermediaries such as the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation are needed to assure that the homebuilder, his workmen, and the homebuyer do not inequitably bear the burden of the Government's efforts to restrain inflation. I seek your support for enactment of such laws.

Thank you very much for this opportunity to appear here today.

Senator BENTSEN. Thank you, Mr. Norman.

The full committee is coming out with a final report on inflation in December. This will be a contribution to the study, and we appreciate it.

I might say for the record that I have known Mr. Norman for many years, and I used to head the financial institution that did some financing for his work. I know him to be a man of great ability and integrity, and substantial experience and expertise in his field.

And I am pleased to see you in such a spokesman role as the first vice president and legislative chairman of the National Association of Home Builders.

Mr. NORMAN. Thank you.

Senator BENTSEN. Will you proceed, Mr. Sumichrast.

STATEMENT OF MICHAEL SUMICHRAST, STAFF VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. SUMICHRAST. Senator Bentsen, I have a prepared statement which I trust will respond to some of the questions which have been raised by many in the last 2 years concerning housing cycles. I will not go over it. I will try to give a summation so that at least the gist of the prepared statement will be presented here.

Senator BENTSEN. Mr. Sumichrast, we will take your prepared statement in its entirety for the record.

Mr. SUMICHRAST. Some of the conclusions resulting from an examination of the housing cycles are listed in section VIII of the prepared statement, and I will briefly go over these.

The No. 1 conclusion I reached from this prepared statement is that the question which has been discussed for many years now is what is the credit sensitivity of housing starts. I think it is clear from an examination of the cost of cycles, and especially in the last three cycles, that the residential cycle is credit induced. The cycles are not really the result of the major forces in the market such as family formation, net removal rate of housing from the inventory, or many others. The major variable which affects housing production is credit.

The cycles are also directly related to monetary policies. And these policies, for whatever reasons, make credit either very expensive, or not available, or quite available. In a period of very rapid increase in the cost of money, the thrift institutions and the mutuals lose money at a very rapid rate, and this, in a sense, effectively dries up the funds for mortgages and construction.

Now, there are two parts to the picture. And one is construction financing, which is short-term financing which becomes very expensive and unavailable. And then mortgage money, which is provided for the home buyer, and in a cycle also becomes very expensive and not available as well.

A second major conclusion I reached is that the mortgage interest rates do tend to affect housing starts more than some of the authors have suggested. There is a high degree of elasticity between interest rates and production. This subject has been discussed for many, many years, and no unanimity has been reached, in spite of the fact that commonsense will tell you that if you need credit and money is expensive, housing will not be available.

The third conclusion is the fact that residential construction measured in terms of the GNP concept accounts for between 4 and 4½ percent of GNP, and the decline in production of housing during a housing cycle carries as much as one-third to 40 percent of the total cyclical movement.

Fourth, one of the reasons why there has been a lot of nonunanimity among authors who have looked at the cycles has been the inability of any models to make use of the new variations which do occur in the cycles; no one period is like the other. And the period we are now going through has so many variations that you cannot compare its cycle to another cycle. This makes it very difficult to come to any kind of a conclusion.

Fifth, the current cycle is already the deepest cycle in the postwar period. We do not know, Senator, the full extent of the housing cycle during the depression, because we do not have good information for the period, one reason being that at that time no information was collected, no housing starts were collected beyond the Rockies, the Western part of the country was not covered, and therefore we cannot really make a precise judgment of the current cycle compared to the depression. But in terms of percentage or in terms of the annual rate, the current cycle is the deepest cycle since the Second World War.

Also, it seems to be the longest cycle. Although the cycle is incomplete yet, the best estimate now is that we will not reach the bottom for the next few months. This cycle could therefore be the longest cycle on record.

What we probably need is a new definition of the housing cycle, not only taking into consideration the next year's starts and the value put in place, but also to construct a model which will take into consideration such things as the unemployment rate of construction workers, and the bankruptcies.

Sixth, there has been a lot of discussion about the cost of cycles, and no unanimity has been reached here either. Many authors suggest that there is no cost. But I think that logic would once again tell us that there is cost involved. It is very difficult to put this cost in dollar terms, because there are so many problems involved in developing any kind of model to tell you what the cost of a cycle to the society is. But what we do know is that there is a cost, and that the cost is substantial, but we don't know what it is. The only thing I can tell you is that probably if you put it in terms of increase in cost to the final consumer, the cost would tend to increase at about double the rate during a cyclical downturn than it would be during normal years.

Seventh, there have been many studies made as to the total requirement of funds for housing in the seventies. I think they all agreed that relatively more funds, either measured as a percentage of GNP or as a percentage of total funds, really are needed for the seventies to build units for the growing population. There seems to be an agreement on this.

The level of the funds varies, depending on what studies you read. There will be more funds needed. Now, if you are going to need more funds, the question is, where is the money going to come from? And there are conceptually only two areas where you can get money. One, you must develop some new sources of private funds, or you have to

rely on Government or Government agencies to provide these funds, or supplement such funds.

One source of these funds, as Mr. Norman already mentioned, would be from pension funds which strangely enough—and I cannot really understand why—provide no help to housing. When you look over the last 2, 2½ years, pension funds as well as life insurance are in a minus position rather than a plus as to total mortgages. This compares to some other nations where pension funds do provide substantial funds for housing.

Another source of additional funds could come from indirect allocation of credit by defining some loans as productive and some as nonproductive. The nonproductive loans, in periods of capital shortage, would be those which create no employment, goods, or services—best described as speculative credit.

I think it is also terribly important that we start living within our means so that the Government will start having a surplus and can pay some of the debt, because the Government is a very strong competitor for money in the financial market.

And finally, in the short run we have a liquidity problem which I have never seen before in this country. And it is not only our own problem, Senator, because obviously many people outside the housing industry are going bankrupt. A study of the large public construction companies shows that about 20 are already bankrupt and another 30 large public companies are on the verge of bankruptcy.

Senator BENTSEN. What do you mean by saying "on the verge of bankruptcy"?

Mr. SUMICHRAST. Public construction companies. They are either technically bankrupt, insolvent, unable to pay their debts, or not paying the interest rates on their loans.

Senator BENTSEN. Are you talking about companies in homebuilding?

Mr. SUMICHRAST. I am talking about companies in homebuilding, publicly owned companies now. We do know that the bankruptcy rate in the construction industry is the highest on record for the first 7 months in terms of liabilities. It is about 68 percent above what it was the first 7 months of last year. So we have the problem of liquidity——

Senator BENTSEN. How does that compare with other periods?

Mr. SUMICHRAST. In terms of liability this is the highest. In terms of firms it is not. In terms of firms, in the first 7 months there were 1,043 which failed.

Senator BENTSEN. So that finally it is just going to be survival of the strongest?

Mr. SUMICHRAST. That is correct. But the problem is not only ours, this, as I already said, spills over to the banking institutions, especially to commercial banks. And I am really worried about the ability of these institutions to survive, because if you take the commercial banks plus the real estate investment trusts, plus the mortgage bankers—because they depend on a line of credit from commercial banks—you can see that commercial banks have, directly and indirectly, between $35 to $40 billion presently in construction lending. If these loans go sour, if the banks take over with these loans, I feel that this would be a major calamity to the financial institutions.

Senator BENTSEN. Don't you have a situation now with construction loans that are in real trouble because the bank just does not want to operate the property?

Mr. SUMICHRAST. That is right.

Senator BENTSEN. They are not sure they can do much more with it, and they are trying to close it out?

Mr. SUMICHRAST. We are trying to urge on banks, as well as the Federal Reserve Board, to become a partner and try to work out these problems rather than take over, because I think it would be terribly bad for the country to have widespread bankruptcies and sheriffs' sales. The banks usually wouldn't be able to get a hundred percent on the dollar; they might get only 50 percent. If they work it up, they might get a hundred cents on the dollar. But it is a problem of the total banking industry.

Senator BENTSEN. The banks say, it is no problem with us, because we have just got 90 days, and they just keep rolling over.

Mr. SUMICHRAST. That is the end of my oral statement. I thank you very much.

Senator BENTSEN. Thank you, Mr. Sumichrast.

[The prepared statement of Mr. Sumichrast follows:]

PREPARED STATEMENT OF MICHAEL SUMICHRAST*

HOUSING CYCLES: CURRENT PROBLEMS AND FUTURE PROSPECTIVES

I. PURPOSE OF THIS PAPER

The present drop in housing production and an unusually deep liquidity crisis in residential construction have brought about a renewed interest in determining the reasons and possible cures for housing cycles.

Housing production already shows the deepest post World War II decline. From the October 1972 peak to August 1974, housing starts at a seasonally adjusted annual rate dropped 55.1 percent. In the same time frame, production is down 1,383,000 units—also measured at seasonally adjusted annual rates. (See table 1.)

Few people maintain that housing cycles cause little disruption and have little effect on the efficiency of production.

Some, most notably the Federal Reserve Board in its study of housing cycles, agree that for the most part the declines have been too deep, creating hardships

*The opinions expressed in this paper are the author's and do not necessarily represent those of the National Association of Home Builders.

[1] Some selected studies dealing with the cyclical movement of construction: Leo Grebler and Sherman J. Maisel, "Determinants of Residential Construction: A Review of Present Knowledge," in the Commission on Money and Credit Volume, *Impact of Monetary Policy* (New York: Prentice-Hall, 1963); Irwin Friend, "Study of the Savings and Loan Industry," *A Study of Mortgage Credit* (Washington: Government Printing Office, 1967); *A Decent Home*, The Report of the President's Committee on Urban Housing, (Washington: Government Printing Office, 1968); and the following Federal Reserve Housing Study Papers: James B. Burnham, "Private Financial Institutions and the Residential Mortgage Cycle, with Particular Reference to the Savings and Loan Industry"; Robert Moore Fisher, "The Availability of Construction Credit for Housing"; James L. Pierce and Mary Ann Graves, "Insulating Housing: The Effects Upon Economic Stabilization Policy"; William Poole, "Housing Finance Under Conditions of Inflation"; Stephen Taylor, "Long Range Projection of Demand for and Supply of Mortgage Credit"; Alan R. Winger, "Mortgage Characteristics and Lender Mortgage Acquisitions During Periods of Monetary Restraint and Economic Analysis"; Arthur F. Burns, "Long Cycles in Residential Construction", in *Economic Essays in Honor of Wesley C. Mitchell* (New York, Columbia University Press, 1935), pp. 63–104; Leo Grebler and others, *Capital Formation in Residential Real Estate, Trends and Prospects* (Princeton: Princeton University Press, 1956); Saul Klaman, *The Postwar Residential Mortgage Market*, a study of the National Bureau of Economic Research (Princeton: Princeton University Press, 1961), p. 301; Lawrence R. Klein, *Economic Fluctuations in the United States* 1921–1941 (New York: John Wiley, 1950), p. 174; Clarence D. Long, *Building Cycles and the Theory of Investment*, (Princeton: Princeton University Press, 1940), p. 239; Sherman J. Maisel, *Fluctuations, Growth, and Forecasting the Principles of Dynamic Business Economics* (New York: John Wiley, 1957), p. 552; Geoffrey H. Moore, ed., *Business Cycle Indicators*, a study by the National Bureau of Economic Research (Princeton: Princeton University Press, 1961), Vol. 2: 157, 173 pp.; Julius Shiskin, *Signals of Recession and Recovery and Experiment with Monthly Reporting* (New York: National Bureau of Economic Research, 1961), p. 191.

for the home building industry. However, some studies suggest that a complete elimination of cycles may not be feasible.

This paper examines the reasons for the cyclical nature of residential construction, the costs involved, and short-term as well as long-term proposals for helping to smooth the cycles.

II. CYCLICAL MOVEMENTS IN RESIDENTIAL CONSTRUCTION

Many studies have focused on the cyclical behavior of construction and housing.[1]

Some time ago Jack Guttentag suggested that residential construction cycles bear little relation to such factors as house prices, income and employment, marriages, or other factors which generally control housing demand. He showed that movement in housing starts generally is counter-cyclical to overall economic cycles and that the cycles follow the patterns of interest rates and other mortgage terms.

Recent studies seem to confirm this view, supporting the traditional understanding of housing experts: that changes in monetary conditions primary cause fluctuations in residential construction.

Since the end of the Second World War, housing starts have gone through seven short-term cycles. All of these sharp cyclical movements resulted primarily from the ebb and flow of mortgage money.

Financing in turn is highly sensitive to overall economic trends, which depend to a large degree on monetary and fiscal policies.

Because construction, and particularly residential construction, is highly responsive to financial conditions, various administrations have used it quite effectively either to stimulate or retard the economy. Changes in financing cause an immediate impact on housing, which leads the overall cyclical movement of the economy. In the last 50 years, housing has shown this counter-cyclical character time and time again.

In the thirty years between 1915 and 1945, housing in the United States experienced three major cycles, or an average of 10 years each. In the 28 years since World War II housing has gone through seven cycles.

The current cycle in particular is the deepest since the end of the Second World War, and probably the deepest since the early 1930s.

These rapid declines in production caused dislocation in the housing industry—to its manpower, and management, as well as to the supporting industries.

For some time, housing economists have argued about the cost of such dislocations. Most agree that these periodic fluctuations have caused production inefficiency and tended to push housing prices up.

III. MAGNITUDE OF THE MORTGAGE MARKET AND PROJECTIONS FOR THE DECADE

Construction in the United States generally has been credit financed. This financing basically takes two forms. The first is construction financing, or one which channels credit into the structure while it is being built. This financing is usually of limited duration, say one to two years, and is limited in amount to about one-half to two-thirds of the final value of the project. The second type is mortgage financing which takes over after the project is completed. These mortgages are of longer duration—they averaged 26.5 years in third quarter 1973—and usually provide a higher percentage of the total price of a unit.

In 1940, total real estate mortgage debt in the United States amounted to $36.5 billion. In second quarter 1974, total mortgage debt increased to $663.2 billion.

Funds invested in residential construction come primarily from lending institutions. In addition, some part of these funds is generated by individual savings in the form of equity investment and finds its way into real estate mostly through downpayments; some investment is made in the form of a cash purchase, although this is of a very limited nature (only about 6 percent of all new homes sold are purchased for cash).[2]

The extent of liquid assets available to individuals—especially those purchasing single family homes—is limited. Thus, residential housing construction is customarily financed by mortgage loans, and therefore credit is an important governing factor. Housing loans are made on a specific security, i.e., a real estate

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[2] Bureau of the Census, U.S. Department of Commerce, *Characteristics of New One-Family Homes: 1973*, Table 4, p. 17. The homes referred to are new homes sold rather than all homes. As many as 21 percent of all contractor-built homes are purchased for cash, and generally only 50 percent of the owner-built homes are credit financed.

property, and are characterized in general by long maturities, small downpayments, and high loan-to-value proportions.

The residential mortgage market experienced three widely different movements between 1920 and 1970. Until about 1932, debt accumulation for multifamily properties rapidly increased with a commensurate decline in debt outstanding among single-family units.

From the middle of the Depression until the early part of the fifties the percentage of outstanding debt for single-family housing increased rather sharply (41.1 percent in 1932 vs. 78.9 percent in 1955) while the multifamily percentage declined.

From the early fifties on, however, single-family housing's share of total debt has declined while the multifamily share has increased.

Projections of demand for loanable funds for mortgages suggest a strong continuation of this trend: a large amount of funds needed for the single-family market, but at a declining rate of increase. The demand for loanable funds for multifamily mortgages is projected to nearly triple during the 1970s, from $58 billion to $181 billion. The amount of debt outstanding at the end of the 1970s for singles is projected to reach $555 billion, up 98 percent from $280.2 billion in 1970.[3]

Much of the future distribution in housing types will depend on continuing changes in trends, which began in the late 1960s with the expansion into townhouses, condominiums, and cooperatives. And the future amount of needed mortgage funds will depend on the housing mix.

A great deal of discrepancy exists in current data since the Census Bureau does not identify apartment starts. Data published by Census break down units by structure into one unit, two units, three- four units, and five units or more.

Thus, in many instances townhouses which have more than 5 units in one building, and most condominiums and cooperatives are counted as multifamily structures of 5 units or more—popularly called apartments. And yet townhouses and condominiums probably accounted for as much as one quarter of all housing starts in 1973.

These difficulties are not as pronounced in the mortgage debt structure, although some confusion also exists there. A fair assumption can be made that mortgage debt data underreport the extent of single-family unit activity (or forsale housing). If units were measured by type of ownership, then the Taylor projections for 1980 might not show a continuation of the decline in 1–4 family debt.

IV. CREDIT SENSITIVITY OF HOUSING

Almost no one today would argue about the fact that housing starts are sensitive to credit conditions. However, credit is not simply the price of money. It also includes availability and the conditions for acquiring a loan.

Most studies seem to confirm the conventional wisdom that the financial variable is the main determinant of housing cycles. The difficulty has been concentrated primarily in separating the variables on the side of supply and demand, as well as separating the impact of availability and the price. These are the reasons why most econometric studies have had more than the usual share of difficulties in reaching firm conclusions on the impact of interest rates on starts. A variety of results have come out of these studies. For instance, Brady[4] suggested a high rate of elasticity on housing starts; while Huang[5] shows that the costs of mortgage borrowing were statistically insignificant in explaining shorter-term fluctuations in housing activity. He shows that the downpayment was more significant.

Five models summed up by Gibson disclose a variety of results, ranging from highly inelastic (DRI), to highly elastic (Swan and Brady). However, Gibson concluded: "that the volume of mortage lending is responsive to market interest rate . . ." and that ". . . on the basis of both cost and availability,

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[3] Stephen P. Taylor. "Long-Term Prospects for Housing Finance—A Projection to 1980." A paper done for the study of housing for the Federal Reserve Board, September 21, 1971, Table 3. Line Ai and A4.

[4] Eugene A. Brady. "An Econometric Analysis of the U.S. Residential Housing Market." Working Paper 11, Office of Economic Research, Federal Home Loan Bank Board, Washington. D.C., November 1970.

[5] Craig Swan. Working Paper, Office of Economic Research, Federal Home Loan Bank Board, Washington. D.C., 1973.

mortgage lending tends to be greatly restricted when market interest rates rise." [6]

What, then, is the problem, and why is there no unanimity of conclusions? The problem seems to lie in the complexities of the housing market, the variations between time periods, and a general inability of models to reflect the vastness and the diversity of variables.[7]

It was said well by Gramley:[8] "There are, however, a priori reasons for expecting the demand for houses to be more sensitive to changes in interest rates than most other categories of private expenditures for goods and services." Gibson also agrees that interest rates are within the higher range of elasticity estimates: "Because of these distortions and because credit is so important to housing finance and its cost, such a large element of the undiscounted total cost of a house, one is tempted to agree with the higher range of elasticity estimates."

Let us sum up some of the intricacies of the housing market to show the enormity of the problem of trying to separate one variable. This is at best a difficult problem and often an impossible task.

Housing supply follows approximately the following sequence. Builders always look for investment opportunities; they either hold the land or have an option to purchase; they make a rational decision about the best use of the land; then they arrange to get commitments to purchase and develop the land; they try to presell units; if sales slow down, they stop building speculatively; if they sell they continue building; if funds dry out and lenders stop issuing commitments they continue building; jointly—as a group—they provide enough units: in single family housing the impact of credit tightening has an almost immediate effect; in the multifamily market the impact is not as immediate—building(s) have to be finished; builders must insure against overbuilding by building in sections, and changing to suit demand.

In the long run housing demand obviously depends on basic demand forces such as household formation, net removal rates, demand for second homes, changes in vacancies, as well as financial variables. However, housing cycles have nothing (or little) to do with these basic demand factors. They are nearly always induced by credit conditions, and, as already demonstrated, have been of a very short duration since World War II.

For the most part, building cycles occur in a narrow time span. The average cycle time is shown in table 1. Clearly, the time is short, and it is especially short on the downslide—supporting the conventional wisdom which says that starts tend to drop much faster than they tend to increase during recovery.

Housing cycles lead overall economic declines and recoveries. For instance, residential construction accounted for nearly 3 percent, or 40 percent of the 7 percent decline in real GNP in first quarter 1974. This 3 percent excludes changes in the inventory. Yet, residential construction accounts for only 4 to 4.5 percent of total GNP.

Housing demand is quite sensitive to distortions of all kinds. It is also quite sensitive to variations in the price levels of credit. Despite the enormity of effort to moderate cycles, despite a much better understanding of cyclical movements as well as an apparent willingness to moderate them, the cycles have been more rather than less pronounced. The 1969–1970 moderation was due more to the infusion of direct government funds than anything else. This was especially true of subsidized housing when, for the first time in the history of housing in this country, the government increased its share to over 25 percent.

V. PECULIARITY OF EACH CYCLE

Probably the greatest misconception resulting from examining the effect of credit variables on housing production is the unrealistic and impossible attempt to relate past experience to the current situation.

Each period carries with it certain new elements which were not present before. Without going into the history of all cycles, let us look at what is different in the housing market today compared to the last two cycles.

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[6] Ray C. Fair, *A Short-Run Forecasting Model of the United States Economy* (Lexington, Mass.: Health Lexington Books, 1971).

[7] William E. Gibson, "Projecting Housing Construction from the Effects of Restrictive Credit Conditions, Working Paper of Brookings Institution, November 1973.

[8] Federal Reserve Board, *Ways to Moderate Fluctuations in Housing Construction* (Federal Reserve Board, Washington, D.C., 1973).

First, interest rates are much higher today. During the 1966–67 cycle, mortgage rates were generally around 6 percent. During the 1969–1970 cycle they were 6¾ percent. In the present cycle they are as high as 11 percent. High interest rates alone may not make a difference over the long run, since consumers may accept a certain level of rates after a period of time. But the price of credit is significant in the short run as it makes for a collective abstention from purchasing homes.

Second, the time span of the rate increases should be noted. Rates have increased faster during the last two periods than in any others. And yet when one looks at this cycle, there is a substantial difference: mortgage rates in previous cycles were quite sticky; the rate took some time to move upward. This movement has been generally accepted as the function of the thrift institutions which, due to their own peculiarities, tend to respond slowly to overall changes.

Nevertheless, in late 1973 mortgage rates shot up from 7¾ percent levels to 9½ percent in less than two months. This rapid movement has never happened before. In the summer of 1974, while funds dried up, mortgage rates increased to over 10 percent and in some areas were quoted at 11 percent or higher. One has not had either the experience or time to measure the impact of this enormous increase in the price of credit on housing production.

Third, the portfolio of thrift institutions has changed substantially. In the last cycle nearly all their assets were in passbook savings. Today, close to 60 percent are in time certificates. In other words, they are tied into certain rates for a longer period.

Fourth, the rate span on deposits was moved upward. The cost of money has increased as never before; and so has the risk tied into the time frame. This is an entirely new set of circumstances.

Fifth, the profitability of S&Ls has changed as a result of the changes in their portfolios. The uncertainties of what will happen to them during the decline in rates has cast another problem not existing before.

Sixth, the consequences of FNMA and GNMA with their instant rate information, has not been fully examined; nor have the consequences of "privatization" of FNMA and its entry or exit into markets at any given time.

Seventh, the housing market itself has undergone substantial changes: the movement into the condominium market has created a large increase in demand for loanable funds. The condominium conversions market has created the need for additional mortgage funds, along with the expansion into the second home market, and the increase in mobile homes, etc.

Eighth, consider the nagging and nearly impossible problem of building new rental properties: when one adds up the 12 percent prime, plus 5 to 6 percent, most of the projects are not feasible to build (see table 2). Penalties are just too high and one cannot get an equivalent rent out of apartments. Add to this the problems of tenants, courts, and the increasing cost of land and other items, and the difficulties are obvious.

Ninth is the problem of environment with all of the cost implications. The no-growth movement, sewer moratoria, bedroom taxes, fees, etc., have caused a shortage of usable land and pushed the cost of land up by 50 percent in the last two years. This situation is new and was not present in the last two cycles.

Tenth is the unknown effect of the energy crisis, which just happened to come at the time of the highest mortgage rates on record and the expected sharpest drop in housing starts ever.

Eleventh includes an imponderable, which neither the building industry nor the consumer has any way of judging: a political climate which is less than suitable for long-term commitments. This uncertainty alone is reflected in a lack of faith in the future, and, as a consequence, people are not making long-term commitments.

Twelfth is the problem of income erosion and the inability of prospective new home buyers to qualify for loans, or simply their inability to see their way around the stiff penalties being paid for high mortgage rates.

Thirteenth, today's record mortgage interest rate carries with it another large share of the problem: the cost of construction financing has an immediate and substantial effect on the sales price level, and so do the other parts of housing cost which are credit financed, as well as all of the other increases which eventually trickle down to the settlement sheet. Thus, the mortgage rate alone is a formidable barrier to the purchaser. Add to the high interest rates the sharp increases of all the other costs (including the cost of raw land and land

development) and the barrier becomes impossible to cross. The ultimate result is a sharp drop in sales, a drop in rental construction, and a sharp drop in housing starts.

Finally, the current liquidity problem and its reflection in new record construction firm failure rates is difficult to project, or put into a model.

VI. COST

Empirical evidence suggests that interruptions in housing production are costly, but how costly is difficult to say. What available data do show is that the cost may be substantial.

The difficulties in isolating the impact of cycles on cost are formidable. For one thing, a typical house has about 5,000 items, which may have their own cost curves, independent of any housing interruption. For another, residential construction requires the purchase and development of land—and land prices, development costs and the fairly new, but apparently heavy impact of environmental costs are difficult to separate. Third, housing starts at best account for 3.5 percent of the standing housing inventory, and in the short run may have only a marginal impact on all units.

Part of the increase in cost probably could be a reflection of the declines in vacancy rates. However difficult to prove, a relationship does seem to exist between fewer available units and prices.

For instance, homeownership vacancy rates measured at the time of the last two Decennial Censuses were as follows: 1960: 1.6 percent; 1970: 1.2 percent.

No appreciable change has occurred the rate since 1970, as measured by Census Bureau's quarterly survey.

Rental vacancy rates also show a similar trend: 1960: 6.7 percent; 1970: 6.5 percent. The rental vacancy rate dropped to 5.5 percent in 1972 and changed little (5.7 percent) in 1973.

The fact is that in 1973 we had the lowest percentage of available for-sale and for-rent units since 1960. The 1972–73 period also had the highest recorded increase in the median sales price of new units (18.4 percent as measured by Census Bureau's C–25 series), and in the cost per square foot (11.11 percent using the same source).

The median sales price of existing homes, measured by the National Association of Realtors also shows one of the highest increases (8.41 percent) in the same period, closely relating the previous high of 8.68 percent in the 1968–69 period to the aftermath of the previous housing recession. (See table 3, table 4, and chart 2.)

Increases in the average overall cost and per square foot cost also suggest a close relationship between housing cycles and cost, with a lag of one to two years.

Particularly interesting is the series on cost per square foot, which shows a substantial 6.23 percent increase in the 1967–68 period, and 6.84 percent in the 1968–69 period, from a 3.58 percent increase between 1966–67, and then a sharp drop to 1.83 percent during 1969–70. (See table 4.)

The two latest housing cycles, depicted in Chart 2, show the relationship between interest rates and the median number of months new for-sale housing remains on the market.

It proves what has been known always in the real world: that high interest rates makes it difficult to sell, and units remain longer and longer on the market. Of course, a cost is involved, since builders must carry these inventories at construction rates, now in a range of 16 percent to 18 percent.

The cost of construction financing during periods of credit difficulties make it terribly expensive to build rental units. This is well illustrated in table 2, which shows a pro forma statement for three projects: one project 6-10 years old; the second, 2-5 years old; and a new project.

One identifiable area is cost of financing. Both construction cost and end mortgages rise rapidly during a cycle, and they add a substantial amount to the final cost of housing. (See tables 5–9).

Another cost is that of industry dislocation as it is deflected in high failure rates. This cost is quite difficult to measure as it affects not only the builder, but his subcontractors, as well as the lending institutions (particularly commercial banks).

Commercial banks carry 37.3 percent ($21.4 billion) of all construction and land development loans (table 10). When a large portion of the $12.5 billion

carried by REITs, as well as some of the nearly $7 billion carried by mortgage companies (funds which come from banks) are added to the commercial bank share, the impact on the commercial banking system is as high as $32–$35 billion. Much of this amount is affected by the current severe liquidity problem, and of course, a cost is attached.

Finally, the cost to communities is reflected in large scale construction unemployment.

VII. PROPOSED SOLUTIONS

Over the last 50 years many proposals have been made on ways to moderate housing cycles. Most of these concern the impact of monetary policies on housing credit.

It is generally agreed that the most important single contribution that could be made toward stability of housing production would be to obtain better control over the forces of inflation.

Proposals to dampen housing cycles have been made in three major areas: efforts to halt disintermediation, support of financial intermediaries by Federal agencies, and direct government support of housing production.

The problem of disintermediation has been attacked mainly through the extension of maturities by using savings certificates. In addition, payments on deposits were raised so thrift institutions could more easily compete for loanable funds.

Congress established new Federally sponsored agencies and programs dealing with housing's problems, and expanded the powers of existing Federal agencies.

Direct government support of construction has been concentrated mainly in Sections 235, 236, 221(d)(3), public housing, and the Farmers Home Administration programs.

Clearly, the reason for housing cycles have received much attention by industry and government, as well as other interested parties and scholars. Still, housing cycles persist.

The problem is not that the causes of cyclical movements are unknown. They are known. What can be done to smooth the cycles also is known. Whether we will be able or willing to use this knowledge is another question.

Short-term objectives should be structured to provide help in the current liquidity crisis. This could be done by:

A general easing in monetary policies. The housing industry needs short term credit at more reasonable levels for an extended period. Measured in terms of bill rates, yields should drop to about 6½ percent levels, and stay there. This step will assure a resupply of loanable funds for thrift institutions and give some hope for an improvement in mortgage lending by Spring 1975.

Direct support by the Federal Reserve System and the Comptroller of Currency to commercial banks to extend credit, or put a moratoria on interest rate payments on construction loans, or the direct opening of the discount windows for such purposes. This would serve effectively as a prevention to large scale foreclosures by banks. As already illustrated, commercial banks are presently quite heavily involved in construction lending and their viability may be impaired if they do not try to work out a reasonable plan of action with builders.

A direct subsidy interest rate. This subsidy could be the Brooke-Cranston Bill, or an expansion of the GNMA Tandem Plan into the conventional market, or Freddy Mac subsidies, or all three.

A tax exemption for savings which would assure a competitive position for savings vis a vis other types of investment.

Long-Term Objectives.—Housing needs throughout the balance of this decade are going to be heavy and so will the demand for funds. Taylor shows that housing mortgages will increase to 30.7 percent of all funds borrowed during the decade of the 1970s, up from 20.5 percent during the period between 1966–70.

To meet this demand, new sources of funds must be developed, or housing will have to depend on financial assistance from the government.

Two possible and most likely areas of new funds would be pension funds and life insurance companies. Pension funds in particular play a substantially higher role in most European countries than in the United States. In this country, pension funds have less than 6 percent of their assets invested in mortgages. In the last few years, private pension funds and government retirement funds have actually had an outflow of funds invested in mortgages. Private pension funds continued this minus position through the first two quarters of 1974 (table 11).

In Sweden, the National Pension Insurance Fund is responsible for the purchase of about one-half of all mortgage bonds issued, while the rest are bought by banks and insurance companies. (Bonds are issued by mortgage and credit institutions, which supply 69 percent of all mortgage funds in Sweden.)

Establish overall national priorities. These priorities should not be of the type used in controlled societies, but rather fairly flexible commitments by Congress to work with the Administration to define broad as well as specific objectives concerning what we as a nation are trying to accomplish. Housing would be part of this overall commitment program.

Set up a national goal to achieve economic stability. It would be advisable to have overall understanding of stability. For instance, a set of numerical goals to have an inflation of certain percentage this year, and for each year for the balance of this decade.

National priorities based on the inevitable fact that we cannot do all of the things we would like to do in the shortrun, and that individual national objectives—whatever these are—should have a certain weight in the overall commitment.

Working toward stability will, of course, require working toward a substantial decline in inflation. A reasonable plan should be worked out to achieve this over the next several years. For this, fiscal policies must be brought into the picture. The goal should be repayment of our national debt in some reasonable way over a longer period of time. Also, the Federal Government's influence on the money market must be diminished.

The same fiscal restraint must be placed on state and local government expenditures, with some schedule of future obligations, and a reasonable growth of debt and repayments.

As a matter of national policy we should encourage savings and discourage speculation in the financial and commodity markets. Housing can profit only from savers and lose from speculation. This does not mean a curtailment of consumer expenditures, but only that a savings depositor be rewarded rather than penalized for savings—especially savings flowing into long term investment.

We should discourage nonproductive credit, and encourage credit which directly relates to the creation of employment and production of goods and services. This applies to the United States as well as overseas financial investments.

Housing needs some longer term programs designed with the mutual cooperation of private and government experts. It is difficult to comprehend why housing, built primarily by private enterprise, is influenced to such a large degree by the Federal Government. Yet, the housing industry has so little to say concerning the development of workable housing programs or housing production levels (this being determined by the availability and price of money).

The proposal for variable reserve requirements for commercial banks also has some validity, as it will direct funds into mortgages.

Some form of subsidized housing for low income families should be a part of the overall housing program, and should be set up for longer time periods, so that planning and execution can be done on a more orderly basis.

We should work toward the establishment of an advisory board on housing where there can be private sector—government exchange, and recommendations can be made for an overall housing policy.

VIII. SUMMARY

Residential construction cycles are largely induced by the availability and cost of credit. These cycles are little governed by what would be influencing factors in other markets—such as the numbers of family formations, net removal rate of housing units from inventory, or the many other variables which ordinarily determine normal housing demand.

Cycles are directly related to monetary policies. These policies—for whatever reason—make credit either expensive and difficult to obtain or easily accessible. In a period of rapid increases in the cost of money thrift institutions are unable to compete, lose funds and stop making commitments for housing. This effectively dries up the mortgage market and stops construction. Both construction financing and end mortgages are affected.

Mortgage interest rates tend to affect housing starts more than some authors suggest. In addition, the interest rate elasticity seems to be higher during rapid inflationary periods.

Although residential construction accounts for only 4 percent to 4.5 percent of the Gross National Product, it will account for one-third of the overall cyclical movement.

Analysts examining the cyclical movement of residential construction have been handicapped in isolating the influence of interest rates because the differences among the cyclical periods are becoming more pronounced.

The current cycle is the deepest post war cycle in terms of both percentage as well as in the number of starts. It is very likely that this cycle will be the longest post war cycle.

What is needed is a new definition of housing cycles which would identify, in addition to the starts and construction put in place series, the failure rate as well as the unemployment rate.

A cost is attached to the building cycle, but such cost is difficult to put in dollar terms. However, from what is known about the housing industry, this cost is substantial. Put in terms of an annual increase in the cost of all housing, it could approach double the rate of increase during normal production years.

As suggested by the Federal Reserve Board study, housing during this decade will require substantially more loanable funds than during the decade of the 1960s.

To meet this demand we must either develop new sources of private funds or rely on government, or government sponsored agencies, to supplement such funds.

One source of new funds could be from pension funds, which, strangely enough, provide little help to housing in the United States compared to most other industrialized nations.

Another source of additional funds could come from indirect allocation of credit by defininfi some loans as productive and some as nonproductive. The nonproductive loans, in periods of capital shortage, would be those which create no employment, goods, or services—best described as speculative credit.

Equally important is the need for the repayment of the national debt so that the strongest borrower, the Federal Government, will interfere less rather than more in the financial markets.

In the short run, we have the nagging liquidity problem, which, if not solved, may cause a severe strain to this country's banking system. The questions are whether commercial banks can afford to take over the $35 billion in construction and land development loans, and, if so, what this would do to the overall stability of our financial institutions.

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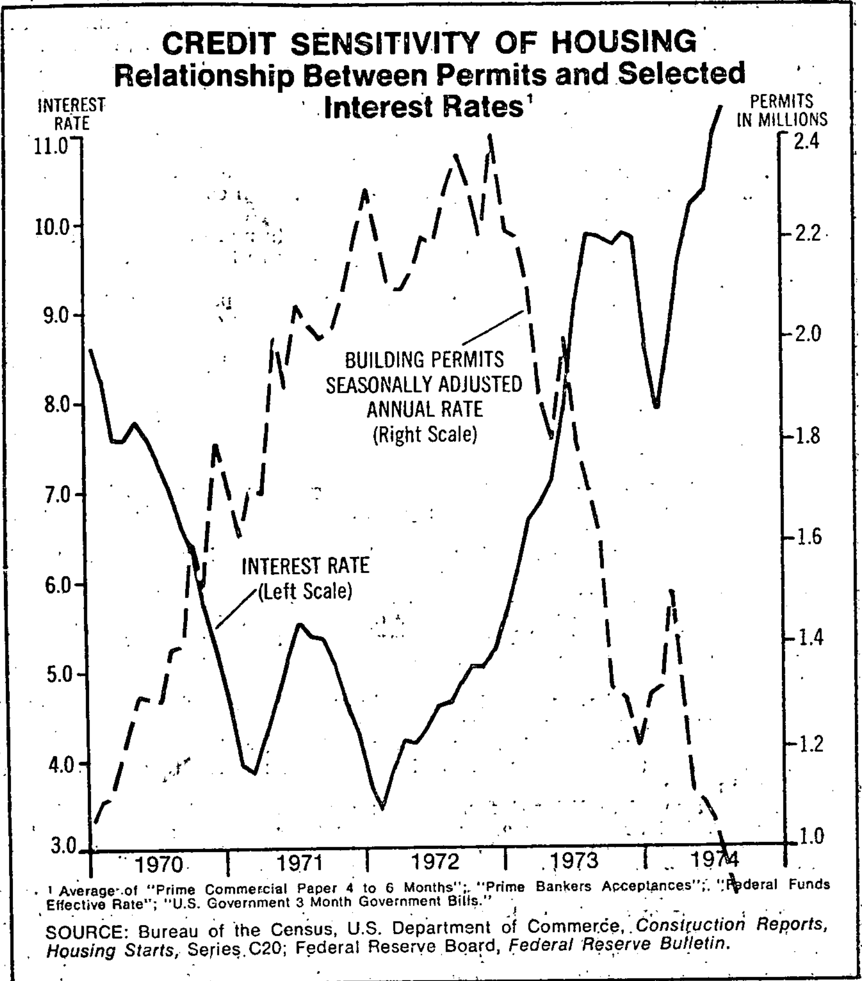
CHART 1



[1] Average of "Prime Commercial Paper 4 to 6 Months"; "Prime Bankers Acceptances"; "Federal Funds Effective Rate"; "U.S. Government 3 Month Government Bills."

SOURCE: Bureau of the Census, U.S. Department of Commerce, *Construction Reports, Housing Starts,* Series C20; Federal Reserve Board, *Federal Reserve Bulletin.*

CHART 2

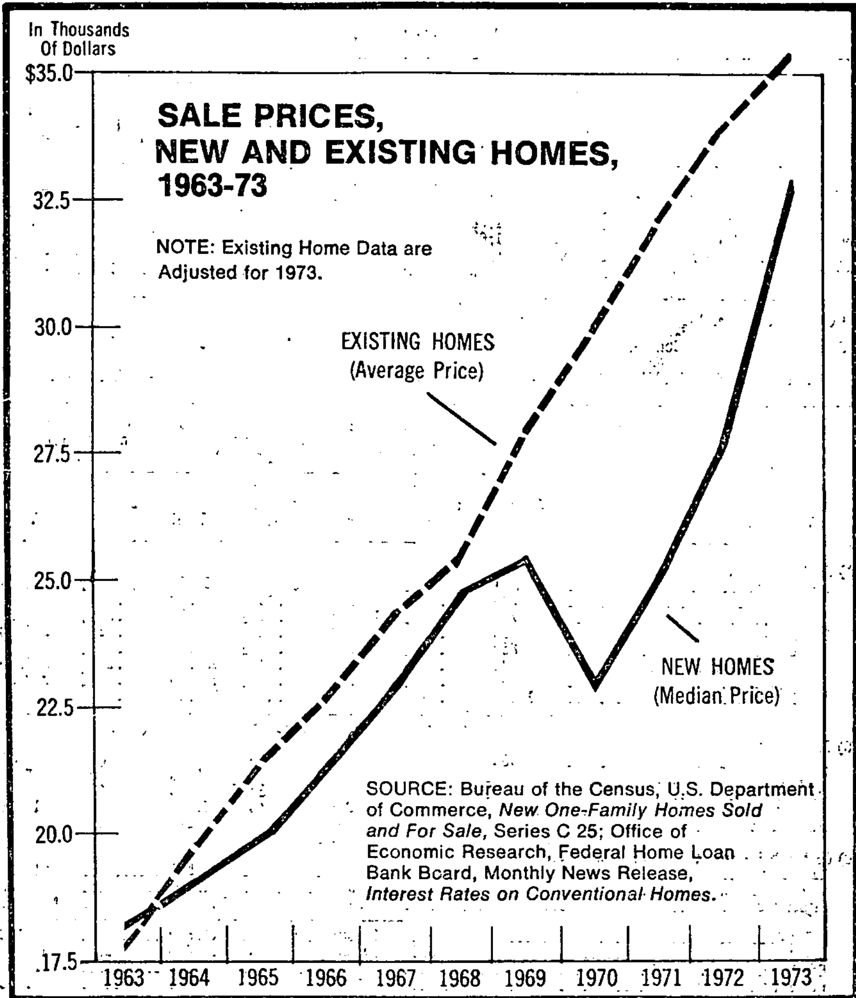


TABLE 1. PEAKS AND TROUGHS IN HOUSING STARTS CYCLES (AT SEASONALLY ADJUSTED ANNUAL RATES)

[In thousands of units]

	Months between high and low	High	Low	Difference	Percent change	3 month averages: High	Low	Difference	Percent change
August 1950 to July 1951	11	1,889	1,154	735	−38.9	1,881	1,182	699	−37.2
December 1954 to March 1957	27	1,703	1,068	635	−37.3	1,664	1,080	584	−35.1
December 1958 to December 1960	24	1,604	1,041	563	−35.1	1,589	1,148	441	−27.8
December 1965 to October 1966	10	1,656	843	813	−49.1	1,522	931	591	−38.8
January 1969 to January 1970	12	1,769	1,108	661	−37.4	1,678	1,252	426	−25.4
October 1972 to August 1974[1]	22	2,509	1,126	1,383	−55.1	2,441	1,351	1,090	−44.7

[1] Cycle incomplete.

Source: Bureau of the Census, U.S. Department of Commerce, "Construction Reports, Housing Starts," series C20.

TABLE 2.—NEW VERSUS EXISTING APARTMENTS PRO FORMA STATEMENT, INDIANAPOLIS, IND.

Type unit	Square feet	Projects 6–10 years old, monthly rent per unit: Per square foot	Total	Projects 2–5 years old, monthly rent per unit: Per square foot	Total	New projects, monthly rent per unit: Per square foot	Total
(A) Rental income:							
1 bedroom	650	$0.20½	$133.25	$0.23½	$152.50	$0.26½	$172.25
Do	700	.20	140.00	.23	161.00	.26	182.00
Do	750	.19½	146.25	.22½	168.75	.25½	191.25
2 bedrooms	800	.19	152.00	.22	176.00	.25	200.00
Do	850	.18½	157.25	.21½	182.75	.24½	208.25
Do	900	.18	162.00	.21	189.00	.24	216.00
Do	950	.17½	166.25	.20½	194.75	.23½	223.25
Do	1,000	.17	170.00	.20	200.00	.23	230.00
		(Percent)		(Percent)		(Percent)	
(B) Cash flow:							
Average size	900	([1])	([1])	([2])	([2])	([3])	([3])
Vacancy		5	$97	5	$113	5	$130
Operating		40	778	37	839	35	907
Amortization		45	875	48	1,089	50	1,296
New cash flow		10	197	10	227	10	259
(C) Cost to build and return on investment:							
Land costs			[4] 400		[5] 590		[6] 1,000
Development costs			1,500		2,000		2,500
Structures			[7] 9,000		[8] 10,800		[9] 12,600
Total			10,900		13,390		16,100
Constant		8.5	10,300	9	12,000	9.7	13,350
Equity requirements			600		1,390		2,750
Percent return (percent)			32.8		16.3		10.6

[1] $162×12=$1,944.
[2] $189×12=$2,268.
[3] $216×12=$2,592.
[4] $8,000 divided by 20 units.
[5] $10,000 divided by 17 units.
[6] $12,000 divided by 12 units.
[7] 900 square feet at $10.
[8] 900 square feet at $12.
[9] 900 square feet at $14.

TABLE 3.—EXISTING HOMES SOLD, 1963-73, PERCENT CHANGE IN SALES PRICE AND SALES PRICE PER SQUARE FOOT

	FHLBB average	NAR median	FHA 203b sales price median
Period:			
1963-64	6.18		1.62
1964-65	14.29		3.00
1965-66	2.78		0.41
1966-67	8.56	3.14	4.89
1967-68	6.22	3.62	1.79
1968-69	10.55	8.68	3.43
1969-70	6.01	5.69	6.89
1970-71	5.67	7.73	6.01
1971-72	5.36	8.26	3.93
1972-73	5.99	8.41	−5.11
1963-68 (5 years)	43.82		12.20
1968-73 (5 years)	38.28	45.24	15.58
1971-73 (2 years)	11.67	17.37	−1.38
Average annual change:			
1963-68	8.76		2.44
1968-73	7.66	9.05	3.12
1971-73	5.84	8.69	−0.69
1963-73 (10 years):			
Percent change	98.88	[1] 55.22	29.68
1963 price	$17,800	[2] $18,760	$14,076
1973 price	35,400	29,120	18,254
Difference	+17,600	+10,360	+4,178

[1] 1966-73.
[2] 1966.

Source: Federal Home Loan Bank Board, monthly news release, "Average Contract Interest Rates," Department of Economics and Research, National Association of Realtors, "Existing Home Sales Series," Davision of Research and Statistics, Housing Production and Mortgage Credit-FHA, U.S. Department of Housing and Urban Development, "FHA Trends of Home Mortgage Characteristics," series RR: 250.

TABLE 4.—PERCENT CHANGE IN SALES PRICE AND SALES PRICE PER SQUARE FOOT FOR NEW 1-FAMILY HOMES SOLD, 1963-73

	Sales price			Sales price per square foot		
	Census C-25 (median)	FHLBB (average)	FHA 203b (median)	Census C-25	Census C-27 (index)	FHA 203b (median)
Period:						
1963-64	5.00	−1.76	1.91	0.00	1.00	0.95
1964-65	5.82	5.91	3.23	1.14	2.31	1.85
1965-66	7.00	5.98	3.76	4.49	3.65	1.38
1966-67	6.07	5.26	4.94	3.58	3.52	3.87
1967-68	8.81	9.64	4.49	6.23	5.10	4.90
1968-69	3.64	11.14	7.22	6.84	8.00	5.86
1969-70	−8.60	3.80	13.74	1.83	3.34	8.27
1970-71	7.69	2.25	3.98	6.59	4.94	2.58
1971-72	9.52	2.75	3.69	6.18	6.33	4.70
1972-73	18.48	5.09	[1] 1.61	11.11	10.46	[2] 4.60
1963-68 (5 yr)	37.22	27.39	19.68	16.29	16.52	11.44
1968-72 (5 yr)	32.39	27.69	35.00	36.81	38.68	28.75
1971-73 (2 yr)	29.76	8.00	4.93	17.98	18.30	9.51
Annual average change:						
1963-68	7.44	5.48	3.94	3.26	3.30	2.29
1968-73	6.48	5.54	7.00	7.36	7.74	5.75
1971-73	14.83	4.00	2.47	8.99	9.15	4.76
1963-73 (10 yr):						
Percent change	81.67	62.66	59.74	59.09	60.42	43.48
1963	$18,000	$24,100	$15,400	$13.20	$90.20	$13.64
1973	32,700	[3] 39,200	24,600	21.00	144.70	19.57
Difference	+14,700	+15,100	+9,200	+7.80	+54.50	+5.93

[1] 4th quarter 1972 to 4th quarter 1973.
[2] 3d quarter 1972 to 3d quarter 1973.
[3] Adjusted to make series comparable.

Source: Bureau of the Census, U.S. Department of Commerce, (1) "New 1-Family Homes Sold and for Sale," series C-25, (2) "Price Index of New 1-Family Houses Sold," series C-27; Federal Home Loan Bank Board, monthly news release entitled "Average Contract Interest Rates;" Division of Research and Statistics, Housing Production and Mortgage Credit—FHA, U.S. Department of Housing and Urban Development, "FHA Trends of Home Mortgage Characteristics," series RR: 250.

TABLE 5.—SHARE OF MAJOR COST ITEMS; TYPICAL SINGLE FAMILY DETACHED HOUSES

Item	1969		1974	
	Percent	Dollars	Percent	Dollars
TABLE I				
(a) Land	22	$5,630	25	$8,950
(b) Financing	7	1,790	10	3,580
(c) Overhead and profit	13	3,330	12	4,300
(d) Other	4	1,020	5	1,790
(e) Hard cost, total	54	13,830	48	17,180
(f) Labor	17	4,430	15	5,370
(g) Material	37	9,400	33	11,810
(h) Total	100	25,600	100	35,800

TABLE II

	1969		1974	
	Percent	Dollars	Percent	Dollars
Hard cost, total	100	$13,830	100	$17,180
Labor	32	4,430	32	5,500
Material	68	9,400	68	11,680

Source: Bureau of the Census, U.S. Department of Commerce, "New One Family Homes Sold and For Sale", series C25, May 1974; Michael Sumichrast, "Long Term Cost Relationship of Land, On-Site Labor, and Materials" (unpublished paper prepared for National Association of Home Builders, April 1973).

TABLE 6.—MONTHLY HOUSING EXPENSE AND ELIGIBLE INCOME LEVELS, NEW HOME MORTGAGES

	FHA financed, 9-percent rate	Conventionally financed	
		9-percent rate	10-percent rate
Median sales price (1st quarter 1974)	$24,700	$36,100	$36,100
Monthly payment to principal and interest	185.07	269.55	293.99
Mortgage insurance premium [1]	9.68	14.15	14.15
Real estate taxes and insurance [2]	43.08	62.96	62.96
Total mortgage payment	237.83	346.66	371.10
All other housing expense [3]	50.00	50.00	50.00
Total monthly housing cost	287.83	396.66	421.10
Minimum income to qualify (total mortgage payment times 5 times 12)	$14,269.80	$20,799.60	$22,266.00
Length of loan (years)	30	30	30
Loan-to-value ratio	92.7	92.7	92.7
Loan amount	$23,000	$33,500	$33,500

[1] 0.0392 times sales price of house; based on FHA 203b data, 4th quarter 1973.
[2] 0.1744 times sales price of house; based on FHA 203b data, 4th quarter 1973.
[3] Heating and utilities and maintenance and repairs FHA 203g, 4th quarter 1973.

Note: Median family income 1973: $12,050.

Source: Bureau of the Census, U.S. Department of Commerce, (1) "Money Income in 1973 of Families and Persons in the United States," series P-60, No. 93, (2) "New 1-Family Homes Sold and For-Sale," series C-25, March 1974; Division of Research and Statistics, Housing Production and Mortgage Credit-FHA, U.S. Department of Housing and Urban Development, "FHA Trends of Home Mortgage Characteristics", series RR:250, 4th quarter 1973; Financial Publishing Co., "Financial Monthly Mortgage Payments Handbook"; NAHB Economics Department.

TABLE 7.—PRICE OF NEW HOUSING AND GS-11 SALARY CHANGES, 1971 TO 1974, WASHINGTON, D.C. SMSA

	1971	1974	1971–74 change Dollars	1971–74 change Percent
Purchase price	$32,000	$45,750	$13,750	43.0
Downpayment (10 percent)	$3,200	$4,575	1,375	43.0
Mortgage amount	$28,800	$41,175	12,375	43.0
Length of mortgage	30	30	0	0.0
FHA interest rate	7.00	9.50		
Monthly payment to principal and interest	$192.94	$344.76	151.82	78.7
Government worker salary (GS-11)	$12,615	$14,671	2,056	16.3
Loan allowed, based on 2.3 times annual salary	$29,014	$33,743	4,729	16.3
Loan needed	$28,800	$41,175		43.0
Deficiency	0	$7,432		

Source: Kenneth Leventhal & Company (Los Angeles, Washington, D.C.); "Financial Monthly Mortgage Payments Handbook" (Financial Publishing Company, Boston, 1971) publication No. 58.

TABLE 8.—INCOME AND HOUSING AND OTHER EXPENSE, 1973–74

	1973	1974 (estimate)	Percent change 1973–74
Median income	$12,050	$12,821	6.4
Median sales price new homes sold (June)	$33,100	$35,500	7.3
Average loan-to-value ratio (July)	78.1	75.3	−3.6
Downpayment	$7,249	$8,768	21.0
Mortgage amount	$25,851	$26,732	3.4
Average length of mortgage	27.2	26.5	−2.6
FHA interest rate	8.50	9.50	
Monthly payment to principal and interest	$204.99	$231.76	13.1
Median monthly real estate tax (2d quarter)	$35.00	$39.35	12.4
Mortgage insurance premium, etc. (2d quarter)	$12.70	$14.37	13.1
Total mortgage payment (estimate)	$252.69	$285.48	13.0
Other monthly housing expense (2d quarter):			
Heating and utilities	$32.00	$34.00	6.3
Maintenance and repair	$17.00	$18.00	5.9
Total	$49.00	$52.00	6.1
Total monthly housing expense	$301.69	$337.48	11.9
Other monthly fixed obligations (other monthly recurring charges)	$390.00	$452.00	15.9
Total monthly fixed expense	$691.69	$789.48	14.1
Monthly income (median family income divided by 12)	$1,004.17	$1,068.41	6.4
Total monthly fixed expense as percentage of income	68.9	73.9	

Sources: 1. Bureau of the Census, U.S. Department of Commerce, Consumer Income," Money Income in 1973 of Families and Persons in the United States", series P60; 1974 income estimate based on Bureau of Labor Statistics, U.S. Department of Labor, news release entitled, "White Collar Salaries Rise 6.4 Percent," #USDL 74-420; 2. Sales Price: Bureau of the Census, U.S. Department of Commerce, "New One-Family Homes Sold and For Sale", series C25, June 1974; 3. Loan-to-value ratio and length of mortgage: Office of Economic Research, Federal Home Loan Bank Board, monthly news release entitled, "Interest Rates on Conventional Home Mortgages,"; downpayment and mortgage amount derived from loan-to-value ratio; 4. monthly payment to principal and interest: "Financial Monthly Mortgage Payments Handbook" (Financial Publishing Company, Boston, Mass., 1971), publication no 58; 5. Real Estate tax, heating and utilities, maintenance and repairs and other fixed obligations: Division of Research and Statistics, Housing Production and Mortgage Credit-FHA, U.S. Department of Housing and Urban Development, "FHA Trends of Home Mortgage Characteristics", series RR:250.

TABLE 9.—1973 MEDIAN FAMILY INCOME AND INCOME NEEDED TO BUY FHA FINANCED AND CONVENTIONALLY FINANCED NEW HOMES

FHA median sales price:	
First quarter 1974	$24,700
Income needed to buy [1]	13,699
Conventional median sales price:	
First quarter 1974	36,100
Income needed to buy [1]	19,759
Median family income, 1973	12,050

[1] Based on median annual income requirement to buy a new FHA 203b home, fourth quarter 1973: 1.827 years of income.

Source: Bureau of the Census, U.S. Department of Commerce, (1) "Money Income in 1973 of Families and Persons in the United States", Series P-60, (2) "New One-Family Homes Sold and For-Sale", Series C-25, March 1974; Division of Research and Statistics, Housing Production and Mortgage Credit-FHA, U.S. Department of Housing and Urban Development, "FHA Trends of Home Mortgage Characterstics", Series RR:250, fourth quarter, 1973.

TABLE 10.—HOLDINGS OF TOTAL CONSTRUCTION LOANS AND LAND AND DEVELOPMENT LOANS

[In millions of dollars]

Institution	End of second quarter 1974		End of third quarter 1973
	Dollars	Percent Distribution	
Commercial banks	$21,391	37.3	$19,983
Mutual savings banks	1,519	2.6	1,610
Savings and loan associations	12,749	22.2	13,670
Life insurance companies	763	1.3	719
Private noninsured pension funds	28	(1)	27
Mortgage companies	6,946	12.0	NA
REIT's	12,452	21.6	11,363
State and local retirement funds	60	.1	33
Federal credit agencies	63	.1	90
GNMA pools, FHD blocks			
State and local credit agencies	1,537	2.7	1,116
Total all	57,508	100.0	48,613

NA Not available.
[1] Less than 0.1 percent.

Source: Office of Economic Analysis, Assistant Secretary for Policy Development and Research, U.S. Department of Housing and Urban Development, "Residential Mortgage Lending Activity".

TABLE 11.—TOTAL MORTGAGE CREDIT BORROWED AND ADVANCED, 1968–74 [1]

[In billions of dollars]

	1968	1969	1970	1971	1972	1973	1973 1st half	1973 2d half	1974 1st half
Total demand (borrowed)	$27.4	$27.8	$26.4	$48.9	$68.8	$71.9	$37.1	$34.8	$30.6
Savings institutions	0.2	(3)	0.6	2.0	1.2	−1.5	0.6	−2.1	0.4
U.S. Government	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1	−0.4	0.3	
Private nonfincial	27.3	27.9	25.8	47.0	67.3	73.2	36.3	36.9	30.1
Households	14.9	16.2	12.5	24.5	38.4	44.2	22.1	22.1	19.4
Nonprofit	1.1	1.3	1.4	1.4	1.4	1.4	0.7	0.7	0.7
Business	11.3	10.4	12.0	21.0	27.4	27.6	13.5	14.1	10.1
Farms	2.1	1.9	1.8	2.0	2.6	4.4	2.3	2.1	2.3
Nonfarm noncorporate	3.4	3.7	4.9	7.8	9.2	7.1	3.7	3.4	2.6
Corporate	5.8	4.8	5.3	11.2	15.6	16.1	7.5	8.6	5.2
REIT's	0.2	0.2	0.1	0.1	0.5	0.3	0.3	0.1	0.1
Total supply (advanced)	27.4	27.8	26.4	48.9	68.8	71.9	37.1	34.8	30.6
Households	1.8	2.0	2.2	2.4	−1.8	0.5	−0.3	0.8	0.6
State and local governments	0.1	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
U.S. Government	1.1	0.7	0.3	(3)	−0.2	−0.6	−1.2	0.6	−0.1
Federaly sponsored agencies	2.2	4.5	5.8	6.3	6.7	10.4	4.4	6.0	6.8
Private financial institutions	22.3	20.7	18.0	40.1	64.2	61.6	34.2	27.4	23.3
Commercial banks	6.7	5.4	2.5	9.9	16.8	19.8	9.8	10.0	6.9
Savings institutions	12.2	12.2	12.1	28.1	37.7	32.6	20.5	12.1	13.3
Savings and loans	9.4	9.5	10.2	24.2	31.9	26.9	17.4	9.5	11.7
Mutual savings banks	2.8	2.7	1.8	3.9	5.6	5.7	3.1	2.6	1.6
Credit unions	(3)	(3)	0.1	0.1	0.2	(3)	(3)	(3)	(3)
Insurance	2.8	2.8	3.3	0.9	0.8	3.4	0.4	3.0	1.6
Life insurance companies	2.5	2.1	2.3	1.2	1.8	3.9	0.6	3.3	1.9
Private pension funds	(3)	0.1	0.1	−0.6	−0.7	−0.3	−0.2	−0.1	−0.4
State and local governments	0.4	0.6	0.8	0.3	−0.3	−0.1	0.1	−0.2	0.1
Other insurance	(3)	(3)	(3)	0.1	(3)	(3)	(3)	(3)	0.1
Finance companies	0.6	0.3	0.1	1.1	4.1	1.4	1.1	0.3	0.2
REIT's [2]				2.5	4.9	4.5	2.4	2.1	1.2

[1] Net mortgage credit including construction and permanent mortgages.
[2] Real estate investment trusts.
[3] Less than $100 million.

Note: Details may not add to totals because of rounding.

Source: Federal Reserve Board, "Flow of Funds Unadjusted, Second Quarter 1974".

Senator BENTSEN. Mr. Powell, please proceed.

STATEMENT OF REED M. POWELL, CHAIRMAN-ELECT, NATIONAL ADVISORY COUNCIL OF THE SMALL BUSINESS ADMINISTRATION

Mr. POWELL. Thank you.

Good morning, Senator Bentsen.

I would like to thank you for this invitation to appear before your committee today to testify relative to current conditions, problems, and opporunities for alleviating inflationary pressures through constructive actions on behalf of the small business sector of the economy.

A word about my background in regard to this testimony may be of interest to you. I have been an active volunteer worker in the small business sector for more than 15 years.

During 1967–69 I served as a member of the Advisory Council to the U.S. Senate Select Committee for Small Business and have been a member of the National Advisory Council to the Small Business Administration since 1971.

Last year I chaired the Policy and Resolutions Committee of the Council and effective May 31 of this year I became Chairman of the Council.

In this capacity I am responsible for providing leadership for approximately 2,000 members serving on district and local small business advisory councils in the 50 States, Puerto Rico, and Guam and for directing the activities of the more than 100-member National Advisory Council, some of whom are from your own State of Texas, and I am sure you know them.

In the following comments I will attempt to draw upon this experience base as well as upon the reactions of the various members of the National Advisory Council and of leaders of small and large business in different parts of the country who have shared their thoughts and problems with me.

I did a survey of the various people in those sectors of the country with whom I was acquainted, personally and through other people, and I did a survey of the National Avisory Council membership to pull together their feelings and comments so that I can present these today. However, my comments should not be construed as necessarily representing the reactions of those in the Small Business Administration.

If anyone doubts that the small businessman is the backbone of the American economy, he should be reminded that:

There are over 10 million small businesses in the United States—that is, before the bankruptcies started.

Over 4 million of these employ others besides family members.

More than 95 percent of all American businesses are small business concerns.

Approximately 40 percent of the Nation's GNP and one-half of the nonfarm labor force are attributable to small business.

Moreover, it should be remembered that every individual and every large business deals with many small businesses. The financial difficulties of these small businesses materially affect them.

However, the impact of the small business community upon the national economy is not limited to economics. The feelings and reactions of the small businessman are woven deep into the interpersonal fabric of the country. His impact upon the Nation's attitudes and

productive capacity is such that no program to combat inflation can succeed unless it considers his problems and elicits his support.

And I would like to talk for a moment about the current condition of small businessmen in today's inflation-recession environment.

It is generally recognized by economists and others that:

In periods of inflation, small businesses get hit especially hard.

In periods of recession, small businesses receive an extra heavy blow.

Therefore, in today's "stagflation" condition, as defined by the economists, the small businessman is in double jeopardy. Let's look at some examples as to what happens to him under stagflation conditions.

His high costs must be immediately passed on to others in order for him to survive. He has no real monetary cushion or time cushion.

He is the first to feel the credit crunch.

The interest rates he must pay escalate faster. In good times he may be lucky and pay only one point over prime. In hard times he may be required to pay from three to five points above the prime rate.

He is the least able to delay payments when receivables are delivered to him.

Usury laws prevent him from charging credit customers the same high rate of interest he may have to pay the bank. And in this regard, interest on monthly installment loans may be limited to 12 percent while he may have to pay considerably more to the bank. He must pass the difference on in the sale price in order to survive.

Personally collateralized loans are common. A drastic decline in the stock market may wipe out his line of credit.

The small businessman pays an extra penalty because of his size. He doesn't have the necessary flexibility, size, materials, money, or managerial assistance to compete on equal terms with his big business counterpart.

Specifically, the small businessman is hurt in the present economic situation because of the:

Tightness of money.

Cost of money.

Lack of opportunity to cash in—that is, there is no public market for his stock.

Additionally, those small business concerns doing business with the Government have fixed-price contract problems. Under the current inflationary conditions these companies are caught in the middle—unable to pass on the unexpected increases, and then they are oftentimes unable to justify a proper escalation rate on new contracts.

As if the above factors were not enough, the small businessman is faced with the untimely arrival on the scene of the zealous Environment Protection Agency—EPA—and the Occupational Safety and Health Act—OSHA—representatives. It's not that their goals are bad or that the small businessman is resistive to making adjustments. Rather it's the "do it yesterday," overwhelming demands that the EPA and OSHA representatives make which create impossible circumstances for the small businessman.

One informant gave an example of the outcome of this type of sudden and dramatic demand for change. He reported that "one direct result of OSHA and EPA demands is the complete chaos in the iron and steel foundry business today. Many foundries have simply gone

out of business in the face of dictatorial edicts by these agencies. The result is that it now takes up to 2 years to get some castings which were previously available in a few days or in stock."

I would like to talk for a moment about some of the financial needs and recommendations for small business.

The financial needs of the small businessman grow and the available funds shrink as we suffer "stagflation"—super inflation, high interest rates and business recession. As prices go up, more capital is needed; and the small businessman cannot get it; or if he can, he has to pay extremely high interest rates. Customers take longer to pay and suppliers put the small businessman on c.o.d.

Bankers, facing a scarcity of money to lend, may feel a pressure to favor their larger and more established customers and leave the small businessman out. Venture capitalists are reluctant to risk financing small business when they can get 12 percent or more on short-term bank certificates of deposit. The stock market has dried up as a source of equity financing for the new or growing small business.

Innovation and increased productivity has been the only sure cure for inflation and both are stifled without financing for small business.

The most significant cost reductions from increased productivity during the last 10 years have come in the electronics industry as a result of the burgeoning entrepreneurship of a myriad of small—or once small—companies. A $10,000 calculating machine of 10 years ago is far outperformed by hand-held electronic calculators selling for less than $100 and available from many suppliers. This is because some people had the vision, ability, and financing to start once-small businesses like National Semi-Conductor, Litronics, and Intel.

The electronic innovations of small business suppliers to the television industry has improved and contributed to keeping the cost of color television sets constant over the last decade, while the price of other products less subject to innovation has been increasing dramatically and the consumer price index has gone up over 50 percent.

The encouragement of small business, and particularly newly started businesses, holds great promise for stopping stagflation, providing full employment, providing a higher standard of living, and offering technological solutions to the energy shortage.

A three-point legislative-financial program is recommended to head this country toward a more sound economy through stimulation of productivity increases in small business. This program has the advantage that it can be quickly implemented within existing governmental agencies and the commercial banking community.

The first point involves expansion of the successful Small Business Administration guaranteed loan program. The second encourages investment in the startup and growth of productive and competitive small business enterprises. The third involves favorable tax treatment for reinvestment of profits in growth of small business.

Let's talk about point 1 for a moment. The Small Business Administration loan program can be very effectively expanded with the aid of new legislation. Suggestions for expansion of this program have come from many of the members of the National Advisory Council. These suggestions are as follows:

One, increase the present $6 billion ceiling for SBA guaranteed bank loans.

Two, increase the size of the SBA staff to provide more field representatives and other specialized talent to rapidly handle a larger loan volume.

Three, increase the maximum SBA guaranteed loan from $350,000 to $500,000 in line with price changes in the economy which have occurred since the lower ceiling was established.

Four, raise the "contractor's line of credit" guarantee for small businesses bidding against large ones from the current $150,000 limit to $250,000 in recognition of cost increases since the initial ceiling was established.

Five, authorize Government funds for "immediate participation" SBA loans. If the Government provides funds for its 75-percent share, cash-short banks will be motivated to make these loans with their own 25-percent direct participation.

Six, establish a federally sponsored secondary money market for the insured portion of SBA guaranteed loans similar to the Federal National Mortgage Association program for Government-insured home mortgages.

The establishment of a secondary money market, with daily available quotations, and readily identifiable buyers and sellers for the Government guaranteed portion of SBA loans, will encourage more banks to participate in the SBA loan problem because of the ready marketability of these loans in the secondary market.

The combination of the above six changes will serve to encourage the spirit of free enterprise and can be administered through the competent hands of the Small Business Administration and the commercial banking community. Such an approach can yield quick and positive economic results while avoiding excesses or business failures because it remains in the hands of the SBA and conservative banking communities with their established success records.

Point 2. The second part of the legislation-financial program is a tax incentive plan to encourage more equity investment in small business. IRS regulation 1244 permits investors to write off their investments in a small business as an ordinary loss in that business fails. Why not also encourage investment in success? Permit one-half of an investment in a small business to be used as an ordinary tax deduction in the year in which it is made. Recapture it later as a capital gain when the investment is sold.

The above approach can also be used for employment stimulation by making the tax deduction available only in the year that the investment results in additional employment. This will stimulate equity investment in small businesses and also encourage bank financing, particularly via SBA loans, to the same enterprises because of more favorable debt/equity ratios which appeal to the conservative banking community.

Point 3. The third part of the program is one of providing small businesses with a greater capability for growth through use of their own earnings via the means of appropriate tax incentives. It is suggested that the corporate tax surcharge exemption be raised from $25,000 to $100,000, thus moving the point of 48 percent taxation up from the base established many years ago to one consistent with today's price index.

Raising the corporate tax surcharge exemption would have little impact on total tax revenues from large corporations but would cer-

tainly greatly aid the small business in financing productivity and increasing growth. Another worthwhile small business tax incentive would be to raise the depreciation allowance for equipment, on which 20 percent first year depreciation is allowed, from $10,000 to $100,000.

This three-point program, containing the above recommendations, has been carefully developed through the contributions of many of the business and banking leaders who are members of the National Advisory Council. It is recognized that financial stimulation of business may be questioned as a means of controlling inflation. On careful analysis of the position of even the most constraint-oriented economists, however, the encouraging of small business growth to increase productivity and reduce prices through competition is recognized as a needed goal. It is respectfully suggested that the threefold plan proposed here creates the necessary financial stimulation for small business without fanning the fires of inflation.

One other point needs to be mentioned, I think—the management assistance needs of small businessmen.

One of the things learned in the Government's program for helping small businessmen is that a bank loan is not enough.

None of us would take an individual out to an expensive, complex airplane and tell him to fly it without first seeing that he had proper instruction. Yet, over the years, businessmen who have had little or no real training in the business side of business have been granted loans.

Professionals like doctors and dentists, because of their high incomes and noncompetitive situations, can often proceed through their careers without bankruptcy. However, many other small businessmen are not so fortunate. They get a loan, work harder than they have ever worked in their lives, and then discover that they're going under.

Their deficiencies in the managerial and accounting areas have compromised their brilliant, innovative technological ideas and their willingness to work. Their dreams of entrepreneurial success turn into nightmares.

The SCORE program, utilizing the consultative services of retired executives, has been a real help to many.

The small business institute program, allowing university students access to live case studies, has provided meaningful learning experiences for the students and new ideas and oportunities for the businessmen involved.

However, these are not enough. What is needed is an integrated, continuing program of managerial assistance designed to aid small businessmen toward optimizing the productive capacities of their organizations, to fully employ their human resources, and to become managerially more competitive with their large business counterparts.

As a university professor and administrator and also as a small businessman, I have noted the increasing desire among students to be able to consider small business as a viable career alternative.

Yet, the paths to the future lead them consistently into larger organizations, denying both themselves and small business firms the freshness of trying out their new ideas and the application of their up-to-date knowledge of business methods and procedures.

From the standpoint of utilizing people in ways meaningful to themselves and as a major factor providing for the productive growth

and continuing innovative contributions of small businesses two programs are strongly recommended. These should be considered as additional elements of a meaningful assistance program which, when considered together with SCORE and the SBI programs, can provide the small businessman with the expertise he needs.

The first suggestion or recommendation is a minority group career opportunity center program.

While this program would place emphasis upon assisting minority group students because of their very real needs, in reality it would help all those desiring to make an effective transition into a small business career.

Emphasizing coordinated counseling throughout the period of their studies, combining this with an internship program in small businesses, followed by job placement, this program would interrelate the university, the government and the small business community in a meaningful partnership for individual, organizational and national growth. And this does not exist in our universities.

Nonbureaucratic in design, practical in its orientation, purposeful in its goals, the program will aid in turning the frustrated, unused potential of many young people into a dynamic thrust force, fulfilling personal needs and providing new human resources capital in the small business community.

The second suggestion or recommendation is managerial training and development program for small businessmen.

The emphasis of this program is upon utilizing the best resources of the university in providing for continuing knowledge and skills-updating as well as new career growth opportunities for practicing small businessmen at all stages of their careers.

Universities have been engaged in this process for a long time with large companies. These companies have recognized the need and have had the resources to pay for such programs. However, small businesses have not been able to become effectively involved in these types of efforts due to size and resource limitations.

This program is also nonbureaucratic in nature. It would be designed to meet needs of small businessmen when and where they occur and to provide, on a continuing basis, the managerial and professional sharpness required for small businessmen to compete and be optimally productive.

I thank you, Senator Bentsen, for this opportunity to present these views on behalf of myself and the many interested people who have contributed to these suggestions.

If Congress, in its wisdom, sees fit to explore further and ultimately implement these suggestions, I believe the small business community will be aided materially in its struggle for survival and that it will become one of the most meaningful forces in the nation's war against the current inflationary-recession condition.

One verbal comment in addition. I was a participant in the domestic economic summit meetings last week, and listened very carefully to what was said. The only person I noted representing the small business sector of the economy other than myself was Mr. Jerry Jones. Mr. Jones noted that 99 percent of minority group enterprises are small businesses.

There was a sincere interest expressed in those meetings in dealing with inflationary problems. A management-labor council of eight big businessmen and eight labor union leaders were appointed to the council. Where was the small businessman? The small businessman lives in a different world. He functions in a different environment. His conditions of work are in sharp contrast to that of the large businessman.

I am reminded of the story of the man and his wife who were having marriage problems. Finally they decided to go to a marriage counselor. On the day they were to see the counselor the man's wife said, "you don't need to worry about showing up, I can speak for the both of us."

I think this is the kind of a situation that we are faced with today. The small businessman needs to be heard, he needs to be considered. Somewhere in the councils, the small businessman has to be represented. I would strongly recommend, to the extent that it is appropriate, that this representation be considered and implemented.

Thank you.

Senator BENTSEN. Thank you very much, Mr. Powell. Your statement certainly agrees with the objectives that I think we have and the way to accomplish some of these objectives brings forth a lot of questions. And I hope we can have those answered after the other witnesses testify.

Please proceed, Mr. Jaenke.

STATEMENT OF HON. E. A. JAENKE, GOVERNOR, FARM CREDIT ADMINISTRATION

Mr. JAENKE. Thank you, Senator Bentsen.

My name is Ed Jaenke and I am Governor of the Farm Credit Administration. FCA is an independent Federal agency responsible for supervising and regulating in the public interest a nationwide network of farmer-owner credit institutions which are currently lending about $25 billion to agriculture annually. They have about 40 percent of the institutional credit extended to farmers and ranchers.

Perhaps nowhere else in the economy have events changed so rapidly in the past 2 to 3 years as they have in agriculture. No longer can we assume, as most people did in the past, that American agriculture would automatically overproduce the market and that food would be abundant and reasonably priced.

Today, the situation is entirely different. American people are worried about high prices for food and there is great concern over food scarcities in countries which are unable to produce enough to meet their own needs.

Not since World War II has agriculture been in its present position, where farmers are being exhorted to go all out and produce fence row to fence row. Now people are reverting to growing "victory gardens" as a means of supplementing the available supplies.

As we entered the 1974 crop season, the supply-demand balance was tight. Extra plantings and a bountiful harvest were anticipated. But just when we needed her cooperation, Mother Nature let us down. We had a wet spring, a drought this summer, a hurricane that tore up the sugarcane crop, and just last week an early frost hit several

Midwestern States, badly damaging corn, soybean, and canning vegetable crops. It has been a bad year for both farmers and consumers.

What this unfortunate set of circumstances means, of course, is a need for greater production next year. Further translated to the agricultural lending community, the message is clear: Farmers, particularly those who suffered losses this year, will need to use more borrowed capital if they are to increase production.

There is another even more compelling reason why farmers will require additional capital in their organizations next year. And that reason is simply that in many sectors of the agricultural economy earnings are down and many farmers are sustaining significant losses. Dairymen, beef feeders, cow-calf ranchers and poultry raisers are in an economic bind because of high feed costs and lower prices for their products. Farmers in areas hard hit by drought or whose crops were wiped out by frost also will need additional borrowed capital to get going again next spring, and they need to know and be assured now that it will be available.

At the beginning of this year, farm debt totaled $84 billion, an increase of $9 billion from the year before. The Federal Reserve Bank of Chicago recently forecast that this year's increase in farm debt would be about $11 billion. In light of the frost and other recent developments in the agricultural economy, our guess is that this prediction is going to be low.

Although the aggregate debt numbers are large, it is important to recognize that individual farmers have found credit essential. The average Farm Credit System borrower in 1973—a typical commercial farmer—managed farm assets of $350,000 and debts of $130,000. For these borrowers their debt was 37 percent of their assets and 59 percent of their net worth.

The rapidly escalating use of credit in agriculture is attributable in large part simply to inflation. Farmers' production costs have risen dramatically. Production expenses last year totaled $65 billion and current estimates are that they will climb to $76 billion this year.

Farmers are deeply concerned and apprehensive over the inflated costs of production. Just in the past year, for example, the U.S. Department of Agriculture Prices Paid Index reports the price of fertilizer climbed 60 percent, seed up 50 percent, diesel fuel up 70 percent, farm machinery up 15 percent, and farmland up 25 percent. All Americans are familiar with the higher cost of borrowed money—some farmers, for example, are paying twice as much to borrow money in 1974 as they paid for interest last year.

Other factors in the rising use of credit in agriculture are the increased size of farms, further specialization among farmers and the adoption of new technology. In such a situation, farmers will continue to substitute capital for labor.

The factors of further specialization and use of new technology also have reversed the historic pattern of the type of credit farmers use. Prior to 1972, real estate debt outstanding always exceeded nonreal estate debt. Now the opposite is true, as farmers increasingly use more short-term credit for operating funds and more intermediate term credit to purchase machinery, equipment, or feeder cattle, and other important items.

One of the troublesome aspects of the change is now evident in the livestock feeding and poultry industry. And I know, Senator, Texas is the leading cattle producer in the country. You are familiar with this and your constituents are.

Senator BENTSEN. I am glad you worked that in.

Mr. JAENKE. Thank you, sir.

High feed prices coupled with lowered live animal prices have reduced farmers receipts, while at the same time their costs and expenses continue to climb. Many are having difficulty generating enough income to live and meet their obligations. And our experience is that many ranchers are coming in now and refinancing with short-term debt because they just can't do it on a long-term basis. For these individuals the problem is one of loss of equity and not of providing colloteral for a loan. And we are going to be hearing more about this in the winter and spring months, because agriculture is a seasonal industry. As farmers come in to get their credit lined up in the coming year, the problems are going to be more than have been experienced up to this point.

Let me give some examples: Earlier this year feeders bought cattle at an average price of about $40 per 100 pounds. To finish the cattle out to proper weight costs about $50 per 100 pounds. Instead of selling at higher prices, cattle sold at prices below both the purchase price and cost of gain. Thus, the more cattle a farmer finished the larger was his loss. Financial leverage was working against him.

What happens to this feeder now in this example is that his current liabilities are exceeding his current assets, thus posing big problems for him and his creditors, who do not want to further erode his savings or foreclose on his operation. This is particularly acute to the farm credit institutions. These are owned by farmers, they are a farm cooperative operation, and they are extremely reluctant to foreclose on borrowers.

Another way to view the problems in the livestock and poultry industries is to examine the livestock-feed ratios—ratios which measure the price of livestock relative to the price of grains used to feed the animals. In all cases—the corn-hog ratio, beef steer-corn price ratio, milk-feed price ratio, broiler-feed price ratio, and egg-feed price ratio—the relationships are at or near historic lows. Never before has the price of feed been as high relative to the price of live animals, poultry, or milk.

Obviously, something has to give. And what is happening is that livestock production is being cut back. We all heard this morning news broadcasts of how ranchers in Texas are finding it advantageous to do away with livestock rather than continuing to feed them and take $100 or $150 losses on them. There are fewer placements of cattle in feedlots at this time. This means that, within a few months, meats will be in short supply and demand will bid up the price again. We are bound to. There are, of course, historic and regular swings in cattle supplies and price. But the difference now is the extent of the swings, which are far greater.

One of the more uncertain aspects of farming today is the business of planning. Adverse weather and unfavorable consumer reactions are but two of the factors that have made markets more volatile in recent years and made the job of planning more difficult.

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Looking at agriculture from a long-range view, we see from agriculture's balance sheet at the beginning of this year that total assets were $478 billion, with farm real estate accounting for more than two-thirds of the total. The debt-to-asset ratio of 17.6 percent was 1.8 percentage points below the ratio of a year earlier. What does this mean? This decrease is due to an astounding 25-percent increase in the value of farm real estate, which gained $65 billion in value in that year. This is fine for the man who already owns it, but for the farmer who needs to expand, to get another 40 or 140 acres to keep his operation efficient, to keep going and keep this business, it is brutal.

Agriculture's debt-to-asset ratio, then, is favorable compared to other industries. When we look at the figures closely, however, there are other conclusions to be drawn. For example, only about one-half of the farmrs in the United States use credit. Many of these, of course, are not what would be considered by any definition commercial farmers. They are weekend farmers, part-time farmers, retired farmers. Thus, they account for only a small portion of the agricultural production, something less than 10 percent. The other half account for over 90 percent. Additionally, of the approximately million farmers who do use credit, we estimate that their debt-to-asset ratio averages about 35 percent. This figure has been slowly rising over the years and will continue to rise this year and in coming years.

Another way to look at the use of credit in agriculture is in terms of capital flow and this addresses the questions that your letter to testify here referred to. In 1973, $21.6 billion of capital flow was utilized by these million farmers.

Of this $21.6 billion, 43 percent, or $9.3 billion, was debt financed. It should be noted that annual capital flow to agriculture last year was the largest ever recorded and it came in a year when farm income was the highest ever realized. I would also like to point out that the percent of the capital flow that was debt financed—43 percent—was nearly four times the level of debt financing that prevailed in the period 1950–54.

There are four primary sources of funds available to farmers: (*a*) Obviously, an increase in debt, (*b*) capital consumption allowances, (*c*) net farm income, and (*d*) nonfarm income. Until the mid-1960's, net farm income was the primary source of funds for farmers and it was not until the 1970's that the percent of annual capital flow realized through debt went over the 40-percent level.

Looking to the future, we can see no let up in the proportion of capital flow which will be debt financed and there is a distinct possibility that the percent could go even higher, while the part financed from net income will be less. Even assuming a slower rate of inflation in future years and a less rapid increase in land prices, the annual capital flow projections remain about $20 billion per year for the remainder of the decade and into the early eighties.

There appears to be a general agreement that inflation is best halted through increased productivity. Certainly, this is true. In listening to my colleagues in the Small Business Administration, I know that the same factors are there. If the million farmers who use credit and who produce nearly all of our food are to achieve required additional efficiencies, it is essential, then, that they have access to adequate amounts of credit and at the appropriate time in their production cycle. It

doesn't do any good for a farmer to get credit in October when he needs it in February or March.

Generally speaking, adequate amounts of credit have been available to agriculture in recent years, although there have been adjustments in the percentages of credit supplied by the various credit institutions. In 1973, for example, commercial banks and the institutions of the farm credit system—the Federal land banks and production credit associations—provided about equal amounts of the annual capital flow for both real estate and nonreal estate purposes, 33 percent for commercial banks and 34 percent for farm credit lenders. Life insurance companies provided about 4 percent. Individuals and miscellaneous lenders provided 23 percent of the real estate credit.

The principal changes in the contributions by the groups from 5 years earlier has been increases by commercial banks and farm credit banks and declines by life insurance companies on real estate loans and declines by merchants and dealers in nonreal estate credit.

Agriculture is recognized among the various industries in the Nation as one in which technology, when put into practice, immediately realizes substantial efficiencies. Farm output per hour, for example, has tripled since the early fifties period. The number of persons supplied farm products by 1 farmworker has risen from 25 in 1960 to 52 in 1972.

One of the principal reasons for this gain is directly attributable to the fact that credit has been available to permit farmers to make use of the new advances in technology. In recent years there has been some concern expressed over the fact that the rate of productivity in agriculture, while still advancing, has slowed. And this is true. The curve has flattened out some.

There are a number of reasons for this occurrence. First, we should recognize that some of the easy and fast advances—hybridization in the grain area, and so forth—have already taken place. Examples are the exodus of a large labor force, the near total adoption of the use of fertilizer and improved cultural practices.

It appears to me that future gains in productivity in agriculture will be both slower and more difficult to achieve. Reasons include the fact that the best of our tillable land is alread in production, the labor-force adjustments have been made, new high-yielding varieties of grains are not on the immediate horizon and available plant nutrients are costly and in short supply.

This is not to say that progress won't be made. Of course, it will. The American system of agriculture, backed up bv a solid network of Government- and private-research facilities, will continue to make substantial progress. There are still avenues open in which to generate efficiencies.

Senator Bentsen, many think of the United States of America as an industrial nation. And we have a right to be proud of the manufacturing and technological sectors of our economy. But agriculture has been, and continues to be, a vital and influential force in the Nation's economy.

Agriculture, in its truest sense, is a growth industry. Now, as a matter of national policy, American farmers are being called upon to produce even more—to feed this country and other countries of the world and to help in our balance-of-payments problem.

I am convinced that our agricultural producers are equal to the task. America's agricultural productivity is unparalleled on this Earth. But if our farmers are to do the job, they need the tools. They need not only the farm machinery, seed, feed, and fertilizers, but they need the capital. A good deal of that capital, as we have indicated, is in the form of credit, some 40 percent.

Capital is the lifeblood of American agriculture. If its flow is cut off or even curtailed, there is no way the economy of the United States can be restored to full health without this basic industry. Adequate credit for agriculture at the lowest possible rates must be given top priority to assure the kind of productivity that will benefit this Nation and its neighbors around the world.

If all lenders do their job in making productive agricultural loans, capital allocation or credit rationing will be unnecessary. So long as the farm credit system has competitive access to the Nation's money and capital markets, farmers will have a dependable source of credit at competitive rates. The farm credit system cannot and should not be expected to carry the full load of financing agriculture. Other lenders must maintain their commitments to agriculture, for it is only through a united effort that needs can be met.

Senator Bentsen, I appreciate this opportunity to present this testimony. Thank you.

Senator BENTSEN. Thank you very much, Mr. Jaenke.

Your statement that the farmers have 40 percent of their capital in credit surprises me; I didn't know it was to that extent.

Mr. Landau, we are pleased to have the background and experience that you bring. You may proceed.

STATEMENT OF RALPH LANDAU, PRESIDENT, HALCON INTERNATIONAL, INC.

Mr. LANDAU. Senator Bentsen, ladies and gentlemen, since I have already submitted my prepared statement in written form prior to today's session of your committee, I will assume that there is no need to go over this in detail, and furthermore, it would take too much time.

It might be worthwhile, however, for the overwhelming number of people in this room who never heard of me to tell them very briefly who I am.

I do not represent any group; unlike some of the previous speakers, I speak solely for myself. I am an entrepreneur. I am not a venture capitalist in that sense of the word. I built a business from scratch in one of the most capital-intensive industries in the United States, the chemical industry. I have been at it for 28 years.

I have a doctor's degree in chemical engineering from the Massachusetts Institute of Technology. I am a member of the governing body of the National Academy of Engineering, and I am a trustee at MIT. Through these various contacts I have lived in the business process and in the entrepreneurial field and in the intellectual world of the university and our engineering profession throughout the country. I am therefore trying in my prepared statement and in my summary of it today to express to you how an active participant in a great deal of the economic and technical processes of this country sees, by a process of inductive reasoning, the way this country has gone,

the kind of problems we all recognize, and the kind of solution we need.

An engineer is trained as a problem solver. Therefore, I can't help but try to look at each of our national problems from the standpoint of: If I were the chief executive officer, what would I do? Thus, some of the things I thought about are contained in my prepared statement.

What I try to say in there could be summarized in reasonably short order as follows: First, as an entrepreneur as well as an engineer who has had continual exposure to the problems facing those who start new enterprises, I am greatly concerned with the change to an adverse climate which faces the entrepreneur today compared with the way matters stood at the end of World War II when I got started. Second, the entrepreneur and the innovator generally are far more important to our commercial industrial society than their mere numbers alone would indicate. History shows conclusively that the small inventor or entrepreneur is responsible for a disproportionately large share of innovation. Large bureaucratic organizations are not geared to doing the really new, and with the problems that our large companies have today just to keep doing what they have been doing,, it is most unlikely that much of a change in this innovation pattern would be forthcoming.

Third, for these reasons and many others, the entrepreneur, specifically the technological entrepreneur, has been and is essential to the welfare of our country, to help solve some of its problems in energy, in pollution, in food production, in housing, et cetera. But his welfare is also linked to the health of our economy generally, because he cannot flourish in a deteriorating climate. Hence, what is bad for industry and commerce and agriculture generally is even worse for the entrepreneur.

Fourth, the greatest problem, then, of such would-be entrepreneurs—and I absolutely agree with the preceding speakers, there are lots of them, you can see them in the universities today—is the increase in governmental regulations and all the associated fallout that are restrictive toward the new. But even more of a problem is the frequency with which changes in the ground rules are occurring for the businessman generally, including especially the entrepreneur who is the most vulnerable. It takes years to get a new enterprise or venture successfully off the ground. Yet when new regulations, tax and accounting changes, laws and litigation, et cetera, keep shifting not only annually, but often much more frequently, it is increasingly impossible to follow an organized game plan.

Fifth, the life blood of America's economic position, as my distinguished predecessor just said a minute ago, is its technological strength, just as it has been for a country like West Germany. We see in that country an example of a pattern we could well emulate. We need less stop and go economic tinkering with more long-range climate regulation, less redtape and regulation, and stronger emphasis on technology, discipline, and hard work, lower taxes on the businessman, and on business generally, and on the investor. I have been in Germany many times, and I know many of the German companies and people, and it is an incredible performance to think that a country which was flat on its back 25 or so years ago, without the

natural resources of this country either in oil or minerals of various kinds, has achieved the remarkable distinction of having foreign reserves twice or more those of the United States, with a population only a third of ours and at this moment is the only country in the industrial world that is running a surplus in its balance of payments. And all of the factors that I have just described lay behind that extraordinary performance.

On the other hand, we see in Britain today the exact opposite pole, a horrible warning to us all. The question we must all ask ourselves is which of these two contrary directions are we going to follow?

Sixth, there are many other obstacles to the success of any entrepreneur in this country, particularly the virtual collapse of our equities market, which is the risk taking capital market, and the terrible strain on our financial resources in a more general way. These are problems even for our largest corporations. We are not saving enough of our gross national product, and we have overconsumed in many areas. All the problems that have been mentioned by the earlier speakers with regard to the lack of capital really come back to the fundamental point that we are discouraging and have discouraged saving, and have over-encouraged consumption, the most important of which is the over-consumption of energy in this country. Hence a shift of emphasis and incentives is needed to encourage savings and investment. This will permit us to deal with our many problems in a more rational way.

Seventh, the interim report of this committee, as well as those of the summit conferences to which reference was made earlier, show how complex indeed are the problems of the most complex society on the face of this Earth, and how diverse are the proposed solutions thereto. We obviously must help the disadvantaged and those most hit by inflation. But we must also work more, we must save more, we must tighten our belts, and a contribution has to be made by everybody. We have to remember that corporations and people are quite different, they have different economic functions, and that when a corporation disappears, there aren't any mourners, but in the end the fallout from lost jobs and lost productivity is more important than would have appeared at the time it went out of existence. The same is true of course for the millions of small enterprises.

Successful companies generate the cash for new jobs and we still have a growing population with more job seekers added every year, and an increased productivity and production are absolutely essential. This can only be obtained from the private sector. The Government gets its money solely from the output of the private sector.

Eighth, therefore, no panacea can possibly help in the short run for the multitude of our problems. It is a definite, rugged, up-hill climb. I have made some suggestions in my written paper, and I am happy to see that some of them have been echoed by the speakers of this morning. However, an immediate attack on our energy, balance of payments, and financial problems would come from a large gasoline tax swiftly imposed and I wrote this in my paper before I heard the rumors going around Washington that this was being considered.

Coupled with this would be a rationing system to limit our oil imports. And to protect the worker and the essential user of gasoline, we should put in a quota system whereby a certain minimum amount of gasoline for such essential uses would be free of such imposed tax.

But everything above such a quota and up to the limit of what this country considers to be allowable imports should be taxed at a very high level per gallon. This would not only reduce our pollution problems, it would provide funds for help to those most hurt by inflation, it would aid in the problems of the small business community and the farmer, and the housing industry, because all of these needs that have been outlined today and last week and the week before at the summit meeting basically call for more capital. We have got to have revenue soon. And it is not going to come by any of the long-range programs that we are talking about. This is where we can get money and shift it from excess of consumption to additional saving. It is later than we think in the energy crisis—and this is a subject I do know a lot about—it is the root cause of our present high rate of inflation, and it is going to get worse if we don't restore the national sense of urgency that we all had last winter.

I am not a politician, and therefore all I can do is to urge the political world to pay close attention to what the underlying realities are down to the grassroots level where, as I think I said in my prepared statement, the worm's eye view prevails. It is you, the political people of the country, who set the ground rules under which the rest of us operate. And we hope you will understand how you influence us in that process.

I am very privileged indeed to be invited to speak here and I might say this is the first time I ever testified before any committee of our Government. I hope the sound of my shaking knees has not been too obvious Thank you.

Senator BENTSEN. Thank you, Mr. Landau, for your testimony. Your prepared statement and attached exhibits will be printed in full in the record.

[The prepared statement, with attached exhibits, of Mr. Landau follows:]

PREPARED STATEMENT OF RALPH LANDAU

In order to qualify my appearance before you today, I would like to say a few words concerning my own entrepreneurial background.

I started my professional career in various large wartime projects, and first learned how large government and private organizations work. Then, as co-founder and President of Halcon International Inc. I have spent 28 years of direct involvement in creation of an industrial enterprise based on new chemical technology. Our work in chemical process research and development, as well as plant design, has resulted in many significant ventures now commercialized in petrochemical plants on a very large scale and on a worldwide basis. We number among our clients such major companies as ICI, DuPont, Bayer, Dow, Monsanto, Standard Oil (of Indiana), and Goodyear, and many others here and abroad. We have contributed significantly by these activities to the improvement of chemical costs, and to increased worldwide competition.

Evolving from a concentration on licensing and design of plants for others, our emphasis in the past decade has been directed toward equity participation in manufacturing ventures based upon our own inventions and developments. The ventures in which we participate are successful from a profit and technical viewpoint and enjoy an excellent reputation in the industry. These too have contributed to improved economics and increased competition. Outside of my business-technical activities. I am a member of the Council of the National Academy of Engineering, a member of the Corporation (trustee) of the Massachusetts Institute of Technology, and vice president of the Society for Chemical Industry, which last year also conferred its well-known Chemical Industry Medal on me. I am also a member of The 1001 Club—A Nature Trust, whose head is Prince Bernhard of the Netherlands, and as a trustee of the American Health Foundation I am concerned with the development of preventive medicine. But I am speaking here only in my individual capacity.

Based on Halcon's own world-wide experiences, I too see the great need for continued growth in productive capacity as a fundamental means of combating the inflation which is sapping the strength of this country and other countries. The entrepreneur, the innovator, the pioneer were never more needed than today, in helping achieve this growth in productive capacity while also improving efficiency and the quality of life. Also, if the entrepreneur vanishes, ten years from now there will be fewer competitors in the market place and even fewer chances to fight inflation by competition.

Further, I will comment on the constraints which limit the ability of the entrepreneur to initiate and enlarge the ventures which are the lifeblood of our technological society.

In these remarks I am adapting certain ideas from an address I gave last year on the occasion of the award of the Chemical Industry Medal, and a copy of this is annexed as Exhibit A hereto.

A. CAPITAL REQUIREMENTS AND AVAILABILITY

The major constraint faced by entrepreneurs and innovators in the chemical industry (and in others) today is the drying up of capital of all kinds. Money is the entrepreneur's major problem—both in getting started and in expanding. He does not usually have the resources available to large corporations. In this inflationary era, it costs more to get started, the size of the first production unit must be bigger in order to be competitive with existing plants, and the risks are greater than ever. Let us examine the state of the available sources of capital:

1. From Sales of Stock.—The equity markets have died insofar as the new company is concerned. For instance, if a small entrepreneurial company decided to raise capital by selling some of its shares to the public today, the result of such a sale would probably realize only 25% of the amount that could have been expected in 1968, and this only if one could find buyers at all, which is very unlikely under today's conditions. Currently, only a handful of new issues is selling at or above their earlier issued price; most are far below. Virtually no new issues are announced these days. Not even large and prominent corporations are offering equities issues, for similar reasons, although some of them might find buyers. Whereas a decade ago the debt-equity ratios for industrial companies were commonly about 1:3, today the ratio is often 3:1. And, over this same period, the nature of the investor in securities has changed similarly; in 1961 the value of all trading on the Big Board originated with individuals, institutions accounting for only 39%. By 1971, these proportions had almost exactly reversed, and institutions accounted for 68% of the value of all trading.

The virtual destruction of confidence of the average investor in stock issues of any kind, coupled with the high interest rates now prevailing, has caused what may soon be irreparable damage to this vital source of capital for the venturer into a new business or product.

2. From Banks and Other Financial Institutions.—Because of the huge demand for loans accelerated by the collapse of the equity markets, and the chronic borrowing by governments, interest rates have shot up, and the demand for such money far exceeds the supply of capital. Where on the totem pole does the would-be entrepreneur come when confronted by competing demands of America's largest corporations, Federal and local governments, etc.? Credit allocation is a very tricky weapon to use in such cases, and involves a possibly dangerous interference with the forces of the marketplace. It is never safe to start a new business on much borrowed capital, as the high risks and difficulties in the early years make repayment uncertain, and the burden of carrying fixed interest oppressive.

3. From Private Wealthy Investors.—These have often been a principal source of venture capital for new enterprises, but with the Wall Street market in such poor shape, and the higher capital gains taxes now in effect, fewer and fewer such risks are worth taking even by very wealthy families, individuals or venture capital firms. Without a healthy equities market, the private investor faces the prospect of his capital being locked into the new enterprise for the foreseeable future without receiving a reward for his patience and risk-taking by selling some or all of his ownership to others when the enterprise is successful. But, if he should be so fortunate as to find such buyers, the current capital gains tax, irrespective of how long he has been willing to wait for any return on his money, is about 40% effectively. Since the return he gets is in depreciated dollars to boot, the longer he waits, the less he gets back in this sense also. Yet, the entre-

preneur needs handholding for quite a few years before his success can be demonstrated. With the incentives and risks going in opposite directions, it is not at all surprising that this important source of capital is disappearing. And, if a capitalist craves equity investment as part of his portfolio, he finds some of America's soundest corporation stocks selling today at 3–5 times earnings, and with good security why take a risk on an untried venture?

4. From Larger Corporations.—In recent years, some corporations have been adopting a policy of assisting entrepreneurs by investing in their enterprises. Now, with even the largest corporations strapped for cash to meet expansion, pollution, safety, and other requirements, such activities are bound to suffer. Large corporations are vital to the entrepreneur—he needs also their raw materials for his plant, he needs them as customers, and as further developers of his products. Their health is vital to his success, as our own history has proved repeatedly. But large companies are not great risk-takers in the entrepreneurial sense—they have too many constraints on them, and they are bureaucratic in outlook for this reason. If we want innovation and new ideas, we must encourage the individual and the small company to take risks which larger organizations do not take. Large corporations are faced with the increasing need for capital to provide buildings, materials and equipment for their own expansion and replacement. As a result of the premium charges on borrowed capital funds, they tend to limit added expenditures to those areas directly related to their present production.

In thinking about the role of large corporations one should never forget that the United States Government takes half of the profits made by large and small corporations, but puts up none of the capital. Hence, the modest tax incentives for entrepreneurial businesses which are government's only investment are repaid many times over to everybody's silent partner. There has been much talk of tax "reform" and tax "loopholes," but, again, the real facts are quite different. Virtually all "loopholes" (or "tax shelters") are tax incentives or deterrents to accomplish some social or economic objective, and "reform" means changing these from time to time. But today our media use it as a code word for "soak the rich," or "the corporations." I have tried to show in these remarks that caiptal formation has received insufficient incentive, and consumption too much incentive, and what I am suggesting herein is not such "reform" but changing the ground rules toward a more efficient society. Government not only gains generally from this; it also gets back more tax revenue from the businessman's and industry's success, and labor gets more jobs and a higher standard of living.

B. OTHER CONSTRAINTS

While money is the single most important problem for the entrepreneur, there are other constraints which increasingly militate against his success. As I stated in my attached speech, his biggest problem is government, and most particularly in the rapidly changing ground rules with which the businessman and entrepreneur are constantly being confronted. Any fledging businessman needs an army of lawyers and accountants just to help him fill out all the forms he is required to prepare; the cost and time for their preparation are a heavy burden on the entrepreneur. Economists must evolve their discipline in the direction of less governmental intervention, fewer stop-start programs, more long-range climate creation. Fine tuning of the economy has been proven to be less than perfect, and we should go on a steadier pace over longer periods of time.

In searching out what other constraints there are, I asked myself the question, "Could we do this over again if we were starting today?" I came to the conclusion that this would be most unlikely, and I would like to quote here a passage from my speech of one year ago, before "double-digit" inflation became a household word. "The reasons for my caution are based on the different climate existing today, as compared with 1946. It is unbelievable how many obstacles to the international technological entrepreneurial enterprise (and to industry generally) now exist because of the heightened role of national governments.

Except for the excess profits tax, all the obstacles (some reasonable, many not) we encountered are still here, and *being added to year by year:* greater restrictions on currency transfers; foreign investment controls; higher taxation in many years; price wage, and profit controls; increased reporting and bureaucratic procedures; increasing ecological restraints; anti-trust and consumerist legislation; political restrictions on imports and exports; and others. It takes many more lawyers and accountants to stay out of trouble, and litigation

consciousness is much greater than ever. Inflation has arisen at unprecedented rates. Resources and energy limitations are becoming very restrictive of economic growth. Non-governmental organizations of all sizes, all over the world, are more and more subject to governmental regulations, frequently changing, and politically unpredictable. Incentives are increasingly chipped away, including raising capital gains taxes, reducing the attractiveness of stock options, reducing depletion allowances in many areas—in short, the formation of capital is constantly undergoing erosion while government's spending increases steadily. As a result of these and other forces, the profitability of industry has declined materially since World War II, and the willingness and ability to take risks has been reduced accordingly. Why take risks if the rewards are less than the penalties? With this has come the unwillingness of the securities markets to take similar risks."

It should be clear that my whole experience suggests the conclusion that the only decent hope for mankind is for more and better innovation—technological, educational, economic and social—but in the direction of less government, less oppression, more freedom, more decentralization of decision and judgment making, and especially of risk-taking. We all accept that each society has the basic political right to set the ground rules and establish the priorities under which its citizens can work, but it must be based on a greater historical and practical understanding of the limits within which successful results can be obtained. Above all, governments should stop changing so rapidly the ground rules under which business operates. Innovation takes years to accomplish; businessmen and entrepreneurs cannot take risks if the rules change frequently in mid-stream. A quotation from Herr Schmidt, the West German Chancellor, is particularly apt: "Despite our abstention from controlling prices and wages, we have the smallest price increases. The whole of our economy is more adjusted to respond to market forces than to regulations . . . This is said by a Social Democrat . . . The deeper you get into regulations the deeper you get into red tape and the more you hamper the dynamic development of your economy." (See Exhibit B.) The contrary British experience is an object lesson of another kind to us.

It is in my opinion more important to recognize the deadening hand of bureaucratic restraints and rapid shifting of ground rules than it is to ask for any particularly new incentives or legislation. However, from my experiences in the business world (where economists, politicians, and financial people seldom immerse themselves, and therefore cannot really grasp how the objects of their laws and practices actually are affected by their actions, and what their reactions will be), I would like to make some suggestions which certainly could improve the capital availability situation for the entrepreneur, and for business in general, since the health of each is very much interwoven.

1. The restoration of a healthy equities market on Wall Street ranks as a vital priority for our country, which for the first time in its history faces a shortage of capital to cope with all the needs and desires of its people. Much attention should be given to improving the rules and behavior of large financial institutions vis-a-vis the purchase and sale of securities, but this is not a subject on which I can pretend to have any expert knowledge. In addition, it is obvious that a reduction or elimination of governmental deficits (which can be achieved by various methods) will shrink the competition for capital between government and private industry, and lead to a lowering of interest rates. This in turn will make equities look like better investments, and we must never forget that equities and risk go together. But one very worthwhile legislative change would be to make dividends up to some reasonable limit tax free.

The burden of the double tax on corporate profits would thus be lifted for the smaller investor to whom dividends are essential, even more than capital appreciation. Professor Peter Drucker, in his "Age of Discontinuity," discussed this matter in much greater depth, and while I do not share all his ideas, he is a very innovative man on the economic-business scene, and is worth listening to.

2. The large private investor will in no way be tempted back to risk taking unless something substantial is done to reduce the capital gains tax. As I pointed our earlier, such investors have to be patient, and take great risks. The longer they hold on, the less their capital gain tax should be. This is so obvious that it is difficult to understand why so little has been done in this direction. It is a mistake to equate lower capital gains taxes with income taxes in any way.

They serve different purposes, and I am entirely willing to see the income tax on individuals adjusted in accordance with society's ideas as to equity—such

as lowering individual taxes for the poor, and somewhat raising them for the rich. (But for this latter category, the difference between earned and unearned income should be eliminated, and a maximum of about 60% imposed. We cannot go higher or an important source of risk capital will begin to disappear, and the manager of a company will lose incentive to improve his position if he pays so much incremental tax. The attached Exhibit C from "The Economist" shows the value of this incremental tax in Europe, and again the lesson is clear.)

In all of these suggestions I have tried to keep in mind that a better balance between consumption and investment is needed in our country in order to reduce the long-range impact of inflation and to provide us with the resumption of economic growth. In this regard, the fundamental fallacy of equating increases in wages or salaries with increased profits should be clear to any person who studies the workings of our economic system. A very small part of the recently somewhat improved corporate earnings has gone into dividend payments to individuals and because of the double taxation very little winds up in the hands of the stockholders.

The bulk of corporate cash flow is used for reinvestment or reduction of debt, and to that extent does not directly contribute to increasing consumption of consumer goods. Increases in wages that go beyond the national ability to increase productivity simply mean a forced redistribution of income to those individuals able to exert clout from those individuals less able to defend themselves. In fact, wage earners themselves must be made to understand that this process has not truly helped their real standard of living grow very much, because of the concomitant inflation it causes. A corporation is not an individual, and its entire economic role is completely different. As The Wall Street Journal points out in its article attached as Exhibit D, government deficits also have contributed to the increase in consumption patterns and to the rise in inflation.

But the capital gains tax reduction is a vital necessity for capital formation and risk taking by entrepreneurs. I am not talking about helping Wall Street trading here, but of making risk-taking investments attractive enough. Otherwise, the entrepreneur may be tempted to sell his whole company out prematurely to a larger listed company, and so another entrepreneur's business disappears.

It is interesting to note that West Germany does not have long-term capital gains taxes, nor Holland. The "socialistic" Scandinavian governments waive taxes on gains after assets have been held for five years. Only Britain, which, as The Wall Street Journal says, "remains intent on bankrupting itself," follows the U.S. example of steep taxes on capital. Again, the experiences of others can teach us to avoid their mistakes. Are we more likely to follow the German or the British pattern? Another aspect of this problem is the treatment of capital losses, a possibility very frequently encountered by venture capitalists. The taxation of these should be liberalized to help induce more such capital to be risked in new enterprises, or in expansions of such companies.

3. As I mentioned above, corporations are going to be strained to provide the cash needs of the private sector. One tool that can be made available to them to assist in risk-taking and new investment and which will in the long run increase the government's income by participation in company profits is to permit total flexibility as to the time period over which the investor may take depreciation of his new investment. This is a system used in other countries, and it certainly would assist the assumption of larger risks in individual cases, such as in entrepreneurial organizations. It permits each manager or investor to draw up his own rules of the game, and as such it is a tool which would be valuable in shifting more capital immediately into the private sector where it is badly needed and from which most of the increase in productivity in this country is to be expected in the forthcoming years.

4. Stock options for corporate managers should be made attractive once more, and the negative effects of the Revenue Act of 1969 eliminated. This is particularly applicable to the small entrepreneur who has to use the stock option to attract skilled help from larger companies who generally can afford to give greater security and higher wages to such people. The combination of the reduced ceiling on earned income contained in the Revenue Act of '69 and the elimination of stock options has led to the predictable result (although it is by no means a straight cause and effect), namely that corporate salaries in the higher executive brackets have risen sharply while at the same time the value of the stock of their company has been declining more sharply. The stock option represents a real way for entrepreneurs and business managers to have a stake

in their company without having a large amount of capital at their disposal, and it seems to me that this is a vital aid in improving the performance of industrial enterprises as well as assuring a greater interest by the public in the equities market.

5. Much has been said in the press and in recent discussions about the high cost of pollution and the quality of life. As an engineer and businessman, I can certainly confirm that the sharp change in society's demands that has taken place in the last few years in this regard has confronted business both large and small with an unusually heavy burden coming on top of the needs for more production capacity in many industries. My own interests in conservation and preservation of the quality of life are as great as anybody's, and I certainly approve of the national goals in this direction. The problem, however, is that the pendulum swung too far the other way in legislation which was passed at the height of the emotional feelings on the subject and essentially confronted industry and municipalities with too idealistic a set of standards. It is clear that the costs and the benefits of each particular potential or actual pollution have to be studied and a reasonable balance struck. For example, the country accepts as a necessary price for its standard of living an annual death toll on our highways of scores of thousands. In the long run we should be perfectly able to cope with the pollution problems and to provide for them routinely in new investment in the future, but it is a major undertaking to try to correct what has already been built in a short period of time, especially when jobs and rising income may be adversely affected in the near term. But if some of my suggestions just below regarding energy were to be adopted, we could gain a very substantial improvement in the quality of life at no cost at all!

6. One of the major causes of our double-digit inflation, as has been so clearly brought out in recent days by the President and the Secretary of State, is the unconscionable rise in the price of oil that took place last year. The effect of this rise has been to extract approximately a hundred billion dollars per year from the industrial world and effectively to put it into cold storage, which means removing it from the standard of living of the industrialized world.

Much is being made of recycling this money back to the industrial and the less developed world, but in my opinion this will be a vain hope insofar as any meaningful effect is concerned, at least over the next five years or so. I fully agree with our government's efforts in this regard, but I feel also that a major and sustained effort has got to be maintained to reduce immediately the energy consumption of this country by conservation measures of all kinds. As an example, we should adopt the European system of placing heavy taxes on any automobile of larger than a minimum size, and make them progressive so that the gas gulpers which are still so popular in America will once and for all disappear. Other excise taxes on luxuries might also be reimposed, especially those that are high in energy consumption.

In particular, higher taxes on gasoline, even if only a few cents a gallon, will not only discourage excessive use of an expensive material that costs us a lot of foreign exchange, but will contribute enough additional revenues to the Treasury to make up for some or all of the reductions suggested herein (even, perhaps, supporting a public job program if unemployment rises too much). European nations have long had much higher gasoline taxes than we do, and France has just shown determination to reduce its imports of oil. We too should consider anew the idea of gasoline rationing, whereby essential uses for lower income people are covered while incremental consumption requires much higher cost "free" coupons. Energy is at the root of our inflation problem.

The recent study of "U.S. Energy Prospects—An Engineering Viewpoint" issued by the National Academy of Engineering, deals with many other aspects of this vital question, and it is my hope that some considered policies will emerge based on the results of that study.

7. In effect, the Federal government has subsidized borrowing by state and local governments by virtue of making tax-free issues possible. This has of course attracted large investors and institutions who furnish the necessary capital. If it is deemed vital in the national interest to do the same, let us say, for the housing industry (below a certain value for houses or apartments), then it should be equally justifiable to make, say, a thousand dollars a year of interest from savings and loan institutions tax-free. This would be a much better basis than tinkering with the interest rates as has been the practice in recent years where the small saver has been compelled to accept a much lower rate of interest than the large saver.

8. It should be clear from what I have said before that I am totally opposed to the re-imposition of price and wage controls. They represent the worst kind of governmental intervention in the private sector, and we are still paying the price for the distortions that were caused by our last bout of such controls. They are particularly bad for the rapidly growing entrepreneurial company because historical criteria for fixing of prices and profit margins have no real validity in such cases and prevent the entrepreneur from generating sufficient internal cash flow to maintain his forward progress.

9. There is a real misunderstanding outside the business world about the recent rise in prices instituted by large companies in such fields as metals, chemicals, autos, etc. Somehow, it is fancied that competition doesn't really work in these fields, that prices are "administered," and the fact that prices go up despite falling demand proves this theory. Well, I have worked with (but not for) large organizations all my professional career, and I do not believe any of the foregoing.

The rise in prices reflects not only the effect of higher energy, labor and other costs; it also reflects attempts to recover from the debilitating effects of price controls, and to restore profit margins (only partially) to former levels so that new capital can be generated for expansion of productivity. A new capital investment costs far more today per unit of capacity than did a similar plant just a few years ago. If the price of the product remained too low, the new investment on such a higher capital base would show an unacceptably low return which no management responsible to its stockholders could justify.

This is particularly true in the capital intensive basic industries. But as such prices needed for new investment go up, the consumer can delay purchase of a new car, for example. This is the risk a management takes when it raises prices, or puts in new capital for more capacity. Alternate products may even take a market away altogether. Imported goods may be priced lower than a company's own products, and threaten this market or his return. There are many such consumer choices. That's how the price system allocates the production and consumption patterns of a country.

Rather, we should pay attention to removing the large number of governmental rules and restrictions which force high costs upon the public, restrict imports and exports, and generally prevent the maximum competition in the marketplace, which we believe will aid in holding down inflation.

In conclusion, may I say that I am privileged to be invited to appear before this distinguished committee, and thank you for allowing me to submit my views. As I said before, what I have tried to express is the result of 33 years of industrial and technical experience on the front lines, i.e., the entrepreneur's world; not a macroeconomic view but a microeconomic analysis. You might also call it the worm's eye view—how the fellow in the trenches feels when he gets contradictory and frequently changing orders from his commanding officers, and what he tends to do about it. In short, I have have tried to express what the reality of our economic functioning is from the participant's point of view and not from any vested interest's point of view. I am lobbying for nothing at all!

EXHIBIT A

[From Chemistry and Industry, Feb. 2, 1974]

INDUSTRIAL INNOVATION: YESTERDAY AND TODAY

CHEMICAL INDUSTRY MEDAL ADDRESS

(By Ralph Landau)

As one who has participated directly in creating an industrial enterprise primarily devoted to innovation. I stand before you in a somewhat different category from many of the distinguished past recipients of your prestigious award, which I am so deeply honored to accept tonight, on behalf particularly of the wonderful people who make up the Halcon group of companies. The last such technological entrepreneur medallist (Bradley Dewey) received his award from you almost thirty years ago. The suggestion has been made to me, therefore, that I spend a short while tonight on observations based on our own experiences, which might have some pertinence for conditions today, and this is the reason for my choice of title.

Before I do, however, let me quote from a particularly relevant treatise, which seems to have been written with great insight into organisation such as ours. Professor Peter Drucker says in his remarkable book, *The Age of Discontinuity,* 1 'the fifty years before the outbreak of World War I have been called the 'Heroic age of invention.' They might equally be called the 'Heroic age of the entrepreneur.' The inventors of the period had to know how to convert their technical work into economic performance, and their invention into a business. It was then that the big businesses of today were founded . . . In the . . . years since World War I, the premium has been on management. Not that entrepreneurship has been lacking . . . Since the end of World War II, more new businesses have been founded . . . than in any similar period before . . . More of these businesses have grown . . . into worldwide giants, such as IBM, Xerox, and some of the pharmaceutical companies, yet the great need has been for the productive organisation of large numbers of people . . . for doing something that was already reasonably well known. Now we are entering again into an era in which emphasis will be on entrepreneurship . . . It will not be . . . the ability of a single man to organise a business he himself could run, control, embrace . . . It will rather be the ability to create and direct an organisation for the *new.* We need men who can build a new structure of entrepreneurship on the managerial foundations laid these last . . . years . . . and who ask: Where are the opportunities for a new industry, or at least for a new major process? [or product] . . . In an age of rapid change, a technological *strategy* is essential for the success and indeed for the survival of a business and perhaps even of an industrial nation. The market is the most potent source of ideas for innovation . . .' Thus, Professor Drucker says what I am convinced is deeply true: *Innovation geared to market demands is vital to the solution of man's many problems of the future.* 2

History and growth of Halcon International

Time will permit only a very 'high-spot' description of our evolution as an enterpreneurial innovative organisation. Actually, our history could be conveniently seen as a series of five-year periods, included in each of which was the commercialisation of at least one successful and important new organic chemical process. This is a rate considerably better than that of most companies in our industry, I believe.

Our first fifteen years were devoted primarily to forging an independent existence. The first prerequisite, after the basic idea, was money. No capital was available for an unconventional business such as we aimed at, i.e., a research-oriented company in the organic chemical field. Therefore, we were able to get started only by providing services. Initially, this was consultation abroad, and the management of the design and construction of a chemical plant in the United States based on a client's new process (Stauffer Chemical Co.). We purchased a research laboratory in Manhattan in 1947, and began the work on our first commercial proprietary process, that for the direct oxidation of ethylene to ethylene oxide. Only one commercial installation of this kind existed, based on a French chemist's discovery; everyone else used the World War I invented chlorhydrin process. Our first pilot plant was erected in England with an innovative firm (Petrochemicals Ltd) seeking to establish Europe's first petrochemical plant, but the initial commercial version was installed by Naphtachimie in France. Thus, we discovered very early that Europe, exhausted by war, was eager for new ideas flowing from the United States, with few reservations about a struggling young enterprise without credit or reputation, and that technology was international in outlook and opportunity. We also proved that mission-oriented research, closely associated with top management, was the prescription for successful growth.

It took us some years before we could get additional work in the United States because continued competition from the larger engineering companies made it very hard for us to break in. Finally, Allied Chemical gave us some significant engineering contracts back home. We subsequently were able to enter the construction field, commence the manufacture of catalysts, and undertake substantial lump-sum turnkey projects, all under the name of Scientific Design.

Undoubtedly, a substantial boost for this diversification came from the enhancement of our reputation by the development of our first wholly novel industrial chemical technology, the Mid-Century Process for terephthalic acid.[3] Even though we were persuaded to sell this technology to Standard Oil Company (Indiana) in 1956, despite our hopes for a joint manufacturing venture, we were 'put on the map' as an important international designer and builder of new chemical plants, and as a truly innovative organisation.

Standard Oil has carried this invention very far in the seventeen years since then, through its subsidiary, Amoco Chemicals Corp. In the recent words of H. Cudd, Amoco's President, 'the process constitutes our major area of growth without qualification'. The worldwide production capacity for terephthalic acid using this process, built or building, is 5.3 billion pounds/year, and it provides a majority of this free world's basic raw material for polyester fibres.

This particular invention of ours also illuminates a larger truth. Twenty years ago, when we started on the search for a better way to make tetraphthalic acid, no government plan or prodding put us up to it—we did it because we thought we could make money if we succeeded. Simultaneously, Du Pont was working hard to build a market for Dacron fibre (invented in England) which was still expensive and a luxury, and other companies (like Chevron) were studying how to make *p-xylene* more cheaply. What government plan could have produced the result of all these and other efforts as seen in 1973—that polyester fibre has become substantially cheaper than cotton, and remains the principal hope for eking out the inexpensive clothing market now supplied by cotton? While cotton acreage diminishes as food production needs preempt the land,[4] the functioning of a private international incentive system has produced a workable and improved product at lower cost, not dependent on slave or sharecropper labour. And we derive a good deal of satisfaction from the fact that, as we have developed higher yield technology, we have also been working in the direction of pollution reduction, because the more efficient and direct a process is, the less it generally pollutes.

This is what innovation at the grass-roots and private levels is all about—and it can not be made to order by government fiat. And now this kind of strategy needs to be applied to government science also, as W. O. Baker, President of Bell Telephone Laboratories, has recently said.[5] The era of large government research projects in performance systems of national and strategic importance is drawing to a close and th echallenge is to serve mankind in economic systems.

Our work in the later part of this primary period led to projects in Japan, as well as the United States and Europe. We formed strong ties in the Far East, and it is interesting to note that the first terephhalic acid plant in the world to use the Mid-Century Process actually started up in Japan at Mitsui Petrochemical. More processes were discovered, including especially our cyclohexane oxidation process for the production of cyclohexanone-ol mistures, the building block for nylon manufacture. It has been licensed to Monsanto, Bayer, ICI, Mitsubishi, Rhône, Poulence, and others.

Thus, by the end of these fifteen years, we finally began to create enough cash flow through royalties and fees to permit us to dream once again of going into the manufacture of chemicals. This was not a new thought, but now we felt we were on the threshold. The reason for this desire on our part were complex, but included:

1 recognition that royalty income alone could not pay for the increasingly greater costs of research and development for new technology.

2 recognition that pure service organizations would never have great capital value;

3 realisation that the return on really creative new technology would be greater by participation in the manufacture of the products under the exclusive protection features of the free world's patent system, in large units, rather than by nonexclusive licensing for modest royalty to many smaller plants (often uneconomical in size). We are gratified to note that spokesmen for such successful companies as Du Pont and Dow have recently expressed similar conclusions. [6, 7]

At the beginning of our second phase of existence (the last twelve years), we discovered the third of our truly original chemical processes, the epoxidation of propylene, and other chemicals, to propylene oxide with oxygen or air. This tool gave us the opportunity at last to enter the chemical manufacturing field ourselves. The prevailing industrial situation was like that in ethylene oxide manufacture fifteen years earlier—all industry was still using the World War I developed chlorhydrin process. We really geared up to exploit this technology, organised Halcon as the parent company with primary emphasis on its own research and development to be utilised in operating subsidiaries in a variety of ways, and came to an agreement in 1966 with the Atlantic Richfield Company which also was doing innovative work in the same area. From this was born the Oxirane group of companies, which are owned equally by us. We also have formed with Calvo Sotelo S.A. in Spain the firm of Montoro, which is now in successful operation, and are, in association with Sumitomo Chemical Company and Showa Denko, also building as Nihon Oxirane Co., a large propylene oxide-styrene plant in Japan.

In the seven years since then, as Professor R. Stobaugh of the Harvard Business School has put it last year, "the Oxirane family has resembled that of a family of rabbits . . . Beyond the rapid announcement of over one billion pounds/year of worldwide PO capacity, the Oxirane entry into the PO field is notable for choice of different by-products at different locations. Since the Oxirane technology produces roughly twice as many other chemical co-products as PO itself, this means that in this short period of time, the total productive capacity of the Oxirane group for organic chemicals, built or building, has achieved the order of 4–5 billion pounds a year (new capacity having been announced by Oxirane after Professor R. Stobaugh's article).

Again I want to emphasise: the work done by Atlantic and ourselves, paralleled work being done independently by many other innovative organisations in other aspects of this broad field of polyurethane chemistry—Bayer, Du Pont, Upjohn, and other companies in isocyanates, Wyandotte and C. C. Price in polyethers, Carbide, Mobay and Houdy in one-shot urethane foam technology, and many others. The combined results of the efforts of all these organisations, guided by market and competitive forces, is the great urethane polymer industry of today.

Now, in furtherance of our new existence as an R & D oriented manufacturing enterpreneurial company, we have hit upon our fourth fundamental discovery, a new way of converting ethylene to ethylene glycol with unusually high yields, well suited to these days of rising ethylene costs and scarcity. Plans are well along to exploit this advance in the other part of the polyester fibre molecule. Other even newer technology is in the offing, and we believe our fifth major discovery is on its way. We are confident that many new opportunities for our type of approach and in our fields of specialisation lie ahead.[8]

Recently, we participated as a stockholder in an ethylene oxide-glycol-amine-ethers complex (Oxiteno S.A.) in Brazil, the country which is growing economically at the fastest rate, and which has some lessons to each us, too.

But we are not neglecting the engineering business which got us started. Just today, Scientific Design signed an agreement with the well-known French engineering firm of Technip, to sell them an interest in our subsidiary, SD Plants, Inc., which will broaden its services into many new areas of technology such as cryogenics, petroleum and gas processing, fertilisers, pharmaceuticals, foods and others. In addition, we are going to put Scientific Design's innovative chemical engineering skills to good use in new fields such as synthetic fuels, coal processing, and so on. The demand for chemical (and other) engineers in the future will strain all of our resources, for they hold many keys to the solution of society's problems, as I have written recently in another paper. [9]

In this account of our evolution, you may have noticed that I omitted any reference to our frustrations, heartaches, setbacks, and failures, of which we have had plenty!

Government intervention

If there are any lessons in our history, they perhaps come into focus a bit more sharply if we ask the question, 'Could we do this over again if we were starting today?' I hope so, but I have some doubts. The reasons for my caution are based on the different climate existing today, as compared with 1946. Of course, the non-American worldwide technological and industrial vacuum resulting from the World War is happily no longer in existence, although large gaps exist between the industrial powers and the rest of the world. But the really basic difference is that we have too much government today. To paraphrase Wordsworth:

Government is too much with us; late and soon,
Getting and spending, *it* lays waste *our* powers. . . .

It is unbelievable how many obstacles to the international technological entrepreneurial enterprise (and to industry generally) now exist because of the heightened role of nationalist governments. Except for the excess profits tax, all the obstacles (some reasonable, many not) we encountered are all here, and being added to year by year: greater restrictions on currency transfers: foreign investment controls; higher taxation in many areas; price, wage and profit controls; increased reporting and bureaucratic procedures; increasing ecological restraints; anti-trust and consumerist legislation; political restrictions on imports and exports; laws favouring restrictive trade union power; and others. It takes many more lawyers and accountants to stay out of trouble, and litigation consciousness is much greater than ever. Inflation has arisen at unprecedented rates. Resources and energy liimtations are becoming very restrictive of economic growth. Non-governmental organisations of all sizes, all over the world, are increasingly subject to governmental regulations, frequently changing, and polit-

ically unpredictable. Incentives are increasingly chipped away, including raising capital gains taxes, reducing the attractiveness of stock options, reducing depletion allowances in many areas—in short, the formation of capital is constantly undergoing erosion while the government's spending increases steadily. [10] As a result of these and other forces, profitability of industry has declined materially since World War II, [11] and the willingness and ability to take risks has been reduced accordingly. Why take risks if the rewards are less than the penalties? With this has come the unwillingness of the securities market to take similar risks.[12, 13]

So I say that concentration of power in government and its misuse are the primary obstacles that we face in improving the environment for technological and economic innovation, which alone can really solve the many problems of our rapidly increasing world population.

But the will to create new enterprises (and new ideas) is still very strong in the United States and abroad. What is signally lacking today is the risk capital to start and help sustain in the early years many of these ventures. We were able to accumulate capital by long years of service work, before we could generate enough to enter the capital intensive chemical industry; today, it would be much more difficult. Hence, new approaches are needed to help spawn the enterprises of the future. But this does not mean that the great companies of today are anything other than indispensable for the future as well. Their role, as before, is essential in helping new ideas enter the marketplace, and our organisation could never have grown beyond a small consulting group without simultaneous growth of a healthy worldwide chemical and petroleum industry, who became our clients, customers, and partners.

Size and innovation

In addition to the adverse influence of big government, we must, however, recognise that big, highly structured organisations in general do not have any strong incentives to engage in far-out innovation. The risks usually outweigh the likely rewards. This appears to have been true of the great chemical companies, which could grow in the post-World War II period largely on the basis of proven technology and an apparently insatiable worldwide demand for their products. Hence, many of the great discoveries of this period in our organic chemical industry did not originate in such major companies, for example:

1 Polyester fibre—discovered by R. Whinfield working at the most unlikely research laboratory of the small Calico Printers Association in England.

2 Ziegler-Natta-chemistry—this single most important post-World War II chemical discovery, resulting in a rare Nobel prize for industrial innovation, came from a German independent researcher in a small laboratory, and an Italian university professor. We owe high density polyethylene, polypropylene, polybutadiene, and polyisoprene rubbers, among many others, to their work.

3 Acrlonitrile from proplyene and ammonia, a base building block for many plastic and fibre products, was discovered in the small chemical research laboratory of a smallish oil company, Standard Oil Company of Ohio.

4 The great evolution in manufacture of olefines, aromatics, and other chemicals from light and heavy hydrocarbons was provided by contracting organisations such as Kellogg, Lummus, Stone & Webster, and UOP.

There are other examples, but the above illustrate a fundamental point, that basic invention is often done outside 'establishments.' [14] But these discoveries, like many of our own, could never have been industrialized (and the innovation completed) without the subsequent participation of the major oil, chemical, and rubber companies, who had the marketing skills, people, and capital. The aforementioned inventors were pursuing their own path, which they hoped would lead to fame and fortune, but they needed the big fellows to accomplish these goals.

There are, of course, exceptions even to this pattern. One that comes immediately to mind is the Du Pont Company, with such internally discovered innovations as Qiana, Fiber B (Kevral), Delrin, and its new Hexamethylene Diamine process from butadiene, for nylon manufacture. The Bell Telephone Laboratories can be mentioned in another field. An even bigger exception may appear to be the United States Government achievements for the atom bomb and the space programme—here, the scale required was so enormous that only government funds liberally applied could provide a solution. Nevertheless, most of the real innovations in both these projects were made by private companies or universities working on government contracts. When the stakes are big enough, and the rewards (monetary or otherwise) large enough, big organisations can be innova-

tive indeed! Another example is the American oil industry, which has developed major innovations in finding gas and oil by scientific prospecting, and where the rewards of success outweigh the risks. Our pharmaceutical industry provides other examples. How long will governments permit these successes as things are going today? They seem to want to reduce the rewards, and collaborate constantly at increasing the risks.

One can see the full consequences to innovation of government control in a country such as the Soviet Union, where it becomes very hard to find. Even its space programme was inherited (as was ours at the beginning) from German World War II work, and pioneering work by Goddard in the United States. I have found no evidence of any creative innovations at all in their chemical industry; and no appreciable record of Russian contributions to the competitive international chemical scene exists, despite the fact that there are many brilliant Russian chemists. It is difficult to escape the conclusion that no incentives exist for risk taking in such a topheavy society. [15] An excellent account of this was given in a recent article from the London *Economist* [16] . . . 'Managers in industry are given little opportunity, or incentive, to do more than stick to the task of fulfilling the production plans handed down to them by remote bureaucratic bodies. A story in the Soviet *Builder's Gazette* illustrates the pitfalls of the single-minded concentration on crudely defined targets. Russia apparently produces twice as much glass as the United States, although it builds only half as many houses. Where does it all go? Well, 46 per cent of it gets broken before or during installation. Why? Because glass production plans are set in terms of square metres, which tempts managers to concentrate on producing thin glass, which then breaks easily.

'It is not surprising that innovation, that essential part of technological progress, does not flourish. Many inventions emerge but few are applied, because, as Soviet economists themselves admit, it is safer and more profitable for the managers to churn out the same old items than to expose themselves to the risks and uncertainties of new production. According to a *Pravda* report last year, more than 600 standard processes and blueprints in the petrochemical industry were 20–30 years old, and only about 80 were being revised'.

Is it any wonder that this society still cannot feed itself, fifty-five years after their Revolution? I am convinced that for Russian industrial society to develop as far as it has, it would have had to invent a capitalist industrial system to model itself on; fortunately, such a system already existed! In fact, Chairman Brezhnev's recent visit to the United States in search of our capital and technology shows how important these really are. In this part of the world also we feel, as do others, that the day of licensing really modern technology for royalty is over: it is simply too valuable. As I said earlier, the invention must be exploited by investing in a plant in order to get a fair return, because such technology *is* capital. If the Soviet philosophy bars the actual embodiment of a joint venture, ways should be found to provide the equivalent of a manufacturing return. As to capital *per se*, I think we can rely on prudent investors to decide what degree of risk they wish to take in any given foreign country. The same will no doubt apply to trading practices. In all this, we must not forget the Japanese experience. Japan's extraordinary growth from a defeated country to a major competitor in world markets shows how little time it takes if advanced technology is made available cheaply, as was the case in most instances.

Needs and conditions for innovation

From the foregoing historical analysis there emerges the paradox of today: the increasing difficulty of enterpreneurial innovation, and the increasing need for it. The challenges for innovation are immense, and we are all aware of them: the public desires greater amenities, better education and knowledge, improved communications and transportation, better attention to ecology and pollution problems, more complete medical and health care, relief from job boredom, more leisure, compassionate help for the unfortunate of the world, better nutrition—and more. We see, as a consequence of the explosive growth in world population, the great shortage and high price of foodstuffs on a world scale, which will persist for a long time and create great inflation. [17, 18] What better area for technological innovation is there than in agriculture and food science, where America has always led the world? Taiwan's experience also shows the value of innovation in agriculture. The same is true for energy requirements, for its creation in all countries, particularly the less developed ones.

Our balance of payments problems also underline that a technologically advanced industry can make real contributions to society. The chemical trade sur-

plus of the United States jumped 41.5 percent in the first half of '73 over the first half of '72, and even more in August; but for years we have had a healthy surplus.[19] This is certainly not the case for many less technologically oriented American industries.

Finally, one fact is crystal clear: the idea, propagated by some ill-informed (and, yes, immoral) ecologists and others that zero economic growth is the only hope for mankind is a stillborn idea. No one can hope to freeze the *status quo* of mankind today. Redistribution of existing wealth, which such misguided spokesmen advocate as an answer to this critique, means sharing the poverty by enforced totalitarianism—something which all of Western civilisation for over 2000 years has been painfully trying to escape. The failure of this concept in Chile, and the contrasting successes in Brazil, Iran, Japan, Taiwan, and others, point to one clear conclusion: the only decent hope for mankind is for more and better innovation—technological, educational, economic and social—but in the direction of less government, less oppression, more freedom, more decentralisation of decision and judgment making, and especially of risk taking.[20–22]

We must all accept that each society has the basic political right to set the ground rules and establish the priorities under which its citizens can work, but it must be, as I plead herein, based on a greater historical and practical understanding of the limits within which successful results can be obtained. And I would dare to suggest that industry should be less defensive, and take positive initiatives to work out with government and the consumer better balances between society's needs, the consequences of fulfilling them, and the critical necessity for economic growth.[23]

Suggestions for innovation

In this address, no panacea for the problems we all perceive comes readily to mind. But I can offer some suggestions of my own, in addition to my broad theme of the basic need to encourage innovation and reduce bureaucratic restraints. These would include:

1 Recognition by governments that capital formation and profits are essential to maintain the climate for the innovative society.[24] Big companies and large pools of capital as well as new types of venture capital and changes in investment practices by our large financial institutions are essential to provide the tools for the entrepreneurial growth of the future.[25] The current hearings by Senator Bentsen's committee on these subjects are of extraordinary importance to the healthy growth of our society.[26] Examples being considered by that committee include suggestions of radically reducing the capital gains tax, especially in connexion with property held for longer periods of time, and changes in the whole structure of financing equity issues of American corporations and maintenance of suitable markets for them. These are essential to encourage risk-taking investment.

2 Governments must stop changing so rapidly the ground rules under which business operates, as has been the practice during these last fifteen years.[27] The innovative programmes I have described take years to accomplish; businessmen cannot take risks if the rules change frequently in mid-stream. Economics as a profession must evolve further in the direction of less governmental intervention, fewer stop-start programmes, more long-range climate creation.

3 For many years, education for the élite was grounded in the classic and humanities, which were preparation for the callings of the law, medicine, religion and teaching. The twentieth century has shown that our present liberal arts curriculum is no longer able to prepare the educated citizenry of the future.[28] A recent article in *New York* said,[29] 'Mass higher education has created a new problem: a growing liberal arts proletariat that is only marginally employable'. In my opinion, the future education of the public (a large percentage of which now goes to college) should be grounded on science as the basic liberal education for all. This is not meant to exclude other cultural subjects from the curriculum. From such preparation the student can proceed to specialised schools for any further training he wishes. I know this is expecting a great deal of our educational system, and certainly it will have to develop much better and different methods for teaching science universally. But if the general public (including economists, lawyers, politicians and journalists) cannot acquire a scientific understanding of the world, it will become increasingly frustrated by decisions made (or *not* made) by a small élite of technologically trained people, and this bodes ill for our society.[30] Toward the same end, the large gap that exists today between the real worlds of economic behaviour, and the university, must be narrowed significantly.

4 Large corporations can develop even better ways to work with the technological entrepreneur, not necessarily by taking his enterprise over or seeking to control it (as often occurred in the past), but by various imaginative means which can preserve the best features of both types. I must in this regard pay tribute to the entrepreneurial spirit and imagination of our distinguished partners, the Atlantic Richfield Company. They helped find a way to marry a modestly sized technological enterprise with a great international oil major to produce the Oxirane group as an offspring, and I do not think either parent can do anything less than take great pride in what is probably the most successful internally generated growth staged by an chemical company in recent years.

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Exhibit B

[From the Economist, Sept. 7, 1974]

A Socialist of a Different Stripe

Herr Schmidt won the praise of good Europeans, or at least good Italians, when he slipped Italy a badly needed £800m at the weekend (see page 63). The question is whether his own Germans, including his own Social Democrats, still feel as warmly about him; the latest opinion polls show a sharp drop in his government's popularity. The answer, as usual, is that it depends what any given Social Democrat means by social democracy.

The bluff West German finance minister, Herr Hans Apel, is writing a book. It will seek to establish whether there is any possibility of establishing, one fine day, a united Social Democratic party of western Europe. The tone of the book, to judge from Herr Apel's recent obiter dicta, will suggest that a Wilson, a Mitterand and a de Martino would make a curious omelette when combined with a Schmidt. The countries of western Europe run of left-of-centre governments are all going their own roads to socialism, whatever that is. The conclusion of Herr Apel's book, from what one hears, will be as forthright as its author: not a hope of unification.

But turn the problem on its head and ask the impertinent question: are Herr Schmidt and Herr Apel really social democrats themselves? Both are men more concerned with making financial and economic institutions actually work than with consulting the tomes of their Trier-born forebear, Herr Karl Marx. With an embarrassing trade surplus of almost £5 billion in the first seven months of this year they are not doing too badly in the making-it-work game. With inflation at just over 7 per cent, unemployment at 2.3 per cent, the average industrial wage at more than £2,000 a year, they are positively slapping themselves on the back.

Herr Schmidt's philosophy as he put it in an interview with your correspondent earlier this year, is this:

> Despite our abstention from controlling prices and wages, we have the smallest price increases. The whole of our economy is more adjusted to respond to market forces than to regulations . . . This is said by a Social Democrat . . . The deeper you get into regulations the deeper you get into red tape and the more you hamper the dynamic development of your economy.

These words are swallowed with some difficulty, but swallowed they are, by the thousands of workers in the motor industry who have been on short time this year, and by those laid off in the building industry. Both these sectors are being allowed to shake themselves out in accordance with the dictates of the market economy. No help for lame ducks on one side, and no calls for nationalisation on the other. It requires considerable political courage and a certain lack of what social democrats normally call "social consicence" to turn the other cheek to industries in trouble.

It is, of course, true that Germany's Social Democrats remain in coalition with the Free Democrats and have to cut their political cloth accordingly. Anyway, the opposition Christian Democrats have a maojrity of one in the upper house of West German parliament, which is enough for them to delay legislation and sometimes to inhibit its drafting. Compromises have already had to be reached in legislation affecting workers' participation in managing industry, tax reform, abortion law reform and education policy. And the complicated proposals for workers to acquire shares in industry ("creeping nationalisation", according to the employers) have already been put off until the next parliament. If the Social Democrats were the sole governing party, with a comfortable majority, such legislation would have a more fullblown look about it—but not much more, compared with the ideas of left-wing British, Italian or French socialists.

Many of the Christian Democrats one talks to say that "for a Social Democrat, Helmut Schmidt is doing a good Christian Democratic job". Such attitudes may well increase the Social Democrats' vote in the province elections that will take place before the general election in 1976. That election will be fought, as ever in West Germany, more in terms of personalities than policies, but the battle will be about which personality seems best to represent the middle ground of politics. There will be no talk about the ownership and control of the means of production, distribution and exchange. Agreed, Herr Apel, or not?

EXHIBIT C

[From the Economist, Sept. 14, 1974]

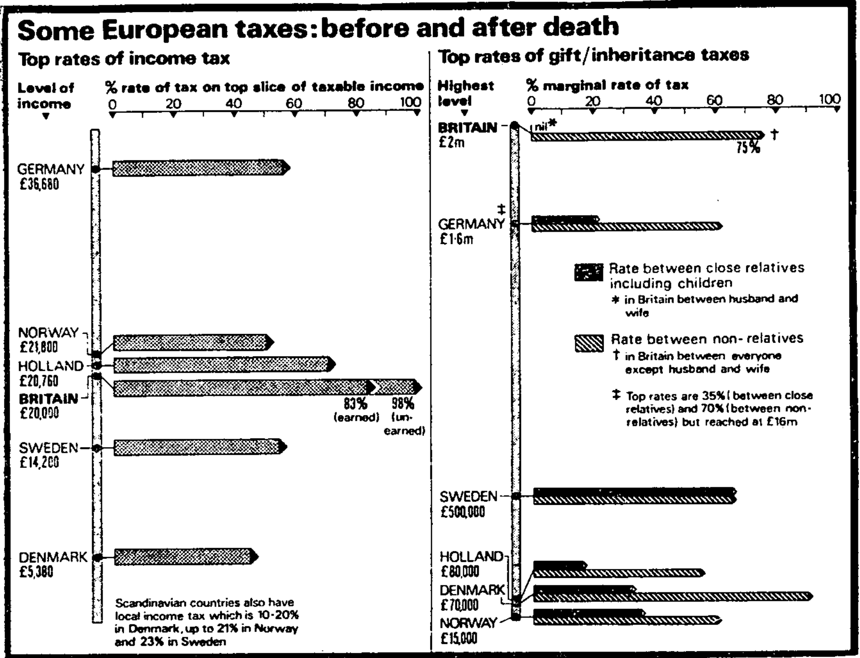

EXHIBIT D

[From the Wall Street Journal, Sept. 23, 1974]

THE OUTLOOK

REVIEW OF CURRENT TRENDS IN BUSINESS AND FINANCE

(By John O'Riley)

Inflation. On no subject around is there more talk and less understanding. And don't feel inferior if you haven't fathomed it. The smart guys don't fully understand it either. None of them can do more than guess how fast it will abate. But there are some basic facts that can help keep it in perspective. And these point to two things. First, neither President Ford nor anybody else can make it vanish in a hurry. And second, there is some reason to believe it may lack a lot having spent its fury.

Why can't it be stopped in a hurry? It is on this point that the public is most befuddled and misled. The answer lies in the fact that it wasn't launched in a hurry. The prime force behind it has been long abuilding. It has been the pouring forth of a flood of new money, new buying power. This happens when the federal government spends more money than it takes in. When it does this, new money in effect must be printed up to cover the difference between income and outgo.

The table below traces the federal budget record back to 1965. "Surplus" means more money coming in than going out. "Deficit" denotes a bigger outgo. The figures cover fiscal years. Add six ciphers to each, making them represent billions of dollars.

SURPLUSES AND DEFICITS

Year	Surplus	Deficit
1965		$1,600
1966		3,800
1967		3,700
1968		25,200
1969	$3,200	
1970		2,800
1971		23,000
1972		23,200
1973		14,300
1974		3,500

That largely empty column down the middle of the table tells the story. In only one year out of ten was there a surplus. Over the decade, the federal government spent $102.9 billion more than it took in. That's money. In four fiscal years alone, 1968 and 1971 through 1973, outgo exceeded income by more than $85 billion.

If this is bad, why has it been going on? Well, it has been politically popular. No Congressman has ever lost votes by getting more federal money spent in his home state or home town. Stepped up federal spending helps many people immediately. And, as it continues, it spreads more buying power through the entire public's pockets.

And make no mistake about the vast growth over the past decade in the amount of spending money in consumer hands. With all the attention focused on rising prices, the rising tide of this abundant money in pursuit of things to be bought gets little notice. But it is there. And, naturally, pushing prices up.

The table below gives two official Department of Commerce yardsticks for measuring the income surge. One is the nation's median family income and the other is per capita disposable (after taxes) personal income.

CONSUMER SPENDING POWER

Year	Median family income	Per-capita dispersed personal income
1965	$6,957	$2,436
1966	7,500	2,604
1967	7,933	2,749
1968	8,632	2,945
1969	9,433	3,130
1970	9,867	3,376
1971	10,285	3,605
1972	11,116	3,843
1973	12,051	4,295

What the tables add up to is:

The Median Family Income: Up 73%.

Per-Cap. Disp. Pers. Income: Up 76%.

The great growth in the spending power of the country's families cannot be measured in the level increase of individual paychecks, as sharp as that has been. An extremely important factor is the gain in multiple paychecks per family. Working wives permeate the economy. Between 1960 and last year, adult women at work rose nearly 10 million—or close to 50%. Working teenagers of both sexes increased 75%. Meanwhile adult male employment rose a relatively small 15%.

The median income of families with both husband and wife working last year was $15,237. And that of families with three wage earners was $18,050.

But hasn't all this income been outrun by the rise in prices? No—and this is almost never noted—the prices have trailed the incomes. Here is the record on both wholesale and consumer prices as reflected in Labor Department indices, taking 1967 as 100.

THE PRICE CLIMB RECORD

Year	Wholesale prices	Consumer prices
1965	96.6	94.5
1966	99.8	97.2
1967	100.0	100.0
1968	102.5	104.2
1969	106.5	109.8
1970	110.4	116.3
1971	113.9	121.3
1972	119.1	125.3
1973	134.7	133.1

The climbs mirrored in these tables:

Wholesale Prices: Up 30%.

Consumer Prices: Up 40%.

Not all incomes, of course, have run so much ahead of prices. The working man who has to feed his family alone has it much rougher than the one with a working wife. And retired people on fixed income have taken a brutal beating.

Spurting prices have outpaced overall per-capita income in 1974, but the big picture is unaltered. This year's second quarter per-capita disposable income, expressed in "constant" dollars, removing the impact of all the inflation, still shows a leap of 27% from the 1965 level.

The thought that somebody can wave a magic wand to bring back the prices of yesteryear while leaving the incomes untouched is mere dreaming. There is no sudden halt to the price climb in sight. And the runup may be far from over. Those who would lead the public to think otherwise are guilty of deception.

Senator BENTSEN. Mr. Landau, in your prepared statement you mentioned the need for raising capital in this country and the problems of getting it today. It is interesting to see a situation today where you have stocks selling at three and four times earnings. And if you are talking about expanding the markets and having more plentiful goods to hold down prices, you can't go to the equity market to try to raise your money with three and four times multiples, because you can't get that kind of return on your investment. So what do you do? You turn around and buy your own stock in many instances, because that is the best buy you can find. And what is the result of that? You have reduced your capital. And therefore you can't expand. It is counterproductive to the social objectives we want for the Nation today.

I just don't believe the day is past when we are going to have new ideas come forth. And I think there is some fellow tinkering in some basement trying to come up with a great idea and he ought to be financed.

I attended one of those minisummit meetings. And I heard one of the economists say, that what has been impressive is the resiliency of the national system, where even the small businessman can get financing. That shook me up a bit. And then he said, they get it from big business. You know what that is? Big business then dictates the profit margin, and that small business, if he gets financing from the large business, becomes a captive of that large business. He has no more freedom to go out and find his market. He is then owned by that big business. I don't agree at all with that kind of a limitation on financing. I think it is wrong.

Mr. Norman, you are talking about interim financing from banking institutions. I notice in your testimony that it gets up as high as 18 percent. And I expect that that is in conformance with that sort of thing. Don't you then have to crank that into your final costs, price that you put on your product and pass it right on to the consumer? Isn't

it a major contributor, of course, to today's inflation when you lean on a monetary system with interest rates this long and to this extent? Doesn't it finally contribute to inflation itself?

Mr. NORMAN. Absolutely. It can do nothing but drive up the cost.

I would like to make a point about how nonproductive the high interest rate is. For example, when you start building a project you know you just don't think about it one day and then the next day you go into action. This is a process of anywhere from 8 to 18 months from the time of concept to the time when you start producing. I have a project—we negotiated the loan and got the financing and everything set up in the early part of 1973, a $5 million loan project, and construction, and everything else. We started the construction in the spring, and moved on ahead. The loan was pegged to prime, three points above prime. Prime at that time was on the order of 6 percent, 9 percent. We figured that with our financing cost percent, added to fees and everything else, then, you could run up to 10, maybe 11, and live with it.

Right now we are having to pay 15½ percent on that loan. Now, that has doubled the financing costs, and it has not added one job for anybody. We had no control over that particular cost, which is exactly—you know the economists say, when you tighten up money, that slows down demand and everything, and therefore it will cool off the economy. That is the theory. Of course, that is in economics I in college. But that did not stop me from building. I was already committed. I had to move. It added nothing but cost, it inflated the price of the project, and nobody got any benefit out of it. I doubt even if the banks got any benefit out of it.

Senator BENTSEN. Mr. Norman, I think ultimately that is one of the things they can do to curb inflation. But when they do that I think this has had a very disproportionate effect on the economy. I think they have put the country through a wringer, and they have run unemployment up to unacceptable levels. I think the job can be accomplished without those kinds of excesses.

Now, you suggest in your statement that we have some kind of a tax credit for savings in thrift institutions. We have been giving some study to that in the Senate Finance Committee. And some other countries do that. They do it in Japan, they do in Brazil, and they do it in France, and they do it in Germany, some limited tax exemptions for income savings in thrift institutions. The concern, of course, is the loss in tax revenue. That is what we have to try to balance out. We have to try to find other sources to take care of that. We are trying to work toward a balanced budget. We don't want a large entity like the Government, as some of the witnesses were talking about in competition for the funds.

We also understand that cutting the budget is not the only answer to this problem of inflation.

Mr. NORMAN. Senator Bentsen, could I address that particular issue? Our position is that the first $1,000 received by the saver in a thrift institution—that is, a saving and loan, mutual savings bank, an institution primarily dedicated to mortgage financing—would be exempt from the Federal income tax. I have heard that the Treasury says, well, we can't quite do that, because we will lose $1.08 billion. That might be the cost. But I would like to suggest to this committee that the direct Federal benefit will be as follows: There will be a projected increase in personal taxes from construction and related

workers of $730 million. There will be corporate and business income tax from builders and their subcontractors of some $518 million. There will be taxes paid by savings and loans on increased savings of some $200 billion, which will give a net benefit to the Treasury of $342 million.

Now, the Treasury has indicated what the Federal tax cost is, but they have not indicated what benefit that program will really have. And that I will supply for the record.

Senator BENTSEN. You now have it in the record.

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

[From the National Association of Home Builders Economics Department, September 1974]

COST BENEFITS OF $1,000 INTEREST EXCLUSION PROPOSAL

In one year this proposal will generate about $29 billion in new funds for savings and loan associations and mutual savings banks.

About 65% of these funds would be used for existing mortgages and 35% (or $10 billion) for new mortgages.

The $10 billion will generate 300,000 new housing units, or 555,0000 man years of employment.

The employment, in turn, will generate $1.4 billion in Federal taxes, $87 million in state taxes, and $172 million in local real estate taxes.

The Treasury Department estimates the loss in Federal taxes would be at $1.08 billion. However, with total direct benefits of $1.422 billion, the net benefit to Treasury would be $342.2 million.

In addition, the indirect impact of the new construction on the rest of the economy would add at least the same additional amount to Federal and state taxes.

An interest exclusion proposal would permit taxpayers to accrue $1,000 worth of interest annually on time and savings deposits at S&Ls and mutuals without a Federal income tax liability.

Cost-Benefits

[Dollar amounts in millions]

	$1,000 interest exclusion
Housing units (new)	300, 000
Man-years of work	555, 000
Federal costs (tax loss)	$1, 080. 0
Direct Federal benefits:	
Increase in personal taxes from construction and related workers	730. 8
Corporate business income tax from builders and subcontractors	518. 4
Taxes paid by S. & L.'s on increased savings	200. 0
Total direct Federal benefits	1, 422. 2
Net benefits	342. 2
Direct additional benefits:	
Increased State income taxes from workers	87. 3
Increased local real estate taxes	172. 5
Indirect benefits—Multiplier effect throughout rest of economy [1] (housing construction is a primary industry and any new expenditure can be expected to have ripple effects throughout the economy. An estimate of these benefits to governmental units is given below but care should be taken in using this data since indirect costs are also involved which are difficult to measure):	
Increase in Federal taxes	1, 422. 2
Increase in other taxes	90. 0

[1] Based on $22,000 direct construction cost per unit times 300,000 equals $6,600,000,000. Using a multiplier of 2 equals $13,200,000,000 times 20 percent equals $2,640,000,000 in Federal taxes.

Source: NAHB Economics Department.

Senator BENTSEN. Mr. Sumichrast, you talk about pension funds allocating part of their money to the housing market. Most pension funds today are administered by bank trust departments. And most people who are in the bank trust departments came from the commercial side of the bank, and they are not really people that have a background in long-term financing to the extent that some in other thrift institutions have, they deal primarily in short-term financing. And I think that experience probably starts them out with a bias against mortgages as such. But when we get into a situation where we have the concern for inflation, and you have an institution that says, well, inflation is 8 percent, or 11 percent, what is my true yield? Why should I get into a long-term mortgage? What am I really getting back to the pension funds that I am administering?

What do you think of the feasibility of a variable interest rate where you would vary the interest of the mortgage in effect by the prevailing interest rate? Do you think that it is feasible or not to try to compete for long-term financing?

One of the things that built this country of ours was being able to get long-term financing for homes and businesses. But it is exceedingly difficult to do that now.

Mr. SUMICHRAST. My private opinion is that I don't particularly like it. I think it has some potential. For several years NAHB policy has been in support of variable interest rates with some seven or eight provisions in it which would protect the consumer.

But as to the tapping of pension funds through the variable interest route, I think I would suggest that maybe something like they have in Sweden would help. I understand the problem of people who do not want to have some low-mortgage rates. But I think what the Swedish system does, it effectively channels money into the mortgage market through purchases of mortgage bank securities or mortgage bonds. These are issued by the various institutions, and they in effect provide about half of the financing for mortgages.

Senator BENTSEN. You mean the Government itself does through the secondary mortgage market?

Mr. SUMICHRAST. The Government and private commercial lenders as well. But the point is, they are eventually purchased, half of these are purchased by pension funds. And this eliminates the problem of buying single mortgages or getting involved in individual purchases.

Senator BENTSEN. Is that mandatory purchase allocation by pension funds?

Mr. SUMICHRAST. Well, the Swedes as far as I understand it do not do very much of that kind of thing. They have an understanding that when they want to do something they just do it. And they do it through the fact that businessmen do what the Government asks them to do. This is particularly true when the same situation occurs——

Senator BENTSEN. I am not sure I am ready for that, Mr. Sumichrast.

Mr. SUMICHRAST. I am just suggesting that, last year, they had a liquidity crisis in housing similar to what we have in short-term financing, and in a sense the meeting of the Government and the commercial lending institutions finally produced an agreement by which the lending institutions just turned around and provided an extended short-term financing into long-term financing at a good rate. And this was done without any legislation at all.

But the variable rate, as I say, I particularly don't like, because we had variable rates, as you know, in short-term financing, and it embodies a charge which the consumer has to pay. It works on the up side, and I am not so sure that it doesn't work on the down side for the consumer.

Senator BENTSEN. Mr. Sumichrast, what you have with the thrift institutions, they have their assets and long-term investments, and yet their savings or deposits are short term. So they get whipsawed. And that is where you get your disintermediation. And to keep them a viable institution is going to be very difficult.

We had testimony yesterday that if inflation continues at over 5 percent, that the thrift institutions in this country will be very much in peril. And I frankly don't think that a $1,000 exemption will be enough to take care of the problem under those conditions.

Mr. SUMICHRAST. I accept the variable interest with the provision that there must be some protection of the consumer. I understand the problem of disintermediation. And I know it is very difficult for savings and loan institutions to compete. I sat on the board of a savings and loan institution that we started about a year ago, so I know how difficult it is to start these institutions, and even more difficult to keep one going.

Senator BENTSEN. I used to have one of them, and I know something about the problems.

Mr. Powell, you talked about giving a reduction for one-half of an investment in small business, just on the ordinary income of the corporation, because of the fact that that was in some way recaptured under capital gains. There is a hiatus there, and we don't know what the length would be, and you are letting it go at a lower tax rate. Before the Senate Finance Committee we get an awful lot of recommendations about giving additional tax concessions equal to the inflation, and we rarely get a recommendation on where we increase the tax to compensate for that. And I wondered if you had something in mind where we could pick up the taxes.

Mr. POWELL. Actually, one of the things that this was designed to do is to deal with the very problem to which you refer. The Small Business Administration, for example, in its efforts, and its loan financing, basically helps the company that has a track record. If you have a track record and need money for growth, you can usually obtain a Small Business Administration guaranteed loan. The problem area for obtaining loans is that dealing with the birth process. Obtaining initial funds and getting people to invest, so that new ideas can become business realities and contribute to growth of productivity and innovations in technology is where small businessmen encounter special problems. Interestingly enough, we give tax benefits for failure.

What I am trying to suggest is a tax benefit encouraging investment in business successes. It would seem to me that if there is substantial growth in the business, the tax loss would be more than recaptured in the capital gains tax suggested. We are not saying that they won't pay taxes. Rather, we are saying, "Give small businessmen a chance to get started then recapture the tax lost on the front end through the capital gains." If you can provide for the successful birth and growth of new firms, you are establishing the wherewithal to be taxed.

Senator BENTSEN. Mr. Landau over here is talking about reducing the capital gains tax. I have some sympathy with that idea on the long term.

Mr. LANDAU. In the long term it is the only reward that an entrepreneur really gets.

Mr. POWELL. I don't view these points as conflicting.

Senator BENTSEN. I do. If you substantially reduce the capital gains tax on long-term loans, I don't see how you can recapture it.

Mr. POWELL. What we are trying to do is find a way to provide that initial stimulus—initial capital for a business. I recognize that there has to be some kind of revenue base for the Government in order for the Government to function. That is what we are trying to do here. The main thing we are trying to do is suggest ways and means of providing for the birth and growth of small businesses. I do not view that this is necessarily in opposition to what you are suggesting. Rather to the contrary, it is the startup funds, or up-front money, that we are talking about which is needed.

Senator BENTSEN. Let me ask you, then, about this.

I understand the SBA forms are getting so sophisticated that a new enterprise has been created, the people who are in the business of completing the forms. And they charge $300 to $500 in fees, and then a percentage of the loans. Is that true?

Mr. POWELL. I can't speak on behalf of the SBA, because, of course, I am not their official representative. I can, however, say that from the banking side of the picture over the last couple of years, what they have done has dramatically made the forms less sophisticated. They have facilitated the process of processing loans on the banking side. I think what you are referring to is the loan applicant side. The other day a small businessman called me and talked about the problem to which you refer. His comments suggested the need for attention to the loan applicant side. On the banker's side, the SBA has really made great strides in providing more meaningful and less sophisticated forms. I gather that you are also suggesting this would be appropriate for the loan applicant side as well. I am unaware as to what has been or can be done in that area.

Senator BENTSEN. Mr. Powell, there is one part of your testimony that I was particularly concerned with and interested in; the idea that you should be giving more management and technical assitance, particularly in some of the minority situations. I understand that in San Antonio that they have one that is working rather effectively in helping minority groups get into small business and better understand what can be done. In fact, I met with a group in Austin only last week who said that they had been trying to get the same kind of setup in Austin and had not been able to do so, and they were asking for help. And they said the one in San Antonio was quite effective and helpful.

Mr. POWELL. You have had some real leadership in your State in this regard. I refer to the efforts of Dean Jack Steele of Texas Tech at Lubbock. Their program has been largely an unfinanced effort from the standpoint of university assistance. Their efforts represent a deep commitment on the part of the professors and the SBA in helping to preserve the private enterprise system.

Senator BENTSEN. Is the SBA really behind this effort? Do they really support this? Because the group in Austin says they have been given very little encouragement.

Mr. POWELL. We have been looking for ways and means to try to get this program underway. And thus far the SBA efforts have been largely limited to the SBI program, which is live case studies, sending undergraduate and graduate students out on live case studies. I look upon this as a valuable beginning. What we want to do represents an extension of this management assistance effort in a number of areas.

Senator BENTSEN. I would hope from your testimony that you could get the people in SBA to get seriously behind this and push what we have talked about. I think it would be very helpful.

Let me ask Mr. Jaenke a couple of questions here.

You talk about the future of production and productivity. We have made a lot of progress, but I don't think we are through. I think we still have great breakthroughs ahead of us. I know of a situation where the Agriculture Department percentage of the budget that has gone into research and development and food production was 10.7 percent back in 1955, and it has been going downhill ever since, and now it is down to about 2.5 percent.

We have had a Green Revolution, and many other great breakthroughs. I remember when I was a kid the stories about the Middle West, corn knee high by the 4th of July—that was way up there back then. But it is not true any more. They have got to where they mature corn in a shorter growing season, and the stocks are more resistant to some of the diseases. It seems to me that we ought to reverse the declining percentage that goes into research and development and we ought to increase it materially. That has a big payoff to the taxpayers and food consumers. We are talking about inflation cutting the budget of families. Now research and development gives us something that is good for all, it helps the farmer and the dairymen, the meat producer, and in time, hopefully, the payoff goes to the consumer. Shouldn't we be doing more of that?

Mr. JAENKE. I have absolutely no disagreement at all. There is some real potential to be reached in the areas of research. We do have an outstanding infrastructure in agriculture through the land-grant college system and this provides a tremendous avenue for implementing research findings. When you work with less-developed nations, one of the problems becomes one of getting started with this infrastructure, particularly in the research area. We have it in agriculture. It is a matter of putting some emphasis behind it, and in moving ahead on it.

Senator BENTSEN. Tell me, what is happening to corporate farming in this country? I recall a couple of years ago that there were all sorts of issues being floated in corporate farming, and a lot of buying of farms by corporations. And then I read about their experiences and some of their results. And some of them really took on horrendous losses. Now, are they continuing to expand in farming, or are they contracting?

Mr. JAENKE. First of all, let's define our terms here. Many, many small family farm businesses are incorporating for transfer to——

Senator BENTSEN. I am not talking about that.

Mr. JAENKE. There has been over the last 3 or 4 years almost as rapid an exit as there was an increase in the number of corporations entering agriculture in the late decade of the fifties and early sixties. The front-page center-spread emphasis on food and on the world food problems has in the last 18 months or so created a great deal of recurring interest on the part of nontraditional agricultural investors. And we are beginning to see some signs that some of these may be coming back. In other words, the cycle of the late fifties—of Litton Industry and a number of others getting into agriculture—may be returning, at least board room conversation is in the direction of agricultural investment, partly again because of an analysis of the food situation. But the experience has been very bad on the part of most of these companies.

Senator BENTSEN. A lot of them lost their shirts.

Mr. JAENKE. They just went down the tube on it. And I think that this would be a lesson that many would have learned before.

May I comment on the earlier question on variable interest rates? Virtually all of the $26 billion of loans that the farm credit institutions make are on a variable interest rate. We have one significant difference.

Sentor BENTSEN. They are based on something above the prime or something above your borrowing rate?

Mr. JAENKE. Yes, sir. They are our borrowing rate plus the cost of operations, which comes to, on a long-term loan, about half a point. If we are borrowing money, let's say, if it is going to cost us about 8.60, the rate to the farmer would be about a half a point above that, 9.1 or so. In the shorter term where there is, of course, more processing to be allocated, the cost to the borrower is about a point over the wholesale cost of money.

Senator BENTSEN. Hasn't it worked pretty well for you?

Mr. JAENKE. It has worked out beautifully. And we have one advantage. We are a nonprofit organization. But we have not found difficulty increasing or decreasing our interest rates as has been the experience of some others. And to the degree that other savings institutions are somewhat similarly structured, I think the variable interest rate has some real potential. You have an education factor to go through. You have got to do this very cautiously and carefully. But, we have loans of many millions of dollars, and we have small loans of $500 to agricultural groups and individuals. We find little or no difficulty with variable interest rates.

Senator BENTSEN. Let me ask you this. You say the farm real estate price has gone up about 25 percent in a year?

Mr. JAENKE. Yes.

Senator BENTSEN. Is that correlated to anything, or is that flight from the dollar with people running out there to try to protect themselves from inflation and bidding up the price of real estate?

Mr. JAENKE. The latter. The latter part of 1972 and 1973 were good profit years for American agriculture. The costs had not yet risen, and prices did go up in the grain area. The deal with the Russians and other factors brought this on. So the agricultural industry, which had traditionally been a very low return industry, showed some signs of coming to life in the early part of 1973. This is turning around, as I tried to say in my statement, in fact it is probably going to be the

opposite by next year. But the hedge against inflation, the old idea that, boy, if you can put your money in land, you have got something solid there, has contributed a great deal to this. The other factor is expansion on the part of the existing million farmers who produced 90 percent of our products. They have been in the market bidding, in addition to the doctors, lawyers, dentists, and others who are in it normally.

Senator BENTSEN. How can young people who want to go into farming these days meet the problems of the high prices and capital necessary to get into farming?

Mr. JAENKE. It is feasible but very difficult. We are proud of a young-farmer financing program that we inaugurated earlier this year. And this fall is really the first time that it has been underway. I think it is underway in about 6 districts out of our 12, in about half the country. And it provides for some special-tailored higher risk loans to young farmers, those having the management ability and otherwise. And it provides for joint and participation loans with some of the Government agencies, the Farmers Home Administration, and the guarantee type of loans. But it is very difficult. A $300,000 to $350,000 investment is requirer. And the knowledge, the technology requirements that are required, make it very difficult. And yet we are having an influx of people, and many are marrying into it or inheriting the opportunity. But we are hoping to encourage many others to come in—those who don't have quite that cushion. We want to help them out on the mortgage.

Senator BENTSEN. How about the substantial losses of cattle feeders, the livestock producers, has that significantly affected some of the banks in those areas?

Mr. JAENKE. Yes, sir, it has affected some of our institutions, our PCA's in our case—and I can speak only knowledgeably about those—we don't have any that have impaired their capital position yet, but there are some that are going to take several million-dollar losses on loans. The difficult questions come now in this winter and spring in the financing. We face the problem of trying to figure out ways to help a man who has a good track record as well as the new man with some good background.

Banks in Nebraska, I am told—and this is secondary—and some in Texas which have a high proportion of their portfolios involved in particularly the feeding of cattle are in some trouble. On the eastern shore, where the broiler industry is in just as bad trouble as the livestock industry, some banks are experiencing some difficulty there.

Senator BENTSEN. Mr. Landau, you suggested that we should substantially reduce long-term capital gains. Can you cite some other countries that have done this?

Mr. LANDAU. Oh, yes. As a matter of fact, there are some countries that have no capital gains tax at all. One of them is West Germany, the country I was talking about.

Senator BENTSEN. What is the situation in the Scandinavian countries?

Mr. LANDAU. Despite the fact that they are considered socialist countries, they actually have much lower taxes after 5 years, in fact no tax at all after 5 years on capital gains.

Senator BENTSEN. Are you opposed to the principle of deficit financing by the Government, or is it rather the amount and the timing as to what you describe as "chronic borrowing"?

Mr. LANDAU. I do not believe in deficit financing by anybody, least of all our Government. But I do recognize, as I said earlier, that there are certain needs for government expenditures to alleviate a great many of our ills and to help generate more of the productivity increases that we need; such expenditures have to be paid for, and a balance struck between taxation and spending. But the deficits, the printing of money, are among the root causes of our inflationary problems. We have just got to get out of that habit. It is like drug addiction, once you have it, withdrawal pains are worse than staying on the drug.

Senator BENTSEN. Well, the Democratic Policy Committee has chosen as an objective cutting the budget that has been submitted by some $7 billion. We have already cut it in the first eight appropriation bills that have been submitted by about $5.6 billion. We have four more bills to go and I think we will come close to the objective. But if we cut it a full $7 billion, we also have an economy of $1.4 trillion, and that is only one-half of 1 percent. That is really not a great amount. So I think it is pretty obvious that that is only one of the many things we must do. I certainly don't think that by itself is a panacea that is going to resolve the problem of inflation.

I talked to Mr. Stein, who was before this committee, and I talked to Roy Ash, and to Secretary Simon. And all three stated that in the last 18 months budget busting by the Federal Government had not been a significant cause of inflation. Last year we had great inflation, and about 60 percent of it was attributable to the increase in the cost of commodities, oil, wheat, and everything. It seems to me that one of the things we must consider is that when we make a deal on wheat, for example, with Russia, what effect does it have on the price of a loaf of bread in this country.

I can recall several years ago when President Johnson was President, the people in the executive branch were urging him very strongly to send several hundred million dollars of wheat to another country. They kept pressing him for a decision, and said, it has to be done now, because it takes 6 months to get it all accomplished and get it there. And then after 3 months they said they could get it done in 3 months. And finally he wrote across the top of this request, "What will this do to the price of a loaf of bread in the United States?" And none of these people had really thought about that problem.

Gentlemen, you have been very helpful. And we will take your testimony in its entirety for the record. And we will give it further consideration in the report on inflation that we will be giving to the appropriate committees of the Congress and to the President of the United States in December.

These hearings will continue at 10 a.m. tomorrow morning.

[Whereupon, at 12 noon, the committee recessed, to reconvene at 10 a.m., Thursday, October 3, 1974.]

49-914—75——10

FINANCIAL AND CAPACITY NEEDS

THURSDAY, OCTOBER 3, 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. Lloyd M. Bentsen, Jr. (member of the committee), presiding.

Present: Senator Bentsen.

Also present: John R. Stark, executive director; Loughlin F. McHugh and Courtenay M. Slater, senior economists; Robert D. Hamrin, Jerry J. Jasinowski, L. Douglas Lee, Carl V. Sears, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR BENTSEN

Senator BENTSEN. The hearings will come to order. We have a situation today where inflation and monetary restraint have placed our economy and our banking system somewhat in double jeopardy. To a large degree, rising credit needs reflect rising price levels. At the same time, it seems to me, the Federal Reserve has shouldered an excessive share of the burden of wringing out that part of inflation caused by excess demand. Over the past year the growth of the money supply—M_1—has slowed to a rate of 6 percent. Over the last 4 months it has been something in the area of 2 percent and that has severely limited the supply of funds available for lending.

Since the end of the 1969–70 recession, the combined credit obligations of business, consumers, and Government have soared almost 40 percent to a currently estimated $2 trillion. It is paradoxical, however, that in the midst of this liquidity explosion, we are faced with a growing capital shortage. Record interest rates and growing fears of credit shortages are persuasive evidence that even this massive credit expansion has been insufficient to meet demand. I was talking to a banker yesterday from Texas City and he was telling me the problem of small businessmen today. A record number of them seem to be in trouble. He said it was not a very pleasant time to be a banker.

I attended the recent summit meeting at the White House and I heard one of the economists say one of the encouraging things about today was the resiliency of the financial system of this country where even small businessmen were able to get funds at a time like this.

And when I asked him how, because that was not the story I was hearing, he said because big business funds them. That fellow had never been a small businessman because if big business funds your small business you become captive of that big business and the next

thing they want to do is look at your operating statement, want to decide whether you are making too much profit, and then if it becomes so in their own judgment, then they set your profit levels and finally, you are not a free agent any more.

I think that is a sad commentary if that is what we have going for us. Apparently, from that particular comment at the mine-summit, that is where they are getting financing today.

The dramatic increase in bank credit has been strengthened by capital requirements pushed even higher by double-digit inflation. Some financial experts have observed that the capacity of the banking system to continue lending at this pace is limited and that unless we bring inflation under control, we could conceivably reach a point in the years ahead where no practicable amount of reserve creation would be adequate to meet the inflationary demand.

The most recent drop in short-term money rates is a welcome sign. But we have to ask if this signals a move by the Federal Reserve towards less monetary stringency or is merely a "jiggle" or aberration based on false money market expectations. And, of course, another possibility is that demand for short-term funds has moved lower, reflecting the cumulative impact of recessionary developments.

Mr. James Tobin, of Yale University, who was before us a couple of days ago, reminded us that a shortage of money, unlike a shortage of food, is not an act of God—it is man made. The Government and Federal Reserve can ease the financial shortage which has depressed housing, weakened commitment to investment in capacity expansion projects, and increased unemployment whenever it chooses to do so. While inflation may be enemy No. 1, economic growth with stability is still our No. 1 goal. Sustained economic growth in those areas where shortages are being experienced is our economy's natural defense against inflation. Fiscal-monetary policies to encourage expansion can be adopted. The question is how much is needed and what constitutes a responsible contribution to our national anti-inflationary effort.

I do not believe the monetary floodgates should be reopened, I do not mean that for a minute, but if we are to persevere with more moderate money growth, greater selectivity in lending is essential.

Today we are very pleased to have with us C. J. Medberry, chairman of the board of the BankAmerica Corp.; Ira Scott, executive vice president, Savings Banks Association of New York State; and Henry Kaufman, partner, Salomon Bros. Gentlemen, you represent the views of the financial community—commercial and investment banking and thrift institutions. We are looking forward to your contribution. We made an interim report already to the President on inflation as he had requested, and now we are looking forward to the final report and we want very much to have your contributions for our consideration in that study. Mr. Medberry, would you please proceed, sir.

STATEMENT OF C. J. MEDBERRY, CHAIRMAN OF THE BOARD, BANKAMERICA CORP. AND BANK OF AMERICA NT&SA

Mr. MEDBERRY. Thank you, Senator Bentsen.

I am pleased to be here to take part in your committee's inquiry and to make whatever contribution I can to the study that you are preparing for the Congress here today.

I will review briefly the prepared statement that I have submitted.

Inflation is an extremely broad and complex problem.

There is a root cause which, in the long-term sense, is responsible for the inflation which besets our economy. There is a fundamental remedy which we must apply effectively if we are to curb inflation and prevent its resurgence.

For the past 25 years the emphasis of economic policy, both in the United States and abroad, has been on increasing demand. Our concern has been to achieve full employment: To provide jobs for all workers, to increase consumption, and to make available to every person the means to enjoy a decent—and improving—standard of living.

I am not here to argue whether our stress was right or wrong. My point is that, in our emphasis on full employment, we have seriously neglected supply. In our neglect we have failed grievously to provide for the capital formation which makes increasing production possible. Government and private consumption of resources is now so great that not enough is left for investment. That is the root cause of our inflation.

We cannot cope with our present inflation without bringing our capacity to produce goods and the demand for them back into balance. We will not be able to prevent future inflation unless production is able to keep pace with growing demand. Production requires investment of capital. The mobilization of adequate capital is the aspect of inflation I want to discuss with you today.

First, I want to consider the nature of our capital shortage. Second, I want to talk about the mechanism which can correct that shortage and the critical roles that must be performed by Government, consumers, and financial intermediaries if it is to function properly. Third, I want to discuss some of the immediate problems we face in restructuring the mechanism so that it can generate adequate capital. Finally, I will indicate the magnitude of our capital needs.

I. CAPITAL SHORTAGE

Inflation itself, pressure on financial markets, critical shortages, environmental controls, the tax structure, and political uncertainties have diverted capital from productive investment and prevented adequate capital expansion. Our basic manufacturing industries are producing at virtually full capacity. Yet, they cannot meet the demands put upon them, for lack of capacity and of materials.

Capital formation problems are certainly not unique to these times. They are the basic problems of economic growth. No economy can sustain growth without adequate capital formation. Economies which have failed to form sufficient capital have declined.

In the years ahead, growth in real output and basic living standards in the United States, as well as other countries, will be determined by the resources devoted to capital investment. This is perhaps most noticeably true in the capital-intensive sectors, such as energy and basic materials. Estimates of the amount of capital needed in future years range from large to staggering.

It will be increasingly difficult to finance those major projects——

Senator BENTSEN. Let me interrupt you as we go along.

Mr. MEDBERRY. Certainly.

Senator BENTSEN. I know when you take the cumulative amount of capital that is necessary for future years, it does appear staggering,

particularly at the top limits. But we had a witness yesterday who said it is definitely manageable, and he said the problem is we do not look back enough. We do not see what we have been using and how much capital has been necessary to have placed in capacity in this country and that it is not that much more. Do you differ with that kind of a statement?

Mr. MEDBERRY. Yes.

Senator BENTSEN. Do you think——

Mr. MEDBERRY. I do not agree with that, Senator. I believe it is considerably more partly as a function of inflation and partly as a function of technology and I failed to state previously that in the field of nuclear energy alone the cost of one efficient plant to enrich uranium is estimated at almost $3 billion, and that each such plant would provide fuel to support about $60 billion invested in electric generating facilities.

Now, in order to keep the cost of electricity down, in order to provide the amount of supply necessary for growth in our economy, we have got to build those facilities. In this particular type of uranium enrichment there were two contenders considering financing such plants and both had to withdraw. I believe the numbers are vast and I have not provided any numbers. The New York Stock Exchange, I believe, came to about $4½ billion. I have seen numbers from other sources ranging from $3½ to $5 billion over a period——

Senator BENTSEN. In what period of time?

Mr. MEDBERRY. The period of the next 10 or 15 years.

Senator BENTSEN. We had the chairman of the General Electric before us and they have done quite a bit of studying and forecasting with their economists. They are talking about $4½ trillion in the next few years.

Mr. MEDBERRY. Trillion is what I meant to say.

Senator BENTSEN. Even with the Bank of America, with the figures usually—you have to still translate to Government figures when you get down here.

Mr. MEDBERRY. Thank you, Senator.

The individual firm operating in the utility or basic raw material sector faces difficult investment and financing decisions in the years ahead. Financing the investments necessary for expansion will not be easy. Inflation has eroded the capital base of many firms in those sectors, for the replacement cost of equipment is far above historic cost. Retained earnings will not generate equity in sufficient volume. The opportunities to market additional equity issues do not appear promising, and additional equity sales would tend to dilute existing equity unacceptably. Additional bond or other forms of debt financing would increase the ratio of debt to equity, and, at some point, further debt extension would become impossible at acceptable costs.

II. SOME WORDS ABOUT MECHANISM

A free market economy will generate adequate capital if left free to do so. That is its vital function and its key benefit. Great as our need is to generate an augmented flow of capital, our need is more urgent to restore to our financial markets the necessary freedom and flexibility to enable those ingenious institutions to function properly. Rela-

tively free and open markets provide the best mechanism for generating the capital for expansion.

Capital formation resolves itself into two more-or-less distinct requirements. First, resources and output must be diverted from Government and private consumption into investment, which will ultimately create more consumer goods and services. Second, there must be an effective mechanism to transfer resources from savers to users, so that those resources can be transformed into plant and equipment.

Saving cannot be done without sacrifice. Government and consumers must accept a smaller share of the pie in order that more can be left for investment. There is no magical device by which the share of investment can be increased without reducing the share of Government and private consumption. Sacrifice now, in the present, is the only way to have more in the future. It is the only way to stop inflation.

Savers must be induced to forgo enough consumption to make adequate resources available for investment. How can the inducement be created? Basically, we have two choices: Government can provide the inducement, or private institutions can provide it. Otherwise it cannot be done.

Government, I believe, is the wrong vehicle. For Government to generate savings either by taxation or borrowing and to transfer resources by making loans or grants to investors is contrary to our entire history and philosophy. There is no firm basis in such a system for determining how much to allocate and to which capital users.

Government determination would supplant the decisionmaking function of the marketplace. It would remove the incentives and benefits of competition and create an unnecessary duplication of the existing financial system. It would presume that a small group of persons can make better decisions than the marketplace—a presumption which none of the experience of planned economies has demonstrated. It would provide the public with no effective way to signal its approval or disapproval of economic activities and thus eliminate the market's historical incentives for producing the desired combination of goods and services.

Artificial credit allocation is not a solution. Our problem is not one of misallocated capital but of inadequate capital. The best that credit allocation could do would be to take capital away from one use and direct it to another. That would simply trade one set of ills for another—and probably generate an expensive bureaucracy in the process.

On the other hand, relatively free and open markets, if they are allowed the flexibility to function well, can effectively provide the necessary inducements for savers and the mechanism for transfer of resources. Their capacity for those functions depends on their freedom of operation.

The mechanism which transfers savings to investors in our network of financial institutions also transfer inducements to save.

Financial institutions have no use for funds outside of their own capital. Their function is to reflect the inducements of borrowers to savers and channel the response of savers to borrowers. To perform those——

Senator BENTSEN. Let me touch a minute on this point——

Mr. MEDBERRY. Certainly.

Senator BENTSEN [continuing]. Of credit allocations and the direction of such.

Do you not believe that Government can be of some help in setting up guidelines, whereby financial institutions can on a voluntary basis have these priority areas highlighted to them, where they may make some loans that in the long run will benefit the entire economy, but in the short run they may not be quite as profitable? I can remember back years ago when the President called on the life insurance companies to try to allocate substantial funds—as I recall it was loans for depressed urban areas—and I can recall the Pru, the Met, some of the other large companies, leading off on that and talking about how they were going to set aside a substantial amount of their loans for that purpose and they did that but it was done on a voluntary basis because it appeared to be a national need at the time. Can that not be done?

Mr. MEDBERRY. Yes, I think it can, Senator. I remember the time you are speaking of. I think all of us participated in such voluntary efforts but what I am really saying is I think the difference is that they were voluntary and that they were not in such large amounts or so disruptive of free market operations that they would tend to restrict the natural flows of capital.

Senator BENTSEN. Yes. My recommendation to them was to do it on a voluntary basis, to try to highlight the objectives and needs of the country and try to get the cooperative assistance of financial institutions. My experience has been in the past that the major institutions, if they really understand the objective, and all, that there is some response.

Mr. MEDBERRY. I quite agree. As a matter of fact, I participated in meetings some years ago with the Secretary of the Treasury where there were some requests for voluntary action in connection with housing. I think that really it is a matter of degree that institutions do want to cooperate and in fact they regulate themselves to the public interest in some measure. And I think they do this partly philanthropically and largely out of instinct for survival because those institutions actually are serving the public and if they do not serve the public good, there is no need for the institutions.

Actually, I think the difference between use is technical or one of degree. I believe that there should not be coercive regulation or legislation to force the diversion of certain amounts of capital in institutions, to channel them to some users goring the ox of other users because I think that is not the way the market function is done. I think it can be done.

Senator BENTSEN. I do not recommend it be mandatory at all.

Mr. MEDBERRY. I am aware of that.

Senator BENTSEN. I recommended limitations on investments the bank trust departments can have in corporations.

Mr. MEDBERRY. Yes.

Senator BENTSEN. But I think that requires a prudent institutional investor role.

Mr. MEDBERRY. I would like to comment on that, if I may, Senator Bentsen. I think some of us already had similar regulations just as in this recent tight money period we have had voluntary restraints on our lending policy to try to help ourselves and to try to help the situation and see that all of our funds are productively channeled.

Senator BENTSEN. I think most banks have limitations placed on their bank trust departments, on investment, that probably fall within the limitations I proposed. The trouble is you have some goats in the crowd that do not. What is going to happen to them? You wait and see, Mr. Medberry, some of them are going to get in trouble and when they do, there will be a real outcry in this country and then you will see not corrective legislation but you will see emotional punitive legislation proposed and that is what we ought to avoid. We ought to approach the thing with objectivity at a time when emotions are calm and put some limitations on that are reasonable, and I think that is what I propose. But I can understand some banks would prefer no regulation at all. We just cannot do that.

Mr. MEDBERRY. To perform the services best, financial institutions have to be able to reflect accurately whatever inducements are offered and gather the savings in whatever form they are offered. To the extent that either of these processes is distorted, the transfer process is impeded.

Restrictions on financial institutions do not change the ability or willingness of borrowers to offer inducements or of savers to respond. They simply cause borrowers to go through other channels. Each restriction imposed causes some diversion of fund flows and some reduction in the efficiency of transmission.

This is not to argue that there is no role for regulation. Some regulations are essential to the integrity of the payments mechanism. Without a sound and reliable payments mechanism, growth is all but impossible. But there is a finel ine between protecting the integrity of the financial system and destroying its ability to channel savings to users.

Government's role in assisting the mechanism is essentially twofold: It can best help capital generation by reducing its own use of resources, and it can improve the performance of the mechanism by reducing its regulatory interference and removing some of the disincentives to capital formation which are now at work.

Government must reduce its budget in order to use fewer resources. Government must realize that, for every measure of manpower and material it uses, that much less is available for investment. But Government has no one to induce it to give up resources. Individuals can be induced to save by the promise of profit and more output. No such inducement can be offered to Government. The inducement Government responds to is political—the cry for more expenditures. It takes extraordinary vision and courage and judgment for leaders in Government to accept the fact that every additional use of current resources now means there will be less available in the future.

III. A FEW WORDS ABOUT THE PROBLEMS WE FACE

Reducing the large and growing share of resources consumed by Government is, in some ways, the most difficult problem involved in bringing inflation to heel and augmenting the flow of funds to productive investment. In addition to absorbing resources through taxation, Government competes in the capital markets every bit as much as important industries which need to expand their capacity. If adequate capital is to be had by the private sector, Government must limit its own consumption. It is, after all, private investment and growth in

output which make resources available to Government. The Government's borrowing in the markets must be limited.

Secondary financing adds another major dimension in the competition for capital. Agencies created by the Federal Government dip into the capital market for billions of dollars. The five major borrowing agencies had debt outstanding of $63.5 billion at the close of the last fiscal year. The total borrowing of all agencies is some $70 billion or more.

The creation of the Federal Financing Bank represents a firm step toward a coordinated approach to the markets. As a further step, and as a matter of sound policy, Congress should review those financing programs as a whole and their competitive impact on capital formation and capital markets.

A parallel advantage of reducing Government spending and borrowing is that those same steps are necessary to curb inflation in both the long and the short term. Over the long term, such reductions make more productive capital available. In the short term, they help to reduce excessive growth in money and credit.

Inflation destroys the delicate incentive to save. People save partly to hedge against uncertain future developments but also partly in the expectation that, by deferring consumption now, they can have more in the future. Inflation casts serious doubt on the proposition that the future promises more. So savers turn to current consumption. After prolonged unsatisfactory experiences, they simply become disenchanted with the inducements altogether. That makes resources for investment still more scarce. Only by reducing inflation can we restore the incentive to save.

In the present environment, inflation has done more to undermine the ability of financial institutions to function effectively than any other single force. It is through the financial markets that the effective transfer of resources takes place. As long as turmoil and uncertainty continue in the markets, savers will be hesitant to surrender their financial assets for any but the shortest periods of time. This condition forces business to try to carry out long-term capital expansion projects with a series of very uncertain short-term borrowings. It introduces uncertainty about the availability of funds and makes it virtually impossible to estimate the overall costs of a project. As long as the atmosphere contains such a degree of uncertainty, no business can confidently plan for the future.

The solution to inflation lies in a long-term commitment to balanced fiscal and monetary restraint. There will, of course, be costs involved in reducing inflation. Slower growth and some increased unemployment can be expected. Adequate assistance must be provided directly to those who are laid off and those who cannot find jobs. The increase in unemployment is regrettable but necessary. The alternatives are even less attractive.

Inflation and slow growth are a terrible price to pay for governmental attempts to satisfy all the groups which solicit Government spending. Faster economic growth resulting from larger investment can do more to cure the economic problems of our country than all of the Government programs combined. We depend on Government's vision and courage to reduce its use of resources so that in the future everyone can have more.

Government has still other urgent responsibilities in assisting with the formation of capital. These consist to a great extent of reducing impediments and disincentives to saving, investment, and the functioning of financial markets.

A word on regulation. We cannot try to protect everyone from every economy shock or risk. The attempt to do so leads to an economy so bound by regulations and restraints that it becomes stagnant. Ironically, in a stagnant economy, the very groups we try hardest to protect are those which suffer the most.

It is hard to separate the regulations which protect the integrity of the payments mechanism from those which stifle the ability of business to raise capital. Both effects flow simultaneously from many regulations. We believe the record indicates that regulation has restricted the ability of business to raise capital by failing to change as the environment has changed.

Financial institutions need additional freedom to gather savings in a variety of forms and to reflect whatever inducements the borrower is willing to offer. When businesses that are sound by anybody's measure are willing and able to offer acceptable inducements to savers but the inducements cannot be reflected by financial institutions, something is drastically wrong.

A word on taxes. How Congress raises revenue affects capital formation. I have not come prepared to offer a list of tax reforms to assist savers, investors, and businesses. I simply want to establish the point that the taxation of investment income cannot avoid influencing investment. Tax treatment of a host of factors involving income and assets has a bearing on investment decisions. In the aggregate, the tax laws have a substantial influence on how much investment and what kind of investment takes place.

A word on trade. The economy in which we operate is global. We live in an interdependent world. Capital formation transcends national boundaries. Likewise, a critical part of our trade originates or terminates in foreign countries.

Trade is essential to our economic health, and finance provides the underpinning of trade. Restrictions on the international flow of goods and funds inhibit access to foreign materials and markets. We depend on those overseas resources and markets; thus, goods and capital must be free to move both into and out of the United States. Legislation which restricts those flows is damaging and unproductive. With the world's strongest economy, we have the least to fear and the most to gain from international trade.

IV. HOW MUCH CAPITAL DO WE NEED?

This is the thing we were discussing earlier, Senator Bentsen. I think the only honest answer is to say that, figures aside, we are going to need all the capital we can get. The scope of the problem becomes more apparent when we consider the proportion of current output devoted to capital formation.

In the postwar era, the countries which have experienced very rapid growth have devoted 20 to 25 percent of their gross national product to investment. Japan and West Germany are the outstanding examples.

We in the United States currently devote about 15 percent of our GNP to investment. Therein lines the root of our inflation problem.

Senator BENTSEN. Let us touch on that one just a minute.

I agree with your numbers. Those are approximately what we have found. Why is it in this country that we have put so much smaller percentage of our GNP into fixed capital investment? Is it—do you feel that our tax laws are that much different from some of these other countries?

Mr. MEDBERRY. Yes. I believe that that is a factor. First of all, I think that the transfer payments involved in social legislation which have great political impact on the Congress and for which there is a need may have outweighed the other side of the coin with respect to how we allocate the national income. But certainly the taxes have had an impact.

I was very pleased when the Congress, having increased the tax on capital gains, saw fit in the present emergency to lower it. There are countries where there is no tax on capital gains and capital formation.

Senator BENTSEN. They did that, of course, in West Germany and after 5 years even in the socialist-run governments of Scandinavia, the long-term capital gain tax was removed after 5 years.

Mr. MEDBERRY. I think also that there is a bias in our tax laws toward consumption and against saving, and there have been numerous propositions about exempting some savings income to small savers to get them to postpone expenditures and to help them protect in a time of double-digit inflation the capital that they invest.

Senator BENTSEN. Well, that is done in Japan. It is done in Brazil. It is done in France.

Mr. MEDBERRY. I believe most of these propositions have been put before your committee, certainly before the Congress. I have not felt it would be proper for me to tell you gentlemen who are the real persons of influence in the Congress with respect to decisions which have to be taken to do anything about quantification of such measures. What I am trying to say here, Senator, is that I think that they should be confronted very seriously and that incentives should be given and that disincentives should be eliminated and that a free market generally will then move to correct the situation. In the years to come, if we—if our legislative climate and our regulatory climate is such that there are not disincentives and there are incentives, then we will have all the capital that we need to finance productive endeavors which will provide in turn employment and the high standard of living for our people.

I think that is a basic economic tenet and it runs into conflict with the demands made on the Congress from so many special interest groups which really are beyond our ability to satisfy in the sense of the national income. I think it is a matter of priorities and I have great empathy for the problem in the Congress of sorting that out.

It seems to me that there may be some things that are done to advantage certain articulate groups which have strong political pressures which may disadvantage the large majority of the people. I am not going to give you any specifics on that, but I think that this has tended to happen in the political process. I think that there is a problem in

all of the democratic countries of the west where these pressures are so great in our society today to make allocations which in the long-run which may not be in the best interests of the people that we are supposedly helping and protecting.

I wanted to say also that the indispensable weapon for combatting inflation is increased output and increased output requires more investment than we have undertaken in the recent past. If we are going to devote more of our GNP to investment, including housing, obviously less has got to go elsewhere. And to reach a level of 25 percent GNP where I say some of these other countries are at would require current investments to be increased by two-thirds. To put it in other terms, we now have about a 40-percent shortfall. We would have to nearly double this year's capital investment to achieve 25 percent of GNP next year. We could reach the 25-percent investment level by reducing consumption of individuals 16 percent or we could do it by reducing Government expenditures by 45 percent, and clearly neither of those alternatives would be acceptable. Yet, there is nowhere else to go.

We are going to have to increase investment through a combination of reductions in consumption and in Government spending. Much larger proportions of the gain in output must be devoted to investment. Consumers must be induced to increase their savings, and Government must reduce its use of resources. That is the only way we can generate enough capital so that we will have adequate output in the future and the urgency of the situation requires very disciplined actions. We must begin now and move consistently forward to try to accomplish some of those things.

If I can recap, I would say that we must cut the budget which Congress is addressing itself to now, and spending, and attempt to produce a surplus, to begin to offset the $100 million deficit we have had in the last 10 years, $85 million of it in 4 years of the last 7 years. I think an increase in taxation may be, although it is not politically palatable, a sign that we intend to be firm and that we are going to lick it. I may say in that connection the psychological part of the inflation, the expectation of people that inflation will continue, is greatly exacerbated by a policy which does not maintain some level of consistency, whether it is in the amount of money that is pumped by the Fed or the tax laws that are produced by the Congress or the regulations and changes in those regulations produced by the regulatory agencies.

I said that I would like to see us give incentives, realistic incentives for depreciation allowances, investment tax credit, other tax incentives, and to examine and eliminate disincentives in our regulations and laws that hinder those flows, and to desist from extensive new regulation. I would like to say say that our approach is positive and we apply the gas peddle, you might say, rather than the brake. I want to say in closing that I think the situation is critical and that the responsibility of the Congress to try to lead us out of this situaion by some timely, well-planned action after the study that your committee, Senator, and others are making is most important to our total economy and to the Republic.

Thank you very much for having me here. I would be glad to answer any questions now or later.

Senator BENTSEN. Thank you, Mr. Medberry.

[The prepared statement of Mr. Medberry follows:]

PREPARED STATEMENT OF C. J. MEDBERRY

I welcome the opportunity to present my views to this subcommittee and to contribute whatever I can to the Joint Economic Committee's report to Congress on inflation.

Inflation is an extremely broad and complex problem. Many reasons, both general and specific, can be advanced to explain why we find ourselves in the severe inflationary conditions which prompt your attention to the problem. Many general and specific remedies will have to be put into effect before inflation can be brought under control.

But there is a root cause which, in the long-term sense, is responsible for the inflation which besets our economy. And there is a fundamental remedy which we must apply effectively if we are to curb inflation and prevent its resurgence in still more virulent degree.

For the past quarter-century the emphasis of economic policy, both in the United States and abroad, has been on the problem of increasing demand. Our concern has been to achieve full employment—to provide jobs for all workers, actual and potential and to make available to every person the means to enjoy a decent—and improving—standard of living.

I am not here to say we were wrong. We have dealt with our economic problems as we understood them, and our problems might be equally severe today if we had chosen different priorities 25 years ago.

My point is that, in our emphasis on full employment, we have previously neglected supply—that is to say, capital information. We are now in a situation in which government and private use of resources is so large that not enough is left for investment. That is the root cause of our inflation. We cannot cope with our present inflation without bringing our capacity to produce goods and the demand for them back into balance. And we will not be able to prevent future inflation unless production is able to keep pace with growing demand. Production requires investment of capital and the mobilization of adequate capital is the aspect of inflation to which I want to address myself today.

First I want to consider the nature of our capital shortage. Second, I want to concentrate on a mechanism to correct the shortage and the critical roles to be played by government, consumers, and financial intermediaries. Finally I want to discuss some of the immediate problems we face in reconstructing a mechanism to generate adequate capital flows.

I do not come before this committee laden with statistics or a laundry list of complicated recommendations. My message is one of concept as specifics do not mean much unless we operate from a common, agreed upon framework.

CAPITAL SHORTAGE

One of the very few things there seems to be general agreement on in these times is that the United States is a particularly capital-short nation. For a host of reasons, both financial and non-financial, our level of capital investment has failed to keep pace with our needs. The onset of serious inflation and subsequent pressure on financial markets, selected shortages, exploding environmental control needs, and political uncertainties in many quarters have diverted capital and prevented adequate capital expansion. Capacity utilization has risen rapidly to the point where our basic manufacturing industries are producing at virtually full capacity and still cannot meet the demands put upon them or find all the materials needed for the task.

The problem of capital formation is certainly not unique to these times. It is the basic problem of economic growth. No economy has experienced continued growth without capital formation. And those which have failed to form capital have declined.

In the years ahead, the constraints on growth in real output and basic living standards in the United States, as well as other countries, will be determined by the resources devoted to capital investment. This is especially true in the capital-intensive sectors, such as energy and basic materials. Estimates of the amount of capital needed can be had from many sources. The amounts range from large to staggering. We have all seen projections of capital requirements for petroleum production, the production of synthetic fuels and the electric utilities. The magnitude of these numbers—in the hundreds of billions of dollars in the United States alone—is staggering. In the field of nuclear energy, the cost of one efficient plant to enrich uranium is estimated at almost $3 billion, and each plant will provide fuel to support about $60 billion invested in electric generating facilities.

Some projections indicate a need for such a volume of investment every 18 months by the end of this decade. The numbers are likewise gigantic in petroleum and synthetic fuels. Not only are the total requirements huge, but the state of technology and economies of scale require that those investments be concentrated in very large installations.

We believe that it will become increasingly difficult to finance these major projects in the years ahead. Our declining ability to maintain an adequate system of financing will act to constrain development and dampen the real growth of our economy. A slowdown of real growth in output is not likely to be matched by a slowdown in consumer desires for real consumption increases; and inflationary pressures will intensify.

For example, the individual firm operating in the utility or basic raw material sector faces some difficult investment and financing decisions in the years ahead. Serving the needs of the market will require major investments, and financing those investments will not be easy. Inflation in recent years has acted to erode the capital base of many firms in these sectors, in that the replacement cost of equipment is far above historic cost. Retained earnings will not generate equity in sufficient volume to support the financing requirements. The opportunities to market additional equity issues do not appear promising, and additional equity sales would tend to cause unacceptable dilution for existing shareholders. Additional bond or other forms of debt financing would increase the ratio of debt to equity, and, at some point, further debt extension would become impossible at acceptable costs.

THE MECHANISM

Our concern should be directed not to the amount of capital to be raised but to the mechanism, for the central benefit of a free market economy is that it will generate the necessary capital if left free to do so. Our emphasis should be much less on generating the immediately needed capital than on perfecting a mechanism to provide a continuing adequate flow of capital. We believe that relatively free and open markets provide the best mechanism to accomplish that end.

Capital formation resolves itself into two more or less distinct requirements. First, resources and output must be diverted from government and private consumption into investment which will ultimately create more consumer items. Second, there must be an effective mechanism to transfer resources from savers to investors so that those resources can become plant and equipment. This cannot be done without sacrifice. Government and consumers must accept a smaller share of the pie in order that more can be left for investment. There is no magical device by which we can increase the share of investment without reducing the share of government and private consumption. Such sacrifice now is the only way we can all have more in the future. It is the only way to stop inflation. We must face that fact squarely, and we must face it now.

Since the resources for investment must come from a reduced share for consumption and a reduced share for government, how do we go about making such reductions? How do we then assure the resources freed up go to investment?

REDUCING CONSUMPTION'S SHARE

An important part of saving done in this economy is done by individuals. Capital information is carried out by businesses. Savers must be induced to forego enough consumption to make adequate resources available for investment. How can the inducement be created? Basically, we have three alternatives. Government can provide the inducement, private institutions can provide it, or it will simply not be done.

For reasons which have been discussed at length, we believe government is the wrong vehicle. For government to generate savings either by taxation or borrowing and to transfer resources by making loans or grants to investors is contrary to our entire history and philosophy. There is no firm basis in such a system for determining how much to allocate and to which capital users. Government determination would supplant the decision-making function of the marketplace, remove the incentives and benefits of competition, and create an unnecessary duplication of the existing financial system. It would presume that a small group of persons can make decisions than the marketplace—a presumption which none of the experiences of planned economies has demonstrated. It would provide the public with no effective way to signal its approval or disapproval of economic activities and eliminate the market's historical incentives for producing the desired combination of goods and services.

Artificial credit allocation is not a solution. Our problem is not one of misallocated capital but of inadequate capital. The best that credit allocation could do would be to take capital away from one legitimate use and direct it to another legitimate use. This simply trades one set of ills for another, and probably generates an expensive bureaucracy in the process. Many financial institutions have already initiated voluntary programs to direct funds to needy areas within the limits of prudent financial activity. Further allocation would do nothing to increase the total capital available which is the pressing need.

On the other hand, relatively free and open markets, if they are allowed the flexibility to function well, can effectively provide the necessary inducements for savers and the mechanism for transfer of resources. Their capacity for those functions depends on their freedom of operation.

The mechanism which transfers savings to investors is financial institutions. But financial institutions also transfer inducements to save.

Financial institutions have no use for funds outside of their own capital. Their function is to reflect the inducements of borrowers to savers and channel the response of savers to borrowers. To perform this service efficiently, financial institutions must be able to reflect accurately whatever inducement is offered and gather the savings in whatever form they are offered. To the extent that either of those processes is distorted by regulation, the transfer process is impeded.

Restrictions on financial institutions do not change the ability or willingness of borrowers to offer inducements or change the willingness of savers to respond. They simply cause borrowers to go through other channels. Each restriction as it is imposed causes some diversion of fund flows and some reduction in the efficiency of transmission.

This is not to argue that there is no role for regulation. Some regulations are essential to the integrity of the payments mechanism. Without a sound and reliable payments mechanism, growth is all but impossible. But there is a fine line between protecting the integrity of the financial system and destroying its ability to channel savings to users.

Inevitably, in a market system, there will be borrowers who offer a larger inducement than they can in fact accommodate. In the aggregate, the number of those who do so fraudulently is quite small. The others are honest entrepreneurs upon whom the penalty of failure falls as heavily as it does on the lender. We cannot, however, afford to deny entrepreneurs the right to take that risk. We cannot try to protect everyone from every economic shock. Such attempts only lead to an economy so bound by regulations and restraint that it becomes stagnant. Ironically, in a stagnant economy, the very groups we try hardest to protect are those which suffer the most.

It is difficult to separate those regulations which protect the integrity of the payments mechanism from those which stifle the ability of businesses to raise capital. There are elements of both in practically every regulation on the books. We believe the record indicates that regulation has restricted the ability of business to raise capital by failing to change as the environment has changed.

Financial institutions need additional freedom to gather savings in a variety of forms and to reflect whatever inducements the borrower is willing to offer. When businesses that are sound by anybody's measure are willing and able to offer acceptable inducements to savers which cannot be reflected by financial institutions, something is wrong.

For the amounts of capital needed, borrowers have no place to turn but to financial institutions.

For example, as commercial bankers we are precluded from direct activity in the equity markets and underwriting of corporate bonds. However, we finance much of the construction activity and look to the long-term financing as a primary source of payment for our construction loans. And, in recent years we have been called on to provide a growing volume of longer-term loans to finance capital expansion.

One alternative to the traditional forms of financing major capital projects is off balance sheet project financing. This is an area that is growing rapidly and is likely to continue to do so. Project financing can take many forms and employ many types of instruments. A large portion of the rolling stock of the U.S. railroads has been financed through off-balance-sheet trust and lease arrangements. Regulations such as deposit insurance have a role in protecting the integrity of the payments system, and those kinds of regulations should be expanded and improved. The form in which savings are gathered, by whatever op-

tions of interest rate, maturity and volume a borrowers can reasonably justify, must be left to the province of the free market. Otherwise there is no mechanism by which consumers can be induced to give up resources.

Inflation also destroys the delicate incentive to save. One saves partly to hedge against uncertain future developments but also in the expectation that, by deferring consumption now, more can be had in the future. Inflation casts serious doubt on the proposition that more can be had in the future. The saver then turns to current consumption. After a prolonged unsatisfactory experience, he simply becomes disenchanted with the inducements altogether. This makes resources for investment still more scarce. Only by reducing inflation can we restore the incentive to save in all the various ways—savings accounts at financial institutions, stock purchases, bond purchases and others.

In the present environment, inflation has done more to undermine the ability of financial institutions to function effectively than any other single force. It is through the financial markets that the effective transfer of resources takes place. As long as turmoil and uncertainty continue in the markets, savers will be hesitant to surrender their financial assets for any but the shortest periods of time. This condition forces business to try to carry out long-term capital expansion projects with a series of very uncertain short-term borrowings. It introduces a great deal of uncertainty about the availability of funds even a short time away and makes it virtually impossible to estimate the overall costs of a project. As long as the atmosphere contains such a degree of uncertainty, no business can confidently plan for the future.

REDUCING GOVERNMENT'S SHARE

Government's role in the mechanism is twofold: it can best provide additional capital by reducing its own use of resources, and it can improve the mechanism by reducing its regulatory interference and removing some of the disincentives to capital formation which are now at work.

First, government must reduce its own budget in order to use fewer resources. Government must realize that for every measure of manpower and material it uses, that much less is available for investment. But government has no one to induce it to give up resources. Individuals can be induced to save by the promise of more output as a result. No such inducement can be offered to government. In fact the only cry government hears is for more expenditures. It takes extraordinary vision and courage and judgment for leaders in government to come to grips with the fact that every additional use of current resources now means less will be available in the future.

The federal government competes in the capital markets every bit as much as important industries where we now need expanded capacity. If adequate capital is to be had by the private sector, government must limit is own consumption. It is, after all, private investment and growth in output which make available the resources which government uses. Government borrowing in the markets must be limited.

Secondary financing adds another major dimension in the competition for capital. Many agencies created by the federal government dip into the capital market for billions of dollars. The five major borrowing agencies had debt outstanding of $63.5 billion at the close of the last fiscal year. The total borrowing of all agencies is some $70 billion or more.

The creation of the Federal Financial Bank represents a firm step toward a coordinated approach to the markets. As a further step, and as a matter of sound policy, Congress can and should review those financing programs as a whole and their competitive impact on capital formation and capital markets.

The great efficiency of reductions in government spending and borrowing is that this is the best answer to inflation in both the long- and the short-term. Over the long-term such reductions make more productive capital available. In the short-term it helps to reduce excessive growth in money and credit.

Reducing inflation in the short-term is a difficult but not insurmountable problem, and the tools with which to do it now exist. Much has been said and written about changes in how the economy reacts to economic policy. We are told that the rules have changed and that conventional monetary and fiscal policies no longer work as they once did. We believe the record shows a disregard for the rules rather than a change in the rules. Whatever the reasons, for a decade there have been deficits in the federal budget, sometimes sizable at or very near full employment. For that and other reasons, monetary expansion has been

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spoken consistently outside the range proposed by even the more liberal spokesmen. Efforts at restraint have been forced on the monetary authorities and have constituted a burden they are not equipped to carry.

The solution to inflation lies in a long-term commitment to balanced fiscal and monetary restraint until more normal conditions prevail in the economy. And it requires constant vigilance thereafter to ensure a balanced and moderate policy. There will, of course, be costs involved in reducing inflation. Slower growth and some increased unemployment can be expected. Adequate assistance should then be provided directly to those who are laid off and those who cannot find jobs. The increase in unemployment is regrettable but necessary. Unfortunately, the alternatives are even less attractive.

Inflation and slow growth are a terrible price to pay for governmental attempts to satisfy all the groups which solicit government spending. Faster economic growth resulting from larger investment can do more to cure the economic problems of our country than all of the government programs combined. We all depend upon government's vision and courage to reduce its use of resources to an absolute minimum so that in the future more can be had by everyone.

The second part of government's responsibility is to reduce disincentives to capital formation, and add incentives. Restrictions on the ability of financial institutions to induce savings have been mentioned. Taxes and other areas of regulation must be reformed.

How Congress raises revenue—the taxes we pay—affects capital formation. There is good reason to believe, for example, that taxation has encouraged debt financing at the expense of equity. Tax legislation which would put debt and equity on a more equal footing from the point of view of both buyers and sellers would reduce the force of tax considerations in investing and financing decisions.

We were encouraged by the recent action to increase the investment tax credit for utilities. That is an incentive, and a good one, but much more is needed. A great many other industries would find capital formation easier with a tax credit.

Depreciation schedules should be liberalized as an incentive. Inflation has distorted the measures of equipment value, and inadequate depreciation allowances is a disincentive to capital formation.

Serious consideration should be given to reducing taxes on dividend payments in an effort to encourage broader holding of equity. At the same time a small personal tax increase across the board should be considered as an aid in reducing inflation.

I have not come prepared to offer a list of tax reforms to assist savers, investors, and businesses. I simply want to establish the point that the taxation of investment income cannot avoid influencing investment. Tax treatment of a host of other factors involving income and assets has a bearing on investment decisions. In the aggregate, the tax laws have a substantial influence on how much investment and what kind of investment takes place.

Clearly these suggestions if enacted would reduce Federal revenue. That is precisely the point. A balanced and smaller budget is what frees resources for productive investment. And it is equally important that the budget be balanced over the long term and in surplus in the short-term.

Government has still other responsibilities in promoting the formation and mobilization of private capital.

The economy in which we operate is a global economy. We live in an interdependent world. Capital formation transcends national boundaries. Likewise, a critical part of our trade originates or terminates in foreign countries.

The trade is essential to our economic health, and finance provides the underpinning of trade. Restrictions on the international flow of goods and funds inhibit access to foreign materials and markets. We depend on those overseas resources and markets: thus, goods and capital must be free to move both into and out of the United States. Legislation which restricts those flows is damaging and unproductive. With the world's strongest economy, we have the least to fear and the most to gain from international trade.

Federal legislation places heavy capital requirements upon the private sector. The newly passed pension legislation poses the most recent example. The merits of this legislation are obvious, but there are serious implications for the economy in it too. We must be careful to keep in perspective the cost in terms of manpower and material of Federal programs. Regulatory bodies are tremendously expensive as evidenced by the fact that approximately one in six workers is employed by government. We urge the Congress to be wary of expensive programs which protect the few at the disproportionate expense of the many. These are programs we cannot afford.

HOW MUCH CAPITAL

Once the mechanism has been reformed, then how much capital is enough? The simple answer is that we can use all we can get. The scope of the problem becomes more apparent when we consider the proportion of current output devoted to capital formation.

In the postwar era, the countries which have experienced very rapid growth have devoted about 20 to 25 percent of their Gross National Product to investment. Japan and West Germany are the outstanding examples.

We in the United States devote about 15 percent of our GNP to investment, and therein lies the root of our inflation problem. The indispensable weapon for combating inflation is increased output, and increased output requires more investment than we have undertaken.

If more of our GNP is to be devoted to investment, including housing, less must go elsewhere. To reach the desirable level of 25 percent of GNP for investment would require current investment to be increased by about two-thirds. To put it in other terms, we now have a 40 percent shortfall, and we would have to nearly double this year's amount of investment to achieve 25 percent of GNP next year.

The magnitude of the problem can be demonstrated by the changes necessary to reach the desired level. We could reach the 25 percent investment level by reducing consumption 16 percent. Or we could do it by reducing government expenditures by 45 percent.

Clearly neither of those alternatives would be acceptable. We are going to have to increase investment through a combination of reductions both in consumption and government spending. If we are to have adequate capital and, thus, adequate output in the future, much larger proportions of the gain in output must be devoted to investment. Consumers must be induced to increase their savings, and government must reduce its use of resources.

The list of vital reforms presented here is not exhaustive. It could be expanded in many dimensions. However, these are the basic reforms needed to foster mobilization and growth of capital, and insure orderly operation of the markets.

The thrust of these reforms would be to reduce government interference in the free markets and to encourage the formation of capital. We know these policies will work, and we must act now because time is running out.

Senator BENTSEN. Do you, Mr. Medberry, always oppose deficit financing in the Government?

Mr. MEDBERRY. Deficit financing, no, certainly not. I believe, you know—it has been said that Mr. John Maynard Keynes would not be a Keynesian if he were alive today. I think there is a time for deficit financing and a time for surplus. The terrible part of this conundrum is it is not politically feasible to run a surplus because it is uncomfortable and again I have a understanding of the pressures on the Congress but there is a discipline that should be imposed by a legislative body just as there is a discipline in a family with respect to income and outgo.

I do not believe the Government can continue to run large deficits and pump more money to cover the cost of these deficts and not have a disastrous inflation which impoverishes the people, the citizens of the country.

Senator BENSTEN. Let me say, Mr. Medberry, I had Mr. Stein and Mr. Roy Ash and Secretary Simon before us. Each of them testified that in the last 18 months budget busting had not significantly contributed to inflation. Now, you are talking about moderation of regulations on banks. How do you feel about the Federal Reserve as it is presently constituted?

Mr. MEDBERRY. Well, I think the Federal Reserve is seeking to do what it can in monetary policy to control this problem. They have kept a very firm grip on the creation of money in recent months and it has been hurting but I think it has been a necessary remedy. The fiscal

policy which should support that has been lacking, I believe. I think the Fed no longer has a grip on as much as it used to have because of the changes in our financial institutions. The Fed was created in 1913 and a lot of water has gone over the dam. There are hundreds of billions of dollars that are not affected by Fed regulation.

I believe in the sincerity of those people. I think they are trying to do the best they can with the tools available to them. And I believe that they have not always succeeded in keeping the continuity of money flow and what I am trying to say is have a moderate expansion of money to keep pace with production and trade. I think sometimes it has become necessary to crimp it and then to ease a little too much.

I am not a critic or student of the trend there in recent years but I believe that we have in the middle run probably increased the money supply more than we should, more than we have kept up with productivity, and that is a serious contributing factor to inflation and that is partly the result of the deficits that we run.

Senator BENTSEN. Well, you had a substantial increase in money supply before the 1972 elections and since that time moderation.

Mr. MEDBERRY. Yes, we have.

Senator BENTSEN. Now, let me ask you about the status of banks today in this country and in particular about holding companies. I hear rumors and concerns—I know in years past when I used to pay more attention to banking that when you got up to 85 percent in loans that was considered a substantial loan commitment. If you were a country bank and got up to 50 percent you had a substantial loan commitment. But now I understand that in holding companies, the leveraging that is going on and some of the holding companies trying to really get into I think the numbers game or performance game, that some of them are getting up to 110 percent. Is that feasible? I mean is that possible? Has that happened? If so, is that a danger and a concern for us?

Mr. MEDBERRY. We saw some numbers like that in 1969 when money was very tight. There are tremendous pressures placed on banks when the borrowing demand is so heavy, especially in this last period when the capital markets have not been able to perform. The equity markets have been a shambles and the low-term money market has been very distorted, with a lot of that pressure coming into the banks.

I think the banks and borrowers both thought that the high interest period would be a lot shorter than it was. But I do not believe there is any intention on the part of the major bank holding companies to overleverage themselves unwisely.

You spoke of liquidity and the difference between a country bank and a major money market center bank. There are differences. The flow of funds, the ability of the management, the dispersion of risk, the way that risks are managed, the way the funds are invested in various assets——

Senator BENTSEN. I understand that, Mr. Medberry, but is it correct that holding companies, bank holding companies in this country today, some of them are at 100 percent?

Mr. MEDBERRY. I cannot speak to that, Senator. Mine is not. There are—loan ratios have increased in the last 18 months. Certainly in absolute terms the amount of the loan-outs in the major banks has increased very dramatically and a lot of that lending has been funded by short-

term money which is purchased in the open market. I do not believe that there is a situation which is critical or unsound. I believe that there has been a lot of rumor, some of which is scurrilous. Some of it may be just healthy concern. I do not believe there are practices prevalent which are putting us too close to the edge of the cliff, is what I am saying, but I can speak mostly for my own bank and holding company, and we have run a conservative bank with a high order of liquidity and, although we have been pressed, our assets and liabilities have grown. We have had high demand on us. We seek at all times to maintain proper liquidity and I believe we have done that and I believe we are always going to do that.

Now, that is not to say that some banks—and we have seen some instances where banks, mostly with inadequate management, have gotten in serious trouble, but I do not believe that that is characteristic of the industry as a whole. I believe the trouble that has been so widely publicized with respect to foreign exchange trading and some speculation or failure to observe the regulations that the banks themselves have imposed on their employees really relates to the total banking system in this country.

Senator BENTSEN. It is not your view that some of the large bank holding companies have leveraged themselves up to or over 100 percent?

Mr. MEDBERRY. Well, I do not have any figures in front of me but I do not believe that that is a typical situation at all. I think there are differences in how you give loan-deposit ratios. If you take the reserves out, and as Will Rogers used to say, there are lies, damn lies, and statistics, and there are several formulas, that the actual loan-deposit ratios of banks themselves have risen during this period of scarce funding and enormous explosive loan demand.

Senator BENTSEN. I would accept such figures of a national bank examiner in trying to determine loan ratios, and on such criterion you do not believe that any major bank holding companies have leveraged themselves over 100 percent?

Mr. MEDBERRY. Well, I have not studied the figures to that extent. Ours is about 70 percent. I do not believe that is untoward at all. We are, of course, a different kind of an animal than some other big-money-market banks, but I think there is a tendency in times like this to want to leverage. There is a pressure on profit. But I know most of the chief executives of major banks in this country and I see their numbers from time to time and I do not believe that the situation is critical.

Senator BENTSEN. Thank you, Mr. Medberry.

Now, we welcome Mr. Kaufman; if you would please proceed, sir.

STATEMENT OF HENRY KAUFMAN, PARTNER, SALOMON BROS., NEW YORK CITY

Mr. KAUFMAN. Senator Bentsen, my name is Henry Kaufman. I am a partner and member of the executive committee of the investment banking firm of Salomon Brothers of New York, N.Y., where I also serve as the chief economist and head of the firm's bond market research department.

I appreciate your invitation to appear before this committee and to present my views on several related subjects of great importance—the current health of the credit markets, an analysis of the impact of Federal borrowing on the credit markets, and my recommendations for dealing with our financial problems.

Our credit markets are being ravaged by the forces of inflation and, concurrently, are being seriously impaired by the changing structure of financial institutions and by the practices of their regulators. Our credit markets are in the most precarious position in the postwar years. The pressures and problems now are greater than those of the credit-crunch days of 1966 and of the financial crisis of 1970.

While interest rates have fallen a little in the last few weeks, most are still well above their peak levels of 1970.

Housing financing is contracting sharply and thrift institutions are suffering rampant disintermediation. Last month, housing starts fell to 1.1 million units seasonally adjusted, down 55 percent from their cyclical high. This compares with a 49- and 33-percent contraction during the two previous housing cycles in which lows were reached in 1966 and 1970, respectively.

The credit quality of a variety of borrowers is deteriorating. Domestically, this has been highlighted thus far by the downgrading of the credit ratings of the gas and electric companies. For example, 25 of these companies were downgraded during the first 8 months of 1974 as compared with 32 for the entire 2 previous years. Quite a few industrial and commercial enterprises will probably also experience this credit deterioration as soon as corporate profits fall and debt burdens remain high. Internationally, this credit quality deterioration has already gone beyond the private sector and has afflicted even foreign nations in the industrial world.

For the first time since the 1930's there is concern about the strength of our financial institutions. Disintermediation is hitting savings banks, savings and loan associations, and life insurance companies for the fourth time in 8 years. For example, savings and loan associations held $22 billion of cash and investments or 7.6 percent of total assets at the end of August and a substantial portion of these investments had maturities above 1 year. As recently as year end 1971, this ratio was 10.2 percent. Moreover, the very rapid growth of the commercial banks and their increasing involvement in international lending financed by a large volume of shorter dated liabilities has cast a cloud of suspicion over these institutions. This cloud has been darkened by several failures here and abroad.

The financial markets are also confronted with another unparalleled event. This is the recycling of the surplus funds of the oil-producing nations. The sums involved are staggering. They will create enormous financial and economic dislocations.

I have felt for some time that the basic difficulties in our credit markets reflect not a shortage of funds but rather the automating of the debt-creation process without adequate recognition of the strengths and weaknesses of the market participants. The postwar history clearly shows an acceleration in the debt creation process. The growth of credit-market debt, including the obligations issued by consumers, business, and our governments, averaged annually 6 percent in the 1950's, 7 percent in the 1960's, 7 percent in 1970, and 10 percent during

the past $3\frac{1}{2}$ years. Credit-market debt outstanding increased from $334 billion in 1947 to $2 trillion by mid-1974.

A huge portion of outstanding debt has financed inflation instead of real economic activity. If there had been no inflation in the post-war years, the volume of outstanding credit market debt at the end of last year would have totaled roughly $950 billion instead of $1.9 trillion and, of course, interest rates would be far lower than they are currently.

I believe that both the private sector and Government are to blame for the automation of the debt creation process. The wave of rising economic expectations made consumers willing and anxious recipients of credit cards, installment financing and other forms of credit accommodations that increasingly have encumbered their disposable income. Even the mortgage market became the vehicle for financing some consumer expenditures. Homeowners, having accrued substantial equity in their property, have refinanced their homes and taken the newly raised cash to pay for consumer goods and services. At the same time, many a corporation concluded that leveraging through debt financing was the wave of the future because it seemed to be the vehicle for maximizing earnings per share and, in turn, hopefully raising the price of its common stock. As a result, there rarely was an appropriate time for corporations to sell common stock to strengthen the capital structure. Financial institutions also have become preoccupied with performance and have enlarged their position in the financial system through overly aggressive lending and investing policies. In the process, some forgot their highly responsible niche in our society as fiduciaries for channeling savings and temporary funds.

These transgressions were fostered and encouraged by Federal fiscal and monetary mismanagement, which made it increasingly difficult for participants in the private sector to avoid being caught up in the spiraling of outstanding debt and its attending malaise. Instead of alleviating the problems of the credit markets, the Federal Government has actually compounded them. The Federal budget has become an inflexible tool of fiscal policy. Not only has a large portion of Federal expenditures become uncontrollable but other activities have been debudgeted but still enjoy the umbrella of Federal sponsorship and make very large demands on the credit markets. Only a decade ago, the net market financing demands of the Federal Government, encompassing the new debt issuance of the U.S. Treasury and the variout Federal credit agencies, were exceedingly small. They totaled only $3 billion in calendar 1964 but rose irregularly and dramatically thereafter, reaching as high as $26 billion in 1972. They will probably total an estimated $19 billion this calendar year. The mushrooming credit demands of the Federal credit agencies are particularly striking. In 1964, they totaled net less than $1 billion as compared with an estimated $21 billion in 1974.

I do not question the broad objectives of the Federal credit agencies. Aiding housing, the farmer, and our exports is very worth while but in quite a few instances these agencies fail to achieve their objectives. Four years ago, I stated that there were at least five basic problems associated with the burgeoning volume of Federal credit agency financing. Let me briefly summarize these five for you.

One, these financing activities do not do anything to enlarge the supply of savings, but as agency financing bids for the limited supply of savings with other credit demanders, it helps to bid up the price of money. This is a costly way to try to redistribute savings flows.

Two, because Federal credit agencies can outbid other demanders of credit and they do not add to the supply of new savings, they replace other demanders of credit, who will have to do without funds. This raises several serious questions. Who will be the new disadvantaged in the credit market? How will they fare in their individual sectors as they are denied funds?

Three, this participation by the Federal credit agencies is bound to eliminate a variety of participants in the private sector who become disadvantaged. This, in turn, increases economic and financial concentration.

Four, this large volume of agency issues aggravates the disintermediation process and raises inteerst costs generally.

Five, the debudgeting or privatizing of Federal credit agencies brings these operations outside the discipline of the Federal budget even though they are still on activity of the Federal Government.

With all the failings of fiscal policy, I believe, Senator, that the shortcomings of monetary policy are still substantially responsible for many of our current credit market problems. The rapid creation of debt was given added impetus when our monetary authorities removed regulation Q ceilings for negotiable CD's and thereby encouraged the commercial banks to enlarge their role in the financial system. As a consequence, banks were caught up in the competitive tussle of the marketplace and increased their liabilities massively, becoming large lenders abroad and domestically. For a while it seemed that access to bank funds was unlimited, encouraging business corporations, for example, to incure substantial short-dated indebtedness to finance even long-term requirements? Allow me to quote from an analysis of the current situation, which I made earlier this year.

I said at that time:

> Look at the strikingly different institutional arrangement between the current and previous periods of restraint. In 1969 and early 1970, commercial banks, mutual savings banks and insurance companies experienced disintermediation. Now, however, commercial banks can bid for new funds through the issuance of CD's, but these other institutions cannot. The ultimate consequences of the current arrangements are easy to envision. If the Federal Reserve continues to attempt to merely slow the expansion in the money supply and credit demand remains high, these other institutions will be sharply disintermediated as the commercial banks step up their bidding for funds through issuing CD's.
>
> In other words, under these circumstances, the commercial banks will still increase their size substantially by bidding successfully for new funds and for those held by other institutions.
>
> In addition, this new financial arrangement encourages borrowers to continue to finance short-term in periods of tight money. Banks are able to buy the funds and recycle them mainly to short-term borrowers and, to a lesser extent, to other borrowers who are willing to pay the market rate. This is a process from which commercial banks cannot easily disengage by themselves unless the Federal Reserve finds ways to slow bank credit expansion. The commercial banks are, after all, an integral and large part of a very competitive financial system in which maximization has become a driving force.[1]

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[1] A speech delivered by Henry Kaufman before the Financial Times Conference on "New York as a World Financial Center," the Waldorf-Astoria, New York, Tuesday, June 11, 1974.

Now some are suggesting that the way to make the credit market more viable is to eliminate a number of remaining interest rate ingredients such as fixed rate mortgages and the ceilings on the interest rates paid on savings accounts. These suggestions are based on several assumptions. First, the economy is served best by a highly competitive credit market. Second, sectors restricted by regulations will attract substantial money if these regulations are removed. I question both of these assumptions. An American credit market with very few rules of the game or restrictions will eventually turn into a zoo with no bars. It will automate further debt creation and raise interest rates to extraordinarily high levels whenever the monetary authorities are forced to move to restraint. Under such a system the Federal Reserve will be forced to validate massive debt expansion if disorderly markets are to be avoided. To be sure, competition within financial sectors often improves financial efficiency while unlimited competition among sectors will prove to be self-destructive.

There are vast differences between the impact of competition in our economic markets and in our financial markets. Unrestricted competition among financial institutions does not improve the competitiveness in our economic markets.

Indeed, I believe it is quite the contrary. Unrestricted financial competition leads to more economic concentration because in periods of credit restraint financial markets carry on intense donnybrooks between demanders and suppliers of credit. This forces interest rates to extraordinarily high levels, thereby weakening the marginal participants who fall prey to mergers or acquisitions or are forced out of business. Let us also remember that the economic system serves an entrepreneurial function while the financial system is the steward or the fiduciary of our savings. This is why most nonfinancial units of the private sector have large capital and moderate liabilities and financial institutions are thinly capitalized. Our drive to achieve competition would be served far better if it were aimed at the business world. Success in this effort there would automatically improve the health of the financial system.

Concerning the assumption that more funds will flow to demanders of credit if they are unrestrained by interest rate ceilings or other impediments, I feel that this will be only of marginal benefit to some. Removing these restrictions does not increase the flow of savings. How much can consumers hope to tap in additional funds, when they are competing against Government and business corporations? To the consumer, the higher cost of funds is not transferable. It becomes an immediate burden. To Government, this burden is always transferable. To business, interest rate costs are not an inhibiting factor until they rise very substantially and even then it is often the limited credit availability that is the key deterrent.

There are no simple solutions to our current malaise. If we are to pass through this period with only limited damage, there are a number of actions which, I believe, should be taken. It is critically important that we strengthen our financial institutions. Among other things, this will require effective control over the expansion of debt in a way that will permit new debt to be distributed over a broader base, particularly in periods of monetary restraint. One way to ac-

complish this objective is to limit the expansion in commercial bank credit. Commercial banks are large participants in our financial system. Controlling the flow of funds to the banks, either by liimting the growth of bank lending or by placing ceilings again on CD rates, speeds the restraint process, limits the escalation of interest rates, and acts as a reasonable proxy for total debt expansion. Was confidence in our financial institutions higher a decade ago when interest rate ceilings and other impediments acted as brakes on debt expansion, or is confidence higher now when many of these devices to slow debt have been removed? Unfortunately, I believe the answer is a decade ago. A confidence crisis in financial institutions and in the monetary mechanism can occur, even if our central bank has learned from the lessons of the 1930's. At that time, our problems were compounded by the unwillingness of the central bank to expand the availability of funds to ease the illiquidity pains of institutions and others. In the current period a confidence crisis can materialize if the massive growth of debt is not brought under effective control.

To strengthen confidence in our financial institutions, Congress should also instruct the regulatory and supervisory authorities to tighten their surveillance. In this connection, it would be very helpful if the various agencies involved, such as the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, would include in their annual reports a detailed evaluation and commentary on the health of the financial institutions supervised by them.

I also urge that our private financial institutions should not be a dominant force in recycling petrodollars. By participating massively in such an effort, they will endanger their own credit worthiness as they increase their own liabilities substantially and make loans to borrowers who may become increasingly marginal in quality. Even recycling these excess petro funds through Government institutions can be, at best, a temporary solution. The transfer of hundreds of billions of dollars, totalling perhaps a trillion dollars or more over a decade, is actually a transfer of wealth that will reduce living standards materially in the industrialized countries. This is a problem that financial markets cannot solve. It will require political or other solutions. In any event, it would be a mistake in strategy if the United States rushed to become the major lender of last resort internationally before the basic issues are resolved between the oil-consuming and oil-producing countries.

I also urge that Congress rescind its decision to allow Americans to gold starting next year. No one can accurately project how much gold will be purchased by Americans. Why run the risk now of additional pressures on our financial institutions which may intensify fears about their viability? Moreover, who will actually benefit from such transactions? It will be either the U.S. Treasury or foreign sellers. If the U.S. Treasury sells gold, the proceeds will increase Treasury balances and reduce Federal expenditures net, a poor way for reducing the budget deficit. If foreigners sell gold to Americans, our dollars go abroad and become claims on our resources.

Finally, I would like to urge adoption of a number of suggestions that I made in the past because recent events have confirmed their need. All governmental projections for economic activity should be

tested as to their financial validity. They should be accompanied by detailed credit flow projections. The U.S. Government should make public each year in a very prominent fashion its total involvement in our credit markets and evaluate the impact of this on interest rates and on private demanders of credit. In addition, the establishment of a Federal Fiscal Stabilization Board is, indeed, even more urgent today than when I first proposed it several years ago. We must break the occasional impasse between the Congress and the executive branch of the Government concerning budgetary matters.

This quasi-autonomous body should be appointed by both the President and Congress and be given limited powers to raise or lower taxes by a maximum of, say, 1 or 2 percent per year. This Board should also be required to project net budget surpluses or deficits for the year ahead designed to sustain orderly economic growth. It would be up to the Congress and the President to fill in the revenue and expenditure profile of the budget. Such a body would increase confidence in the budgetary process and I believe in the responsiveness of fiscal policy to changing economic conditions.

Thank you, Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Kaufman. I must say that is a rather discouraging presentation of our financial situation, and particularly our institutions, somewhat in conflict with what Mr. Medberry has stated.

In your review of the present state of our financial markets you talk about deteriorating credit quality afflicting foreign nations, would you explain what you mean by that?

Mr. KAUFMAN. Well, Senator, as you know, the credit quality of Italy has substantially deteriorated. Recently it required that Germany apply a direct loan to that Government because the market itself was unwilling to accommodate the Italian Government.

The city of Rome is in serious financial difficulty. There have been very huge borrowings by a variety of nations—France, United Kingdom, the less-developed nations—in the Eurodollar market, partly to finance their various activities, partly also in particular to finance very large borrowings of oil consumption. These borrowings have been of short maturity generally speaking, and this, of course, has imposed a substantial debt burden on these countries. Their credit quality has deteriorated.

Earlier this year a number of European countries wanted to do financing in the United States in the open market. Those issues were not financeable in the open market. Certainly the banking system has been able to accommodate a number of these countries for the time being but you must recognize that with an oil deficit for these nations and perhaps—and for the United States, the amount of borrowing that will have to be done by the industrialized world is going to be exceedingly large, and consequently, a number of nations are going to have a deteriorating credit quality position that probably cannot be accommodated by any of our financial institutions. And indeed, it would have to be accommodated initially by direct lending among governments and even that I believe has its limits.

Senator BENTSEN. You talk about not having our financial institutions recycling some of these petrodollars and you feel that there would be a deterioration in the lending, the quality of the loans made.

Why should there be a deterioration? Why does that automatically come about and if they are not recycling them, who is going to? I agree that does not resolve our problem by any means.

Mr. KAUFMAN. Well, our financial institutions already have substantial liabilities and a rather small capital base. Let us assume that over the next year or so, the excess—the surplus that will build up in the OPEC areas will total $75 billion and a good portion of that gets recycled into the United States and we will rely then on the private institutions in the United States to mainly offset that by giving these funds back to some of the oil deficit nations in the form of loans.

This will mean substantial lending—to Italy, to the United Kingdom, to the less-developed nations, France, the other countries. As they increase their indebtedness dramatically, their creditworthiness will deteriorate. I believe that is a burden that private financial institutions cannot bear.

Senator BENTSEN. Would you care to respond to that, Mr. Medberry?

Mr. MEDBERRY. Well, I agree with a good deal of what Mr. Kaufman has said but not all of it. This whole problem of the disintermediation of the OPEC country moneys is a very serious problem and does transcend the capability of private financial institutions. Obviously, we are doing it and so are some other banks in what are modest—moderate amounts in relation to the total but the risks involved and the fact that we are unable to match maturities because of the attitude of Arabs at this time and certain other things make that really a central bank or government necessity, but I believe that these things are going to change and grow. It is something of a learning curve. I cannot predict what is going to happen but I know that those people—I have had conversations this week in Washington with people representing a lot of those Arab funds and I believe that we are going to change their attitude with respect to their investments and——

Senator BENTSEN. Long-term investments.

Mr. MEDBERRY [continuing]. Go for longer term.

Senator BENTSEN. They are going to have to.

Mr. MEDBERRY. Not demand so much security, to accept risk investment and that is about all they can do with the money because the system cannot accept it on any other basis and I agree wholeheartedly any other basis would not be sustainable.

With respect to the countries which have very serious economic problems, they result as—not entirely from the oil situation or the energy crisis because they have had some of the same kinds of problems that we have in the management of our affairs. But I do not believe that a country like Italy with the serious problems it has is necessarily down the tube or that it will have to repudiate its debt. I do not think Mr. Kaufman means that either. He is pointing out that their credit is deteriorating and that if private institutions would continue to lend money that that might freeze up a lot of their funds if their problems in Italy or the United Kingdom or somewhere else are not worked out in a reasonably short period of time.

Senator BENTSEN. Mr. Medberry, to get back to another one I asked you earlier, and Mr. Kaufman has touched on it about the performance game that some of the banks seem to be indulging in, is it possible

that in the creation of holding companies, where you do not have the bank—the holding company not subjected to the same kind of regulation as the bank itself, that they can impair the economic viability of the bank or the role of the bank, the stability of the bank, by the operations of the holding company?

Mr. MEDBERRY. I am not too concerned about that for this reason. The Congress in its consideration of the possibility of that gave the authority over one-bank holding companies to the Federal Reserve and the Federal Reserve has a very cautious attitude. You know, that laundry list is not very long and the Federal Reserve has expressed some concern about—in the same direction that Mr. Kaufman has, the fact that those organizations might try to use too much leverage.

On the other hand, the underlying banks which in nearly every case are the principal asset of the holding company are being regulated I think effectively by the Comptroller of the Currency or some other agency which does that, State agencies or the FDIC or both, and I do not believe that the regulatory authorities are going to let—certainly the Comptroller of the Currency is not going to let national banks upstream a lot of money to holding companies to leverage in other types of investments. They are limited in those kinds of investments and in fact in the case of my own holding company it has gone to market and got money and put it downstream into the bank and our relationship—I do not mean to be subjective in my answer but our relationships both in holding company side and bank side are quite straight-forward and I think we have as much concern as anyone else that we do not go too far in leveraging because of the responsibility we have to the public.

I think it has been touched on here before. We are a fiduciary. We have the public's funds. We are the repository of confidence and we must maintain liquidity and we have every intention of doing that. I know that other big banks have been concerned about the pressures on them at this time and are trying to stabilize into—we cannot sustain the growth we have had, frankly, in the last year and a half and we have no intention of trying to. We hope that the pressures will ease and that we will get back to a normal pattern of moderate growth.

Senator BENTSEN. Mr. Kaufman, you talked about the great increase in Government-sponsored borrowing. I think you made a legitimate point. They do not increase savings but they do contribute very much to the utilization of capital for the purpose of Government objectives, and that we ought to make public each year the total involvement in the credit markets.

Do you think it would be helpful for the Federal Government to make a separate credit budget, as the Commission on Budget concepts recommended, that have the effect of combining the overbudget credit activities such as the Federal Housing Administration, overbudget activities such as Rural Electrification Administration? Would that type of report help give us a better understanding of the Federal Government's impact on credit?

Mr. KAUFMAN. Yes. I believe there should be a prominent financial budget displayed by the Federal Government in which we see directly the involvement of the U.S. Treasury and of various Federal credit agencies, also followed by an analysis of the impact of that kind of demand for the period ahead. We often make the mistake of assuming

that every demand can reasonably be financed. We have learned over the last couple of years, Senator, that not every credit demand can be reasonably financed, that there are many that become disadvantaged, and, therefore, there should be more consideration given to where will the money come from, and it is not in the official projections of the Council, it is not in the projections that come out from the Federal Reserve, or from the various budgetary agencies involved with the Office of Management and Budget. We need it.

Senator BENTSEN. Mr. Medberry, I very much concur that in the last 20 years we have paid too much attention to increasing consumer demand in this country and not enough to capacity, development of capacity, but that sure is something—a responsibility shared by both Government and business. I think if business and banks in particular, with the proliferation of credit cards which made it so much easier to buy things—I carry one of yours in my pocket.

Mr. MEDBERRY. I appreciate your saying that, Senator, and doing it. Would you like to have me comment on the credit card? I was not sure whether you were eliciting a response from me.

Senator BENTSEN. If you would like to, fine.

Mr. MEDBERRY. I would just like to say something about the consumer situation in this critical period that we are in now. You know, we have had some disintermediation, quite a bit of it in some financial institutions. There is competition but the consumers have not been forgotten and have not been hurt in their crunch, I do not believe. The mortgage market may be the most striking example of the disintermediation process. Yet in my own bank for the last 4 or 5 years we put $1 billion at least into mortgages each year and in fact we put over a net $1 billion—$1 billion net in 1973 largely in the single family residence situations, after payments, and we probably have put, in spite of the fact that most of the other institutions withdraw from the market in California because of the pressures on us, and a number of the banks also withdrew, we put about, oh, a net of about $600 million in this year through the end of August.

Now, I throw those numbers out. They do not have any meaning. It is in relation to what. The fact is that we are seeking to try to serve those markets, difficult as it may be, and like Mr. Kaufman's associates, we are in the savings bank business as well as in the commercial bank business. I meant not Mr. Kaufman but Mr. Scott, forgive me. We have not in our constraints on our lending hurt the consumer at all because the consumer is the last one to get pressed on that. In dealing in aggregates and trying to restrict your lending, it is the big number item that is the one that you can more easily control and also we feel a sense of responsibility in the retail side of our business to all those people.

Senator BENTSEN. Well, Mr. Medberry, actually, consumer buying has been down in a lot of areas and when you talk about mortgage money, I assume you are speaking of your own institution, but certainly you have a real serious crunch in the availability of mortgage money.

Mr. MEDBERRY. Absolutely. I acknowledge that.

Senator BENTSEN. We have a situation in homebuilding where we are down to about 1.1 million in starts on an annualized basis.

Mr. Scott, we are pleased to have you. We would appreciate your statement at this time.

STATEMENT OF IRA O. SCOTT, JR., EXECUTIVE VICE PRESIDENT, SAVINGS BANKS ASSOCIATION OF NEW YORK STATE

Mr. Scott. Thank you, Senator. I would like to state for the record that before joining the Savings Banks Association of New York State, I was a member of the academic community. I have also been privileged to serve as member of the staff of the House Committee on Banking and Currency, and not too long ago it was my privilege to serve as a consultant to this distinguished committee.

It should go without saying that I deeply appreciate this opportunity to discuss some of the problems of thrift institutions, mutual savings banks and savings and loan associations. Both of these—both types of institutions have much in common. By law and custom, thrift institutions are predominantly mortgage-oriented lenders, and both are especially vulnerable to the effects of monetary restraint. Before discussing these difficulties, I must say that I cannot, and do not, claim to represent the views of mutual savings banks throughout the country. Nor do I pretend to speak for savings and loan associations. Thus, what I have to say simply represent my views of the problems of specialized mortgage lenders in an inflationary environment.

In essence, the thrift institutions borrow short by providing highly liquid, safe assets for the public to hold, and invest the bulk of these funds in mortgages and other long-term and relatively nonliquid assets. It follows from the very nature of their operations that these institutions are highly exposed to the risks associated with fluctuating interest rates. During the early postwar period and indeed, throughout the fifties, short-term interest rates were well below long-term interest rates except for very brief intervals. In short, for several decades the term "structure of interest rates" made it advantageous and seemingly riskless to borrow short and use the funds to acquire long-term assets. It was not until the midsixties, when inflationary pressures began to develop momentum, that the need to hedge against interest rate fluctuations became abundantly clear.

In 1966, for the first time in the postwar period, thrift institutions sustained massive deposit withdrawals, as interest rates on short-term marketable securities rose well above the maximum rates payable on savings accounts. These outflows were followed by a recovery of deposits over the next 2 years, but disintermediation developed once more in 1969 when the posture of monetary policy was again oriented toward severe restraint, and then again in the summer and fall of 1973.

After only 5 months of irregular recovery from the July–October 1973 period of disintermediation, thrift institutions have experienced an even greater surge of deposit outflows in 1974. In the 5-month period between April and August, net deposit outflows from savings banks, before crediting interest, amounted to $2.7 billion, representing a loss of 2.8 percent of the industry's deposits. Over the same period, net savings withdrawals at savings and loan associations have amounted to $1.7 billion, most of which occurred in the month of August alone. This most recent wave of disintermediation clearly reflects the effects of a policy of severe monetary restraint. At the same time, these effects have been compounded by a flood of issues of high-yielding floating rate notes issued not only by bank holding companies but by nonfinancial corporations as well. Matters were made worse

by the Treasury's decision to reduce the minimum denomination on the notes offered in a refunding operation last August.

In accommodating deposit withdrawals, however, both savings banks and loan associations found it necessary to reduce their outstanding mortgage commitments, and new loan commitments have virtually dried up.

The tangible results of this most recent wave of disintermediation are painfully clear. New housing starts have plunged some 55 percent since early 1973, to a seasonally adjusted annual rate of only 1.1 million units in August. The decline in building permits and reduced mortgage commitments suggests that further declines in housing starts are imminent. Indeed, the pace of the 1974 housing downturn could be the worst since the Great Depression.

The underlying force behind these developments is, of course, the eruption of severe inflationary pressures, and with it the escalation of interest rates. In a more fundamental sense, the recent waves of disintermediation reflect the choices that we as a Nation have made—deliberately or inadvertently—as to the types of stabilization policies we have adopted to restrain inflationary pressures. That choice has generally been to assign the difficult burden of limiting demands to monetary policy or to let the inflationary pressures themselves generate their own rationing process. In either case the results are the same. Interest rates in general have been driven up; and in the process, available credit has been redirected from the housing to the business sectors.

The reasons for the uneven incidence of monetary restraint on housing are well known. While housing expenditures are obviously very credit intensive in character, the institutions that specialize in mortgage lending have highly variable inflows of funds. Since alternative sources of funds for these institutions are limited, shifts in rates of deposit inflows are communicated to a strong degree to the mortgage market. At commercial banks, the growth in deposits and other sources of funds is much more stable, but for commercial banks and other lenders mortgages are a residual form of investment.

Moreover, the commercial banks, by the very nature of their operations, are much less limited than thrift institutions in their ability to compete for household savings in periods of high and rising interest rates. In large part, this reflects the substantially shorter average maturity and more rapid turnover of commercial bank assets, which enables the commercial banks to take advantage of higher lending rates more quickly than thrift institutions. Furthermore, the prime and some other lending rates are much more sensitive to changes in market rates of interest than rates on mortgage loans, which are long term and subject to State usury or other ceilings.

By contrast, the ability of thrift institutions to increase earnings and raise deposit rates is limited by the fact that a relatively large part of their assets consists of long-term, fixed rate mortgages acquired in earlier years at much lower interest rates. When mortgage rates are rising, these increases only affect current additions to the mortgage portfolio. And since any new mortgage loans originated in a period of credit restraint constitute only a small part of the total portfolio of thrift institutions, the impact of any current increase in mortgage rates on the overall portfolio return is necessarily quite limited. During periods of monetary restraint, therefore, the rates that

thrift institutions would have to pay to depositors to remain fully competitive rise much more rapidly than the rate of return on mortgages and other investments.

Thus far the major policy response to these withdrawals has been the emergence of a network of governmental or federally sponsored credit intermediation. In essence, these agencies intermediate between mortgage borrowers and the securities market as a supplement to intermediation between mortgage borrowers and depositors at thrift institutions.

Time does not allow me to discuss the role of these agencies in any detail. Let me say, however, that whatever the advantages or disadvantages of Federal intermediation may be, this approach is no substitute for the development of a more viable thrift industry.

Among major financial institutions, thrift institutions by all odds have the greatest imbalance between the average maturity of their assets, largely mortgages, and the average maturity of their liabilities, largely savings accounts. The need to modernize the assets and liabilities structure of these institutions is long overdue.

Two broad lines of approach immediately suggest themselves. The first is to lengthen the average maturity of deposit liabilities in order to reduce their turnover and at the same time increase the potential for interest rate differential by type of account. Progress in this direction has already been made but the extent to which maturity lengthening can be relied upon to stabilize deposit flows is limited.

A second and more promising avenue of approach to the problems of thrift intermediaries is to reduce the average maturity of their assets or increase the flexibility of their yields. This approach allows for either continued specialization in mortgage lending or for asset diversification. To mention only one of the possibilities for asset diversification, thrift institutions might play a more active role in consumer installment lending. Even a small move in this direction could be translated into a higher average rate of return on portfolio and thereby support correpsondingly higher interest payments to depositors.

However, if thrift institutions are to maintain an overwhelming degree of specialization and mortgage credit, it is critically important they be given strong incentives to maintain mortgage lending at the center of their operations. The recent increase in the FHA and VA ceilings on mortgage interest rates represents a welcome change in this direction. Yet, much more could be done, both at the State level where usury ceilings on mortgage rates are maintained at unrealistic levels, and at the Federal level as well.

At the very least, the Federal Government should endorse and publicize its support of private experiments with variable rate mortgages. The widespread application of variable rate mortgage would quickly give savings institutions the effective equivalent of a very short average portfolio maturity, and thereby eliminate the lag between investment earnings and deposit costs. In the United States the development of this type of mortgage instrument has been quite slow, but in other major countries it is a standard and very workable mode of housing finance. In Canada, for example, mortgage rates are typically renegotiated at 5-year intervals.

Thrift institutions in one or more of the many States in which they operate already have some of the consumer loan or other invest-

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ment powers that are required by modern household oriented banking institutions. Unfortunately, these powers are not presently available under the differing provisions of State law for all thrift institutions—especially the savings banks all of which are State chartered. Providing savings banks with a Federal charter alternative and access to the progressive benefits of a dual chartering system would facilitate the transition to a more diversified and financially flexible thrift industry. The provisions of the pending financial institutions bill, which would enable thrift institutions to exercise a wide range of additional powers and provide the option of a Federal charter, should, therefore, be adopted promptly.

Even with broadened powers in the consumer loan and other areas and even with the development of greater flexibility in mortgage interest rates, the development of a more financially flexible thrift industry will necessarily take some time. It would be illusory to expect that the exercise of broader powers or the development of variable mortgage rates would provide any relief from the immediate pressures of disintermediation.

The pressures are, of course, a symptomatic reflection of the larger problem of inflation. Whatever policies may emerge from the recent summit conferences on inflation it seems clear that several years may pass before a reasonable degree of price stability is restored. Under these circumstances, additional action is needed now. Let me suggest three measures that can and should be adopted without delay in order to avert any lasting damage to the Nation's thrift institutions and to the housing activities they finance.

First, deposit insurance should be increased to $50,000 as provided in legislation already passed by the House.

Second, the evasion of deposit interest rate ceilings by bank holding companies through the issue of deposit-type, floating rate notes should be curbed as provided in legislation passed by the House and Senate. At the same time, deposit rate ceilings should be maintained and strengthened.

Third, and most importantly, the Government should provide a tax exemption or tax credit for a portion of interest earned in savings accounts. The impact of this proposal on revenue losses and the budget balance might be largely or fully offset by the reduced need for direct emergency housing and subsidy programs. Accompanied by other measures, a tax exemption would reduce the inequities inherent in a policy of severe monetary restraint, which places a disproportionate burden on thrift institutions and on the housing sector.

In conclusion, the question before us is what is to be the future of the private sector in housing finance? It has long been recognized that the thrift depositor has for years subsidized the home buyer who borrows to finance his home. There is increasing evidence to support the thesis that this is no longer going to be the case. If the depositor is no longer going to subsidize the borrower, who will? Will the Government do so? If Government is willing to pick up the subsidy, then how will the subsidy be arranged? If Government does not provide for the subsidy, the inescapable conclusion is that the borrower must pay what the market requires.

How these questions are answered will determine the future of the private sector in mortgage financing. Needless to say, the responsibility for providing the answers rests upon those in authority.

Thank you, Senator Bentsen.

Senator BENTSEN. Thank you, Mr. Scott.

[The prepared statement of Mr. Scott follows:]

PREPARED STATEMENT OF IRA O. SCOTT, JR.

Mr. Chairman and Members of the Committee, at the very outset, I would like to state for the record that I am employed by the Savings Banks Association of New York State, as the Executive Vice President of that organization. Before joining the Association I served as a faculty member at several universities, in the midwest as well as the East. These included my alma mater, the University of Kansas, Harvard University, the University of Minnesota, New York University, and Columbia University. I have also been privileged to serve as a member of the staff of the House Committee on Banking and Currency, and not too long ago it was my privilege to serve as a consultant to this distinguished Committee. It should go without saying that I deeply appreciate this opportunity to discuss some of the problems of thrift institutions—mutual savings banks and savings and loan associations. Both types of institutions have much in common. By law and custom, thrift institutions are predominantly mortgage-oriented lenders, and both are peculiarly vulnerable to the effects of monetary restraint. Before discussing these difficulties, I must say that I cannot, and do not, claim to represent the views of mutual savings banks throughout the country. Nor do I pretend to speak for savings and loan associations. Thus, my remarks simply represent one man's views of the problems of specialized mortgage lenders in an inflationary environment.

Let me begin by saying a few words about some of the essential characteristics of thrift intermediaries—savings banks and savings and loan associations alike. In essence, these institutions borrow short by providing highly liquid safe assets for the public to hold, and invest the bulk of these funds in mortgages or other long-term and relatively non-liquid assets. It follows from the very nature of their operations that these institutions are highly exposed to the risks associated with fluctuating interest rates. For many years these risks seemed very remote. During the early postwar period, and indeed throughout the 'fifties, short-term interest rates were well below long-term interest rates, except for very brief intervals. In short, for several decades the term structure of interest rates made it advantageous and seemingly riskless to borrow short and use the funds to acquire long-term assets. This pattern of interest rates, which reflected the stability of prices in general, provided substantial, and perhaps historically unique, opportunities for financial intermediation. It was not until the mid-sixties, when inflationary pressures began to develop momentum, that the need to hedge against interest rate fluctuations became abundantly evident.

In 1966, for the first time in the postwar period, thrift institutions sustained massive deposit withdrawals, as interest rates on short-term marketable securities rose well above the maximum rates payable on savings accounts and well above the average rate of return on the institutions' holdings of mortgages and other assets. These outflows were followed by a recovery of deposits over the next two years, but in the interim the availability of mortgage credit was sharply curtailed and new residential construction was hard hit in a cyclical slump that has become all too familiar. Disintermediation developed once more in 1969 when the posture of monetary policy was again oriented toward severe restraint, and then again in the summer and fall of 1973, as the effects of monetary restraint on thrift institutions were intensified by changes in Federal ceilings on deposit rates that reinforced the relative competitive position of commercial banks in household savings account markets.

After only five months of irregular recovery from the July-October 1973 period of disintermediation, thrift institutions have experienced an even greater surge of deposit outflows in 1974, as open market rates have soared to unprecedented highs. In the five month period between April and August, net deposit outflows from savings banks, before crediting interest, amounted to $2.7 billion, representing a loss of 2.8 percent of the industry's deposits. Over the same period, net savings withdrawals at savings and loan associations have amounted to $1.7 billion, most of which occurred in the month of August alone. This most recent wave of disintermediation clearly reflects the effects of a policy of severe monetary restraint. At the same time, these effects have been compounded by a flood of issues of high-yielding floating rate notes issued not only by bank holding companies but by non-financial corporations as well. Matters were made much

worse by the Treasury's decision to reduce the minimum denomination on the notes offered in a refunding operation last August.

The drain on deposits that began last April thus represents the fourth round of disintermediation in eight years, and the second within the past year alone. By now the record of recurrent deposit inflows and outflows has become so familiar that it no longer comes as a shock. Thus far, the thrift institutions have managed to ride out the most recent wave of deposit losses without difficulty, and I am confident that they will continue to weather the storm. The memory of last year's deposit withdrawals was very vivid and savings banks, which enjoy somewhat more portfolio flexibility than savings and loan associations, had increased their holdings of liquid assets quite substantially in anticipation of renewed outflows. In accommodating deposit withdrawals, however, both savings banks and savings and loan associations found it necessary to reduce their outstanding mortgage commitments and new loan commitments have virtually dried up.

The tangible results of this most recent wave of disintermediation are painfully clear. New housing starts have plunged some 55 percent since early 1973, to a seasonally adjusted annual rate of only 1.1 million units in August. The decline in building permits and reduced mortgage commitments suggests that further declines in housing starts are imminent. Indeed, the pace of the 1974 housing downturn could be the worst since the depression. All of this comes at a time when millions of families occupy dilapidated or otherwise substandard housing, and when the demographic potential for new household formation is still exceptionally strong.

So much for the recent and dismal record of disintermediation. The underlying force behind these developments is, of course, the eruption of severe inflationary pressures, and with it the escalation of interest rates to levels that mirror, in a rough way, the recent rates of increases in prices. To state the same matter another way, the acceleration of inflationary pressures over the past year or so has become so deeply embedded in lenders' fears, and borrowers' hopes, that expectations are fully reflected in market rates of interest. In a more fundamental sense, the recent waves of disintermediation reflect the choices that we as a nation have made—deliberately or inadvertently—as to the types of stabilization policies we have adopted to restrain inflationary pressures. That choice has generally been to assign the difficult burden of limiting demands to monetary policy or to let the inflationary pressures themselves generate their own rationing process. In either case the results are the same. Credit demands have risen above available supplies at existing interest rates, interests rates in general have been driven up, and in the process available credit has been redirected from the housing to the business sectors.

The reasons for the uneven incidence of monetary restraint on housing are well known. Housing expenditures are obviously very credit intensive in character, but the institutions that specialize in mortgage lending have highly variable inflows of funds. Since alternative sources of funds for these institutions are limited, shifts in rates of deposit inflows are communicated to a strong degree to the mortgage market. At commercial banks, the growth in deposits and other sources of funds is much more stable, but for commercial banks and other lenders mortgages are a residual form of investment.

Moreover, the commercial banks, by the very nature of their operations, are much less limited than thrift institutions in their ability to compete for household savings in periods of high and rising interest rates. In large part, this reflects the substantially shorter average maturity and more rapid turnover of commercial bank assets, which enable the commercial banks to take advantage of higher lending rates more quickly than thrift institutions. Furthermore, the prime and some other lending rates are much more sensitive to changes in market rates of interest than rates on mortgage loans, which are long term and subject to state usury or other ceilings. And the returns on a large proportion of other commercial banks loans—outstanding as well as newly acquired—are tied to the prime rate. Finally, a large proportion of commercial banks deposit liabilities takes the form of non-interest bearing demand deposits, which generate earnings that can be used in part to pay higher rates on time and savings accounts.

By contrast, the ability of thrift institutions to increase earnings and raise deposit rates is limited by the fact that a relatively large part of their assets consists of long-term, fixed rate mortgages acquired in earlier years at much lower interest rates. When mortgage rates are rising, these increases only affect current additions to the mortgage portfolio. And since any new mortgage

loans originated in a period of credit restraint constitute only a small part of the total portfolio of thrift institutions, the impact of any current increase in mortgage rates on the overall portfolio return is necessarily quite limited. During periods of monetary restraint, therefore, the rates that thrift institutions would have to pay to depositors to remain fully competitive rise much more rapidly than the rate of return on loans and other investments. Since earnings cannot support fully competitive deposit rates, at least not in periods of severe monetary restraint, the thrift institutions are much more vulnerable to deposit withdrawals than commercial banks.

Thus far the major policy response to these withdrawals has been the emergence of a network of governmental or federally-sponsored credit intermediation. In essence these agencies intermediate between mortgage borrowers and the securities market as a supplement to intermediation between mortgage borrowers and depositors at thrift institutions. In other words, the agencies have opened up an alternative supply of mortgage credit by issuing securities in the money and capital markets and supplying funds either directly, or in the case of Federal Home Loan Bank advances to member savings and loan associations indirectly, to the residential mortgage market. As borrowers on a very large scale these agencies can raise sizeable amounts of funds in the capital markets—an option which is not available to thrift institutions subject as they are to severe legal, as well as market, constraints. And as quasi-public agencies, with the actual implied guarantee of the Federal Government behind their debt, the agencies can borrow at comparatively low rates.

In a sense then, the agencies provide a first line of defense against declines in housing production by cushioning the effects of disintermediation at thrift institutions through a process of Federal or quasi-Federal intermediation. In periods of monetary restraint when the availability of mortgage credit from depository institutions is declining the agencies mobilize funds for mortgages through issues of their own obligations. These operations have clearly tended to stabilize and cushion the flow of mortgage credit.

There are, however, inherent limits to the extent to which intermediation by these agencies can be employed productively to moderate cyclical swings in housing. First, increased issues of agency securities, by putting upward pressures on interest rates, are an important contributing factor in bringing about large-scale disintermediation at private financial institutions. A second limit arises from the fact that intermediation in periods of high and rsing interest rates puts a squeeze on the financal position of federal credit agencies very similar to that encountered by private depository institutions. When the maturity structure of the agencies' liabilities is short relative to the structure of their earning assets, the average cost of borrowing rises faster than the average yield on earning assets. Moreover, as the spread between borrowing and lending rates narrows, the agencies risk the loss of their self-sustaining status. In short, they risk becoming public wards with their own obligations becoming direct claims on the nation's tax revenues.

Whatever the advantages or disadvantages of "Federal" intermediation this approach is no substitute for the development of a more viable thrift industry. Among major financial institutions, thrift institutions by all odds have the greatest imbalance between the average maturity of their assets, largely mortgages, and the average maturity of their liabilities, largely savings accounts. This imbalance, more than anything else, limits the ability of these institutions to cope with wide fluctuations in interest rates. The need to modernize the asset and liability structure of these institutions is long overdue.

Two broad lines of approach immediately suggest themselves. The first is to lengthen or stretch out the average maturity of deposit liabilities in order to reduce their turnover and at the same time increase the potential for interest rate differentiation by type of account. Progress in this direction has already been made. But the extent to which maturity lengthening can be relied upon to stabilize deposit flows is limited. There are no doubt individuals who would be attracted into longer term claims if given sufficient yield incentives. But for many individuals who hold time and savings accounts, a major attraction is the ease of withdrawal.

A second and much more promising avenue of approach to the problems of thrift intermediaries is to reduce the average maturity of their assets or increase the flexibility of their yields. This approach allows for either continued specialization in mortgage lending or for asset diversification. To mention only one of the possibilities for asset diversification, thrift institutions might play a more active

role in consumer installment lending. Even a rather small move in this direction would be translated into an improved rate of cash flow generation, a higher average rate of return on portfolio, and thereby support correspondingly higher interest payments to depositors. However, if thrift institutions are to maintain an overwhelming degree of specialization in mortgage credit, it is critically important that they be given strong incentives to maintain mortgage lending at the center of their operations. The recent increase in the FHA and VA ceilings on mortgage interest rates represents a welcome change in this direction. Yet much more could be done both at the State level, where usury ceilings on mortgage rates are maintained at unrealistic levels, and at the Federal level as well.

At the very least, the Federal Government should endorse and publicize its support of private experiments with variable rate mortgages. The widespread application of variable rate mortgages would quickly give savings institutions the effective equivalent of a very short average portfolio maturity, and thereby eliminate the lag between investment earnings and deposit costs. In the United States the development of this type of mortgage instrument has been quite slow, but in other major countries it is a standard and very workable mode of housing finance. In Canada, for example, mortgage rates are typically renegotiated at five year intervals. The adjustment in income inherent in this provision has enabled major Canadian mortgage lenders to match more closely the term structure of assets and liabilities, and maintain their ability to bid for funds in periods of tight money.

Admittedly, the Canadian approach, or for that matter any formula for variable rate mortgages, shifts at least some of the risk of interest rate fluctuations from the lender to the borrower. Under present institutional arrangements, residential mortgage borrowers usually bear none of these risks, and it would be quite inappropriate for public policy to encourage, or force, borrowers to absorb all of those risks. Yet it would seem reasonable to encourage arrangements that would provide a moderate degree of risk absorption by borrowers, as a means of reducing the risk exposure of lending institutions and of moderating fluctuations in housing activity.

For the government to encourage exploration of alternative ways of sharing these risks carries with it a concomitant responsibility to see that the distribution of risks is not inequitable. The problems involved in the design of a mortgage instrument that is equitable to both borrower and lender are very real, but not insurmountable. In suggesting that the government encourage experiments with variable rate mortgages, it should be emphasized that the ultimate beneficiaries of this instrument would not be the financial institutions, but the depositors whose funds the lending institutions invest. Indeed, flexibility in mortgage interest rates is a defensible course of public policy only if any resulting increase in earnings shared with depositors.

Thrift institutions in one or more of the many States in which they operate already have some of the consumer loan or other investment powers that are required by modern household oriented banking institutions. Unfortunately, these powers are not presently available under the differing provisions of State law for all thrift institutions—especially the savings banks all of which are State chartered. Providing savings banks with a Federal charter alternative and access to the progressive benefits of a dual chartering system would facilitate the transition to a more diversified and financially flexible thrift industry. In so doing it would help redress some of the competitive imbalances among depository institutions. The provisions of the pending Financial Institutions Bill, which would enable thrift institutions to exercise a wide range of additional powers and provide the option of a Federal charter, should therefore be adopted promptly.

Even with broadened powers in the consumer loan and other areas and even with the development of greater flexibility in mortgage interest rates, the development of a more financially flexible thrift industry will necessarily take some time. If variable rate provisions were introduced into new mortgages as they were written, it would be years before these mortgages became a significant part of the intermediary portfolios. Moreover, time will clearly be needed for thrift institutions to realize the potential opportunities provided by the Financial Institutions Bill. In any event, it would be illusory to expect that the exercise of broader powers or the development of variable mortgage rates would provide any relief from the immediate pressures of disintermediation.

The pressures are, of course, a symptomatic reflection of the larger problem of inflation. Whatever policies may emerge from the present summit conferences on inflation it seems clear that several years may pass before inflationary ex-

pectations are squeezed out of the economy and a reasonable degree of price stability is restored. Under these circumstances, additional action is needed now. Let me suggest three measures that can and should be adopted without delay in order to avert any lasting damage to the nation's thrift institutions and to the housing activities they finance.

First, deposit insurance should be increased to $50,000 as provided in legislation already passed by the House and pending in conference with the Senate.

Second, the evasion of deposit interest rate ceilings by bank holding companies through the issue of deposit-type, floating rate notes should be curbed as provided in legislation passed by the House and Senate. At the same time deposit rate ceilings should be maintained and strengthened through the introduction of meaningful differentials for medium and longer term deposits.

Third, and most importantly, the government should provide a tax exemption or tax credit for a portion of interest earned on savings accounts. While it is important not to impair tax revenues in view of the need for fiscal restraint, this propposal would provide an effective incentive to save. It would generate an immediate recovery of deposits at thrift institutions and facilitate the flow of credit into housing. As a result, the impact of this proposal on revenue losses and the budget balance might be largely or fully offset by the reduced need for direct emergency housing and subsidy programs. Accompanied by other measures, a tax exemption would reduce the inequities inherent in a policy of severe monetary restraint, which places a disproportionate burden on thrift institutions and on the housing sector.

In conclusion, the question before us is what is to be the future of the private sector in housing finance. It has long been recognized that the thrift depositor has for years subsidized the home buyer who borrows to finance his home. There is increasing evidence to support the thesis that this is no longer going to be the case. If the depositor is no longer going to subsidize the borrower, who will? Will the Government do so? If Government is willing to pick up the subsidy, then how will the subsidy be arranged? If Government does not provide for the subsidy, the inescapable conclusion is that the borrower must pay what the market requires.

How these questions are answered will determine the future of the private sector in mortgage finance. Needless to say, the responsibility for providing the answers rests upon your shoulders.

Thank you, Mr. Chairman.

Senator BENTSEN. You have cited a concern of mine, the problems of savings and loan and thrift institutions where they invested in long-term assets and have short-term savings. You get whipsawed very substantially.

What is the attitude as you know it of most people in the business of savings and loan and thrift associations toward the variable interest rate on mortgages? It is not a new idea. I can recall it being done years ago in California. They had—all the people from one subdivision finally came and picketed the savings and loan because they had done the financing out there. As I recall, something like——

Mr. MEDBERRY. There have been several experiences in California, Senator. Several experiments there have not been workable. I think people would like to come to a variable mortgage rate but they have not found out how to do it yet out there. We have not been able to do it either.

Senator BENTSEN. Yet, it has worked in other countries, as I understand, Mr. Scott.

What is the attitude of the industry in General? Can you generalize on this?

Mr. SCOTT. Yes. I think the attitude is that the variable mortgage instrument would, in any event, be difficult to arrange on any broadscale basis. I think it is undoubtedly politically difficult.

I think that the only reason that it is being considered, as I understand it, by the Federal Home Loan Bank Board, and the reason I

have given it some thought recently is that the kind of economic environment in which we live today is simply incompatible with a long-term portfolio. A private institution simply cannot survive forever in those circumstances.

Senator BENTSEN. I do not see how they can survive either. I do not see how they can remain viable institutions unless they adjust to the fluctuations in interest rates.

We had Mr. Sumichrast here testifying yesterday. He testified against variable interest rates. He said that the variables are always on the up side.

Do I understand the reason it is not workable is because of resistance by the mortgage payer when the payment goes up?

Mr. SCOTT. That is correct, sir. I would like to dispute the witness of yesterday, if I may. In New York State the mortgage rate varies only downward. We have a usury ceiling and we also have a law which says that the mortgage borrower may prepay without penalty at the end of 1 year. You see how that works out.

Senator BENTSEN. What about the feasibility—of course, you get into the question then of the residual value of an asset but the feasibility of a payment being left the same and the increased interest rate being added into the end of the mortgage——

Mr. SCOTT. This would certainly be one of the ways of alleviating the burden for the home borrower, and I am making this suggestion as one among others. The real problem is to give the thrift industry an opportunity to compete in the money market for funds and the basis for which to compete, and there are other ways of doing this, of course.

For example, quasi-public institutions, as is the case in some countries, could well make the long-term asset more liquid and provide in effect the flexibility of earnings that is required. This could be done, and the variable mortgage instrument is a possibility. The type of asset that the Canadian mortgage lenders acquire is another possibility where the rate is renegotiated.

Senator BENTSEN. You spoke of exempting interest on savings up to some amount. Have you made any estimate as to what it would cost up to $1,000 if you exempted those?

Mr. SCOTT. The Treasury estimates approximately $2 billion, sir.

Senator BENTSEN. The problem we have, Mr. Scott, and I am on the Senate Finance Committee, is we get all kinds of recommendations on how to cut taxes but we rarely get a recommendation on how to increase taxes to make up for the deficit on the one side.

Mr. SCOTT. Well, I would like to say, sir, that on the general subject which you have discussed with my distinguished colleagues, I share their views that there is a need for fiscal restraint and for a broad approach to that question, including the Federal agencies.

Senator BENTSEN. Well, we are committed to some fiscal restraints. We have cut the budget so far on the first 8 of the 12 appropriation bills by something in the area of $5.6 billion. The Democratic Policy Committee has chosen a target of $7 billion in cuts. Nevertheless, you have an economy that is right at $1.4 trillion. So even the $7 billion is about a half of 1 percent of that total economy. So I do not believe that that is the answer by itself. I think it is a many-faceted problem. It is going to require a number of things.

I know, Mr. Medberry, you are espousing some of the old religion, I believe, here, in the things you talk about. But I note also that one of your associates, Mr. Hoadley, at the presummit meeting, stated some of the old ideas were not working and the economy was changing. And that we had to come up with some new ideas in addition to some of the old ones. Would you agree with that?

Mr. MEDBERRY. Did he have any to suggest, Senator, at the meetings?

Senator BENTSEN. No. I listened very carefully and I did not hear those ideas.

Mr. MEDBERRY. I agree we need to explore new avenues to manage our affairs all the time. That is a management necessity. But I think that I come down pretty strongly on the need for self-discipline, not just in Government but in the lives of individuals as well. I think we have probably learned to cope with adversity better than we have with prosperity in this country. I think we can do a lot and we have done a lot but we cannot do everything. I think we have now come to the realization that our resources are limited and that we must manage and allocate them carefully.

Senator BENTSEN. Do you agree with Mr. Kauffman's statement that private financial institutions should not be the main instrument of recycling these petrodollars?

Mr. MEDBERRY. I believe I stated I do not believe they have the capability to do that in the amounts that are available. I think they are doing it at the present moment in some measure and will cautiously do what they can and I think it is not all just in the intermediation process. Some of it is done on an agency basis. But the sums that we now see are too great for private institutions to handle. I agree with that part of his testimony, if I understood you right, Henry.

Senator BENTSEN. When you talk about substantial Government cuts in expenditures, have you any specifics in mind in that regard?

Mr. MEDBERRY. Well, you know, this is a very difficult situation but I think it has to be done across the board. Every month, every week, every year, the pressure for additional expenditures is very great and I think certain segments of our people are highly articulate and successful in pressing within the political process to get what they want. The rest of us who are all taxpayers, who are not part of some articulate interest group, may not be expressing as clearly to our representatives in Congress not to spend that much money.

You know, it is easy for me to say—I have always felt that the legislature is very responsive to its constituents but that most of the constituents do not speak up and the squeaky wheel is getting maybe a little more grease than we can afford.

Senator BENTSEN. Well, would you agree that in some areas that Government expenditures can be as productive as private expenditures—manpower training, education?

Mr. MEDBERRY. Oh, the Government has done a good deal there and I think that is all very well intended but I think on balance, Senator, I come down on the side that the free market in the long run produces a more economic effect and that it works very well and that that is a discipline of life in the real world, that the more we tinker with it the less well it works.

Senator BENTSEN. Mr. Kaufman, on the question of the purchase of gold, many, many countries in the world have no restrictions on it, you know. France, Canada, Belgium, Germany, Japan. And very minor restrictions in the United Kingdom. In turn, we have had the ability as Americans to buy gold stocks, South African gold stocks, things like that, if that is where they wanted to flee with their dollars to protect themselves from inflation.

Did you seriously believe that it is going to result in a substantial increase in the price of gold?

Mr. KAUFMAN. I believe, Senator, this is not the time in which to take that chance, for several reasons. We are in a period of disintermediation. There is no clearcut projection as to the amount that Americans will buy in gold if they are allowed to do so starting in January. But we are an economy of over 200 million people with vast savings sitting in deposit institutions and elsewhere. We have had Americans denied for many years the purchase of gold.

No one can say with certainty, whether it is $5 billion, $2 billion, or $1 million. But if it should be large, it is a disintermediation force. If the Treasury does not sell the gold here, then there is a transfer of gold from Europe or elsewhere into the United States and we give up our dollars which are claims on us, and to the extent to which Americans buy gold, it immobilizes savings and investments. It does not add to the productiveness of our financial or to our economic system.

Recognize also that we have a vast network of financial institutions and very good marketing techniques in the United States. Allowing the American financial institutions and other entrepreneurs to distribute gold through the United States is perhaps likely to be done with far greater ability in a merchandising way than anywhere else in the world, and, therefore, there is the risk of large purchases of gold at the wrong time.

Senator BENTSEN. Mr. Scott, you talk about the housing starts going down substantially more and they are on an annualized rate of about 1.1 million, about half what they were. How much more are we talking about if we continue with the present monetary policy and interest rates stay where they are, and availability of the long-term money stays where it is? Even on the 1.1 million housing starts, is not a lot of that money that was committed sometime in the past by savings institutions being called on now?

Mr. SCOTT. That is correct, sir. The fact that savings institutions have outstanding commitments has contributed to the liquidity squeeze. And, of course, so long as net-deposit flows are negative, these institutions simply do not have the wherewithal to make new commitments. Therefore, I think there has probably been a delayed effect on capital formation in this area.

Senator BENTSEN. How much money would it take to stabilize housing starts, to get back to the 2 million level: $1 billion, $5 billion, $10 billion?

Mr. SCOTT. Sir, are you speaking in terms of, for example, the Government subsidy of the kind that the Brooke-Cranston arrangements would provide?

Senator BENTSEN. Yes.

Mr. SCOTT. Well, I am not sure I can answer your question offhand. I would be happy to try to do so subsequent to my testimony.

But one can, of course, look at the estimates that these proposals anticipate would be required. I think, if I recall correctly, one of the proposals implies an increase in housing starts of 300,000 units. Well, you can easily see that if you want to get housing starts up to the previous level, this would take at least three or four times as much as is envisaged in this proposal—and so on.

Senator BENTSEN. Mr. Medberry, considering the present condition of banks in the country, and their substantial amount of short-term financing for corporations, are there substantial available funds for homebuilding, and if there are not, should there be a sizable increase in homebuilding loans by the commercial banks?

Mr. MEDBERRY. Well, I will have to qualify my answer. All of the big banks, of course, are not in the homebuilding business.

Senator BENTSEN. No.

Mr. MEDBERRY. The big banks in California are savings banks as well as commercial banks and they do lend on mortgages and have always. We have had some disintermediation of savings deposits but it has not been great. Under regulation Q we were able to pay as much as 7¼ percent on other types of savings than passbooks and we have been able to hold deposits pretty well in the marketplace which are allocated to those uses.

You spoke about a number. I think $10 billion on the national scene might not do what you hope to do, and yet I believe that there is a lot or resilience in the building business and they are hurting now and the construction workers are hurting but it is a relative thing. We have had a number of periods in the last 20 years where, in some of the big growth areas of the country, the housing has been well overbuilt and then it is absorbed through natural increase or in-migration and in times of intermediation the numbers of construction starts go way down.

This is a stop-and-go process which is hurt by high interest rates but I believe it is a pretty viable animal and I think the rates are going to come down and that the construction is going to continue apace. I have not studied the figures and I do not know how many housing starts for a norm per year really are required to take care of our population expectancy, to keep people in good housing, but in addition to the new housing and there has been quite a lot—I would have to defer to Mr. Scott for what the average has been for the last 10 or 15 years. There is quite a large amount of refurbishment and renewal going on and the banks are lending in some measure right along in that market. So I am not really a pessimist with respect to the future of housing in this country or the ability in the long run for the financial markets to accommodate the mortgage market. I admit that it is a very difficult situation at the moment.

Senator BENTSEN. It is a real laying out. You have got about 10.8 percent unemployment in the building trades, for example. You have got 480,000 people out of work in the building trades. I talk to homebuilders who tell me they have seen a lot of their associates now who had their own companies back as foremen on jobs and they are finding a lot of them going out of business. The smaller ones just cannot survive. So you are seeing substantially increased foreclosures and that type of thing.

The problem is we understand trying to dampen inflation, and we all want to do that, but having the sacrifice borne in a very unequal proportion is what we try to find ways to moderate if we can and that is what I am concerned about.

Yes. Mr. Scott.

Mr. SCOTT. Could I comment just a moment on Mr. Medberry's comment about deposit flows? He is correct, according to my understanding of the figures. According to available figures, consumer-savings deposits at commercial banks have continued to increase during this recent period of disintermediation at thrift institutions. And I submit that the primary reason for this is the convenience factor due to the fact that commercial banks are able to provide checking-account services, personal-loan services, et cetera. This factor has long been valued by economists at from 50-to-75 basis points. In 1973, the regulation Q differential was reduced by the supervisory authorities to 25 basis points. The result—a shift in deposits from thrift institutions to commercial banks is to be expected.

Senator BENTSEN. Gentlemen, thank you very much for your testimony. It has been helpful to us in the considerations that we have concerning this report. We will reconvene a week from today when Mr. Arthur Burns will be here to talk to us about those interest rates.

[Whereupon, at 12:05 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, October 10, 1974.]

FINANCIAL AND CAPACITY NEEDS

THURSDAY, OCTOBER 10, 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. Lloyd M. Bentsen, Jr. (member of the committee), presiding.

Present: Senators Bentsen, Proxmire, Ribicoff, Humphrey, and Javits; and Representative Reuss.

Also present: John R. Stark, executive director; John R. Karlik, Loughlin F. McHugh, and Courtenay M. Slater, senior economists; Richard F. Kaufman, general counsel; William A. Cox, Lucy A. Falcone, Sarah Jackson, Jerry J. Jasinowski, Carl V. Sears, and George R. Tyler, professional staff members; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR BENTSEN

Senator BENTSEN. Ladies and gentlemen, the hearing will come to order. Mr. Burns, we are very pleased to have you with us this morning to discuss some of the very serious economic problems facing this country today.

Shortages of money are not like shortages of food. They are not God made but manmade. They are made by Government institutions, and more particularly, money is the responsibility of the Federal Reserve Board and to a degree can be relieved when the Board changes its policy.

You have pledged to the President, as we understand it, that the supply of money and credit will expand sufficiently to meet the needs of our economy, and that there will be no credit crunch.

Mr. Burns, there are a great many people in this country that think there is a credit crunch now, and I happen to be one of them.

The Nation's money supply has been increasing at an annual rate of only 1.3 percent since mid-June. You may call that a middle course, but I consider it a very restrictive course.

Seasonally adjusted housing starts are down 55 percent since 1972, and that is the sharpest decline since World War II. I don't believe it is a result of overbuilding in the last 2 or 3 years. We have seen some of our thrift institutions, our savings and loans, having a substantial outflow of funds. We have seen homebuilders around this country who can't get construction money. While some of the economy is having a recession, in homebuilding we have a full scale depression. We see construction workers in this country, 480,000 of them, out of work.

I don't believe that you really fight inflation in the area of rents when you have a substantial curtailment in construction for apartments and for homes. I attended that first mini-summit meeting at the White House. As I recall you were there, Mr. Burns. I heard one of the economists say how impressed he was with the resilience of our financial system. He said even small business can finance itself and get money today. When I asked where they got their money he said, well, they get it from big business. Well, I understand how that works because I was a small businessman once myself, and when you get your money from big business, you become a captive of that large business, and finally they say, well, we are not sure about your profit margins, let's take a look at your books and let's see what your profit margin really should be. And finally you become a satellite and you are no longer a part of the free enterprise system.

We have a real depression in the equity market today. Middle-sized companies and small-sized companies certainly can't go to the equity market even if they have a growing market.

I am not convinced that a high investment tax credit is the way to encourage the expansion of capacity across the country, because various companies and various industries have substantial varying degrees of capacity, overcapacity and shortages of capacity, and I don't quite understand how you should be giving the same 10 percent tax credit to some of them who are doing very well already. I have urged more selective credit policies as one of the means of helping capital short areas of the economy. I was certainly pleased when the Board of Governors released the recommendations of the Federal Advisory Council for more selective credit policies. I hope the Board will continue to put the full weight behind those recommendations.

Last week we began hearings before this committee on credit availability and the financial needs of our country. I am not suggesting as one witness did then that we can use all the money that we can get. I am not talking about opening the floodgates of credit. But I do think that they can be reopened to a degree with some prudence and discrimination and that we urgently need a less restrictive monetary policy.

Mr. Burns, I will look forward to hearing your testimony and discussing some of these questions with you.

I would now like to call on Congressman Reuss and the statement he might have.

Representative REUSS. Thank you, Mr. Chairman.

I don't have a statement. I would just like to say to Mr. Burns that I welcome you and that I intend in my time this morning to examine rather thoroughly into the matter of the Franklin National Bank. I mention it at this time because you may want to ask one of your associates to get for you, let's say, the balance sheets and probable loss statements of Franklin New York for the last 2 or 3 years and also a record of the Fed's loans and discounts made to the bank in the last year so that when we go into it we have the figures before us.

Thank you.

Senator BENTSEN. Senator Proxmire.

Senator PROXMIRE. No statement.

Senator BENTSEN. Senator Ribicoff.

Senator RIBICOFF. No statement.

Senator BENTSEN. Mr. Burns, you are on your own.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. BURNS. Thank you, Senator Bentsen.

I am pleased to appear before this committee once again this year to discuss our Nation's economic problems. Your main concern at these hearings, as I understand it, is to assess our Nation's needs and prospects for capital formation. Any such inquiry, I believe, should take as its starting point a general evaluation of economic and financial conditions as they exist at the present time.

The rampant inflation that we have been experiencing is having profound effects on the state of our economy—on production, jobs, interest rates, and security prices. Thus far this year, the consumer price index has risen at an annual rate averaging 12½ percent. Wholesale prices of industrial commodities have risen much more steeply, at an annual rate of over 30 percent. And prices of farm products and processed foods at wholesale, after declining in the spring, have recently moved up sharply again, in response to disappointing crop prospects.

Sustained double-digit inflation has pervasive implications for the performance of the economy. Despite sizable wage gains the real earnings of urban workers have eroded and consumer buying has suffered. Reports on business sales and profits are superficially favorable, but they have in fact been distorted by the inflation. Profits from domestic operations, after allowance for the effects of arbitrary accounting practices, have been generally disappointing. Financial relationships have also been thrown out of kilter. Nominal interest rates have soared because of the inflation premium demanded and received by investors; savers have shifted funds from the depository institutions to higher yielding market instruments; stock prices have plummeted.

A still more ominous result of the inflation is the spread of doubts among businessmen and consumers. They do not know what their future expenses will be in dollar terms, nor whether their incomes will be sufficient to meet their costs. They do not know how they can protect their accumulated savings, the real value of which has been eroding despite a continuing buildup in dollar terms. They do not know what markets will be hurt by, nor what markets will benefit from, the higher and higher prices that people must pay. In short, the basic premises for the planning that American business firms and households customarily do have been upset, and the driving force of economic expansion has been blunted.

It is not surprising, therefore, that the physical performance of the economy has stagnated in recent months. Aggregate real output dropped in the first quarter of the year, as the Nation was adjusting to the shortage and steeper prices of petroleum, and it seems to have weakened somewhat further during the second and third quarters. Industrial production has been less affected by the slump in demand, but in August it was about 2 percent below the peak of last November. As a result of slower real output and sales, the demand for labor has tended to moderate. The length of the average workweek has declined somewhat and the growth in employment has slowed. The labor force has continued to expand, however, so that the unemployment rate has moved higher and reached 5.8 percent in September.

The recent stagnation in real output, and the associated deterioration in employment conditions, are regrettable manifestations of the damage to our economy wrought by inflation. If these recessive tendencies persist, they must and will be resisted. But a vital point that has been commonly overlooked is that, given the pattern of demands in the economy, we have not had the capacity for significantly larger output over the past year. Idle capacity that could be used to produce more automobiles or housing units does not directly provide resources that can be used to produce the goods and services that are in stronger demand. The use of raw materials in these sluggish activities is reduced, to be sure, but the investment in plant and equipment—and in the short run, a considerable part of the labor force—is not readily transferable to other endeavors.

The moderation in the Nation's overall output has already lasted a full year. Even so, some industrial materials, component parts, and equipment remain in short supply. Steel, aluminum, coal, plastics, paper, and basic chemicals are still counted among the shortages, as well as fabricated products such as electric motors, bearings, and metal castings. Supply conditions have gradually been improving, however, and price quotations for some sensitive industrial raw materials have declined of late. The weekly index of prices of such materials that the Federal Reserve maintains has dropped 18 percent since the April peak, though it remains higher than at any time prior to last December.

I am hopeful that the availability of basic industrial materials will continue to improve. As it does so, there will be room for orderly expansion of output by industries that are heavy users of materials. Sizable investment programs are now underway in many of the basic materials industries, which will be adding significantly to their capacity in 1975 and subsequent years. Capital spending plans for 1974, for example, are indicated to exceed 1973 outlays by 42 percent in the paper industry, 35 percent in the primary metals industry, and 20 percent in chemicals. These data reflect. of course, higher prices as well as larger physical quantities. Judging from reports on new appropriations and capital spending plans, further substantial increases in manufacturers' capital outlays are in prospect for next year.

It should be noted that the shortages in productive capacity have been spotty rather than general in character. We estimate that the basic materials industries have been operating, on average, at about 90 percent of capacity thus far this year. This is somewhat below the 1973 operating rate, when supplies were exceptionally tight, but higher than in most other years during the past decade. For manufacturing generally, on the other hand, operating rates appear to be considerably lower.

Thus far this year, business capital expenditures have extended their rising trend, in real terms as well as dollars. Indeed, larger gains might be difficult to achieve in the short run, since production of business equipment appears to be close to the limits of that industry's capability. The output of business equipment has grown little this year in the face of continued large increases of order backlogs. Preliminary readings suggest that capital spending will continue at a high level next year, but may not grow much in real terms. We need to encourage larger business capital formation in the interest of enlarging our productive capacity, modernizing industrial technology, and intensifying the forces of competition.

Many observers are forecasting a deepening recession in the U.S. economy in the year ahead. On present evidence, I believe that they are unduly pessimistic. Capital spending, as I have said, can and should move ahead, particularly if tax incentives to investment are increased. Residential construction activity, which is now badly depressed, is likely to experience a revival in the year ahead. The expanded program of governmental assistance in the mortgage market announced by the President will contribute toward that end.

We cannot realistically expect a sustained resurgence of economic activity, however, until confidence in our Nation's economy is restored. This, I believe, will require hard evidence that we are making progress in checking the disease of inflation. Frugality in spending by the Federal Government, and moderation in the wage demands of workers and in the pricing practices of business firms, are essential to regaining stability in the value of the dollar. Meaningful progress in combating inflation would lead to a resurgence in consumer buying, a reduction in interest rates, a restoration of financial asset values, and a rebuilding of the optimism and confidence that engender greater willingness to save and to invest for the future.

Given the intensity of the inflation, as well as the excessive pressures on supply that have been present in key industries, the Federal Reserve has been striving for some time to hold down the growth of money and credit. The policy that we have pursued represents a middle course. We have tried to apply the monetary brakes firmly enough to get results, but we have also been mindful of the need to allow the supply of money and credit to keep expanding moderately.

Our policies have had considerable success in dampening the expansion of the monetary aggregates. So far this year, the narrowly defined money supply—that is, currency plus demand deposits—has grown at an annual rate of 4½ percent, in contrast to an average increase of 7 percent during the preceding 3 years. Under a broader concept of money, defined to encompass also time deposits of commercial banks, except for their large negotiable certificates of deposit, the money supply has grown at a 7 percent rate, in contrast to a 10½ percent average rate of increase during the 1971–73 period.

Thus, the monetary aggregates have continued to grow this year, albeit at a more moderate rate than earlier. However, the demand for money and credit has been much greater than the supply. Short-term business credit, as represented by borrowing at commercial banks and in the commercial paper market, rose at an annual rate of more than 20 percent during the first 8 months of 1974. New public offerings of corporate bonds in the capital market have been nearly double the volume of a year ago. As a result of the huge demand for borrowed funds, credit markets tightened and interest rates in both short- and long-term markets rose to an extraordinarily high level.

Such large credit requirements may seem puzzling in view of the recent sharp increases in reported corporate profits. But the profits being reported by many business firms are in part illusory. They are based on accounting principles devised for a noninflationary environment, and they therefore fail to reflect adequately the impact of inflation on the cost of replacing the inventories, plant, and equipment that are, so to speak, consumed in the process of production. The profits actually available for expansion of investment, or for dividend pay-

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ments, have not increased this year. On the contrary, they have declined significantly.

The most recent comprehensive data on profits relate to the second quarter. Total corporate profits before taxes, according to the Department of Commerce, were at a seasonally adjusted annual rate of $143.5 billion in that period. However, this figure includes the earnings of Federal Reserve Banks and other financial institutions.

It includes the income generated by the operations of foreign branches and subsidiaries of American corporations. And it also includes the amounts paid by corporations on account of the Federal income tax. When we eliminate these several elements, we find that the after-tax profits of all manufacturing ond other nonfinancial corporations were at a $67 billion annual rate in the second quarter, or 18 percent above the corresponding quarter in 1973.

But this profits figure still fails to allow for the using up of low-cost inventories to support current sales. When the higher cost of replacing these inventories is deducted from reported profits, the amount remaining for all other purposes is 21 percent below the level in the second quarter of 1973. Indeed, when so adjusted, recent corporate profits appear to be substantially lower than in the latter half of the 1960's. Moreover, these lower profit figures still make no allowance for the increasing amounts by which charge-offs for depreciation of plant and equipment have been falling short of replacement costs. That shortfall now amounts to many billions of dollars.

This depressing picture of corporate profits has been largely ignored by the general public, but not by the stock exchanges—as the sorry price quotations for corporate shares testify. The recent inadequate level of corporate profits has forced corporations to borrow heavily, not only to finance their large and expanding capital expenditures, but often even to maintain their current production. The recent profit performance certainly provides too little incentive for investment in the new ond more efficient capacity a growing economy will need.

At the very time when businesses have found is necessary to borrow extensively to finance their capital expenditure programs, Treasury and Federal agency borrowings through the securities markets have remained exceptionally large. State and local governments, too, have been raising a substantial volume of funds in credit markets. True, the credit flowing through the mortgage market has fallen considerably, and growth in consumer installment credit has also slowed. In total, however, the volume of funds raised has been so large as to cause serious financial strains.

The strains in financial markets have been reflected not only in the rise of interest rates, but also in a widening of risk premiums among credit instruments of differing quality. Investor confidence has been shaken by the difficulties experienced by the Franklin National Bank, by the closing or reported losses of some foreign banks, and by the acknowledged financial problems of a few large corporations. Market rumors have aggravated the situation, and some sound borrowers have found it exceedingly difficult to obtain open-market credit.

The Federal Reserve has repeatedly made known its intent to fulfill its responsibilities as the Nation's lender of last resort. We have provided large amounts of temporary assistance to Franklin Na-

tional and small amounts to a few other institutions. This has helped to calm fears and has enabled financial markets to function in an orderly manner. But tensions still remain, and not a few lenders and investors are cautious about the credit risks they are willing to assume.

Short-term market interest rates, however, have recently been declining, and this is helping to alleviate pressures in financial markets. The decline in these sensitive rates reflects, among other factors, the present stance of monetary policy. In view of the fact that substantial moderation in the growth of money and credit has now been achieved, and in view also of the recent sluggishness in the over-all demand for goods and services, the Federal Reserve has felt justified in easing the pressure on bank reserves.

Federal Reserve open market operations have thus been somewhat less restrictive recently, and the interest rate on day-to-day interbank lending has dropped from over 13 percent in early July to about 10½ percent currently. Other short-term interest rates, particularly the Treasury bill rate, have also declined appreciably. In early September, the Board announced a reduction in reserve requirements on large certificates of deposit maturing in 4 months or longer. This step was primarily designed to encourage banks to lengthen the maturity of their deposit liabilities, but it also released $500 million of bank funds for additional loans or investments.

It would not be appropriate for me to speculate how far the recent modest easing tendency in financial markets may go. I can assure you, however, that we at the Federal Reserve shall persevere in our basic policy of restraining the expansion of money and credit in the present inflationary environment. The supply of money and credit will continue to expand, but only at a moderate pace. If credit demands now subside, as may happen, market interest rates could decline further and institutionally determined interest rates, which traditionally lag behind market rates, could be expected to follow along.

Substantial progress in reducing interest rates, however, is unlikely to occur until borrowers and lenders are convinced that monetary policy is not alone in the struggle against inflation. I believe that the program proposed by the President on Tuesday, if it is strongly supported by the Congress, will help to provide that assurance. Excessive reliance on monetary policy to achieve the restraint needed in economic behavior has costly side effects. It pushes interest rates to unduly high levels; it causes distortions in financial flows; and it forces industries that are heavily dependent on credit to make severe adjustments in their scale of operations.

The homebuilding industry especially has experienced serious difficulties this year in an environment of rapid inflation, extraordinarily high interest rates, and taut monetary policy. Homebuilding was already suffering from inflated land costs and sharply rising materials prices and wage costs. Also, the supply of housing units available for rent or sale had increased to unusually high levels during 1973 as a result of overbuilding in the previous 2 years and lagging consumer demand. The escalation of interest rates and reduced supplies of mortgage credit this year have thus aggregated an already deteriorating situation.

Not only do high interest rates raise the cost of home financing, and thereby reduce the demand for housing, but they also induce individual savers to shift their funds into high-yielding market instruments and away from the financial institutions that traditionally supply mortgage credit. This summer, many savings and loan associations and mutual savings banks suffered outflows of funds. Inflows of household deposits to the commercial banks were also substantially lower. In consequence, these institutions were forced to cut back on their new commitments to make mortgage loans. The result has been a drying up in the availability of mortgage credit and a further sharp drop in housing starts.

The financing problems of the construction industry have been exacerbated, moreover, by the abrupt curtailment in the lending activities of real estate investment trusts. These are relatively new institutions, which depend heavily on open-market financing. Some of them became overextended and have experienced difficulty in rolling over their maturing debt. Much of this debt has had to be refinanced by the commercial banks, which the Federal Reserve has encouraged—within the limits of banking prudence—as part of its effort to protect the stability of the financial system.

The financial distortions and difficulties that are caused by excessive reliance on a restrictive monetary policy have not been limited to the housing and construction industries. They are felt also by other industries that must raise a large share of their funds in credit and capital markets. The electric utilities, in particular, have been having a difficult time this year. High interest rates, depressed stock prices, and increased investor caution in an uncertain environment have intensified the underlying financial problems of these companies.

Regulatory commissions have lagged in permitting the increases in electricity rates that are necessary to match the sharp increases in fuel and other operating costs, so that the earning capacity of the utilities has been badly eroded. As a result, the quality ratings of the bonds issued by some utility companies have been reduced, and this development has added to the cost of their borrowed funds. Moreover, as prices of utility stocks have fallen, in many cases far below book value, it has become very difficult and expensive for the utilities to raise new funds through the sale of stock.

In recent months, many utilities have announced large reductions or postponements in their planned capital expansion programs. To some degree, cutbacks of previous plans may be warranted by the efforts of business firms and households to conserve on the use of energy. But inability to raise the necessary financing has also been a major consideration in numerous instances and this could lead to serious problems in the future. If the supply of electric power is to be adequate for the Nation's needs in the years ahead, the utilities must be in a financial position to invest heavily in new capacity.

In view of the financing problems that have developed for the utilities, for homebuilding, for the thrift institutions and real estate investment trusts, and perhaps for other industries, some economists and legislators have suggested that there is need for a governmental program of direct credit allocation and control. I would strongly oppose such a course of action. Special programs of credit assistance may well be needed, such as those already in operation and newly

announced by the President for housing. But to embark on a policy of allocating credit to particular individuals and business firms by governmental fiat would be a serious mistake, because it would not and could not work.

In view of the variety of financial channels available to most borrowers and lenders, controls would need to be rather comprehensive, if they are to be at all effective. They would need to include not only the banks but other institutional lenders, such as the thrift institutions, finance companies, insurance companies, and pension funds. They would need to cover not only the lending by financial institutions, but also the financing done through the public markets for debt and equity securities. They would probably need to regulate not only domestic lending and borrowing, but also access to lending and investing alternative abroad. This would be a task of enormous administrative complexity.

Nor is even this the entire problem. The ultimate difficulty is that, by disrupting the orderly processes of financial markets, such a program could create serious industrial imbalances and bring the economic activity of some industries and communities to a virtual halt. In my judgment, there is no good substitute for the decisionmaking process provided by our highly developed, sensitive, and intensely competitive financial system.

Nevertheless, we at the Board recognize the need to avoid using our Nation's scarce banking resources for unproductive purposes. Last month the Board received a report prepared by the Federal Advisory Council—a statutory body under the Federal Reserve Act—that suggested a set of priorities that should be followed under current conditions in bank lending. In releasing the Council's guidelines, the Board noted that limited credit resources best serve the public interest when used for purposes that encourage expansion of productive capacity, sustain key sectors of national and local economies, provide liquidity for sound businesses in temporary difficulty, and take account of the special problems of the homebuilding industry and of small- and medium-sized businesses.

In the Board's judgment, the Council's statement on lending priorities can be helpful to bankers. We have sent it to all member banks in the United States and we will be following their response. I would urge that other types of financial institutions also review their lending policies with a view to the special needs of the current economic and financial environment. But any such effort must have considerable flexibility, in order to provide for the wide variety of circumstances that our thousands of institutions and millions of borrowers inevitably face.

In conclusion, I would readily grant that there are numerous imperfections in the behavior of our financial system. Institutional reforms are needed. The Board supports the principles of the proposed Financial Institutions Act, which aims to strengthen depository institutions and to promote greater competion among them. But it is also necessary to reform our regulatory structure so that the stability of the financial system may be enhanced. This need is receiving much attention at the Federal Reserve Board and elsewhere, just as stronger tax incentives for investment are concerning Treasury and other Government officials.

I must add, however, that in the Board's judgment, the main obstacle to the efficient functioning of our financial system is the raging inflation that we are experiencing. Inflation must be brought under control, not only through the exercise of monetary and fiscal discipline, but by a crusade in which all citizens participate, as the President has proposed. I am confident that the battle against the disease of inflation can be won. As meaningful progress is made in doing so, interest rates will return to lower and more normal levels, the tensions in financial markets will abate, and reasonable financing will be found for the many worthwhile investment projects that a healthy, private economy always generates.

Thank you.

Senator BENTSEN. Thank you, Mr. Burns, for your statement.

The President in his speech on Tuesday said that you had assured him that money and credit would expand sufficiently to meet the needs of our economy. Now, that is a positive statement. Can you give us your own words concerning that?

Mr. BURNS. Well, those are, if I may say so, my own words.

Senator BENTSEN. You say those are your own words; is that what you said?

Mr. BURNS. Yes; the President quoted what I told him. He reported very accurately.

Senator BENTSEN. What concerns me is the statements made that there will be no money crunch, and yet I feel that substantial segments of our economy are having a very severe money crunch now, so I would like to have some feel for your parameters.

You say there is no money crunch, and if I had a large corporation, had a substantial cash flow and was a top priority customer of a large bank, then I would agree with that. But I happen to be a small businessman who is having a very difficult time getting financing, and I can't agree with that.

When you talk about the equity market being in bad shape because of a lessening in pockets, and yet certainly fully as important, it seems to me, is what happens to interest rates. When the President made his statement about interest rates and about moderation in monetary policy we saw the stock market go up, it went up about 28 points yesterday, not because profits all of a sudden had increased, but because they thought there was going to be less competition for money by high interest rates and securities would yield higher rates.

We ought to have some kind of understanding, try to get some feel for what the objective is in the way of a moderation of rates. When can we effect the prime rate to come down significantly?

I understand your feeling about not trying to make a hard forecast, but yet on the other side of that coin is the small businessman, a homebuilder trying to find confidence in this economy that money is going to be available. Can't you give us something more definitive?

Mr. BURNS. If you mean by that can I give you reassuring numbers, the answer is "No." More accurately, I can throw numbers around as well as the next fellow, but I have made it a practice not do that. I know my limitations and I also know the limitations that go with life.

Now, let me comment on the term "credit crunch." The term is used in different ways. When I speak of a "credit crunch," and I think this is general usage of the term among financial economists, I have in mind

a condition such that the total volume of credit is no longer expanding or is expanding at a minuscle rate. Now, that is not our condition; nor has it been. Credit expanded enormously this year.

You are perfectly right in saying that for some sectors of the economy there was a serious reduction in the availability of credit. You can speak, I think, of a credit crunch for some individual sectors; but I do not think you can speak of a credit crunch, taking the widely accepted usage, for the economy in general.

Now, when you ask me for a word of reassurance, and I think words of reassurance are necessary in these days, I believe that if the Congress will support the President's recommendation concerning the need for a more frugal Federal budget, and that recommendation has also been made by many congressional leaders—some of those participating in this meeting today have fought vigorously for restraint in spending—I think if the Congress would support the President on the budget, this would give great reassurance to financial markets. For the Federal Government will then no longer be borrowing as heavily as it has been doing; therefore, interest rates could come down.

Senator BENTSEN. Mr. Burns, I think all of us agree that we must have fiscal restraints, and we have cut the budget that was submitted by President Nixon by almost $5.7 million already. But when I look at the figure of the increase in the money supply since mid-June, as I understand it, 1.3 percent, I interpret that as a substantial restraint and not a moderate approach.

Mr. BURNS. Well, you shouldn't do that, Senator, if I may say so.

Senator BENTSEN. You tell me why when it is substantially less than last year in that same period of time, why it is not restrictive?

Mr. BURNS. Well, I can say this to you, that we at the Federal Reserve cannot control the money supply over a short period of a week or a month or two or three. If you want to judge Federal Reserve monetary policy you have to judge it over a period of 6 to 9 months as a minimum.

Second, the figure that you cited, I take it, refers to the narrow money supply. That is an increasingly less significant magnitude at a time of rising interest rates when people are converting much of their demand deposits into interest earning deposits. During the very short period that you cite, and I would repeat we ought to be looking at a longer period——

Senator BENTSEN. You say some decline in short-term rates. Are you in a position where you can give us some forecast of a substantial fall in long-term rates which really would help the housing market?

Mr. BURNS. You are entirely right. I cannot give you any assurance on that until real evidence is forthcoming that the inflation rate is beginning to abate.

Short-term markets for a brief period can be very responsive to Federal Reserve monetary policy. Long-term markets are not. Long-term markets have stabilized in recent weeks, but an appreciable decline in long-term interest rates, in my judgment, will take place only when investors have some confidence in the anti-inflation program of this Government. As yet, that confidence does not exist in the financial community.

Senator BENTSEN. Don't you think when you have high interest rates for this long period of time, on home mortgages and that type of thing,

that it may add to the inflation itself and be passed on to the consumer—don't you believe that any corporation trying to figure its unit cost of production when they have seen it this long, start cranking those into their costs and start passing it on to the consumer?

Mr. BURNS. There is a grain of truth in that but no more than a grain of truth. For every dollar of interest payments by a typical American corporation there will be $20 to $30 in wage payments. There will be other costs.

Senator BENTSEN. Let me ask you about your statement on the investment-tax credit. You talked about a substantial increase in investment capacity by some of these basic-material-producing companies, and a large investment taking place, and that, you say, is in response to increasing prices. If that is already taking place, if those commitments are being made, do you have any kind of proof that in the boardroom that there is a material consideration to continue those as an investment-tax credit?

Mr. BURNS. I think that is a good question, Senator. As you point out, the market is doing its work to a significant degree. In the very industries where we have had the most pronounced shortages during the past year or two, expansion of investment outlays is proceeding at the fastest rate.

But there is a question in my mind whether we in this country are investing as much relative to our economic activity in the aggregate as we ought to be doing. Certainly, our investment rate is lower than that of other industrial countries, and that is something that we ought to watch.

I, for one, believe that a higher rate of investment would prove beneficial in this country. Whether the investment-tax credit is the best way at this juncture of history of achieving that is a fair question.

Senator BENTSEN. Mr. Burns, are we in a recession?

Mr. BURNS. The term "recession" is defined in different ways by economists. As far as I am concerned, I would say that we have a recession but it is a most unusual recession, a recession for which there is no precedent in history. First, because we are having a galloping inflation at the same time; and second, because business capital expenditures are continuing to boom.

Now, I know something about business-cycle history. I have spent a great part of my life on this subject, and I cannot give you another instance of this kind.

Senator BENTSEN. This is the worst kind of a recession, then, if we have galloping inflation at the same time.

Mr. BURNS. Well, you can characterize it as you will. You can choose your adjectives and I am not going to quarrel with them. You asked me a direct question and I gave you a direct answer. I have to point out the extraordinary peculiarities of this recession. To use the term "recession" without noting these peculiarities is certainly inadequate.

Senator BENTSEN. I wasn't asking for that, and that is why when you say it is exacerbated by galloping inflation at the same time——

Mr. BURNS. That is all right, but you can turn that around and say that the galloping inflation that we are having is being exacerbated by the decline in industrial activity that is taking place.

Senator BENTSEN. I guess we can continue this one, but I don't want to use too much of my time.

Senator Javits, you have an amendment on the floor.

Senator JAVITS. Thank you so much, and I am grateful to Congressman Reuss for allowing me, and I shall keep my time limited.

Mr. Burns, I want to thank you, as always. You are probably one of the most important resources of the United States. You are always ready to come here and speak frankly to help our country and our world, and I am very grateful to you and I am sure my colleagues are, too.

I would like to take up where Senator Bentsen in his excellent questioning left off.

Let us say the key point—"ominous" in your statement—"A still more ominous result of the inflation is the spread of doubts among businessmen and consumers."

I think you put your finger on this issue, which is the emotion of confidence in our future which really almost never happened in this country in this century. Isn't it true that a great contribution to that is the changing of the confidence in our financial institutions? You have just had a situation with the Franklin National in my own hometown where that has occurred, and you have made it clear that the Federal Reserve will be a lender of last resort, if necessary.

Now, question: In the choice between certain monetary policy goals of the Federal Reserve and saving our individual financial institutions, can you tell us what will be the policy of the Federal Reserve Board?

Mr. BURNS. No question about that. First, it is to save our financial institutions and they will be saved. I am also reasonably confident that this can be done without injury to the basic policy, basic monetary policy of the Federal Reserve. I say that on the basis of some experience.

You may remember the action we took at the time of the Penn Central failure. There was a danger of a financial panic in the country. We took energetic action. The discount window was opened to the banks on an unprecedented scale.

But we did not lose control over monetary policy. For a short period reserves increased sharply, but then we pulled them back again.

The assistance to Franklin National, as you know, has been on a gigantic and unprecedented scale. No central bank in the world has ever come close to dealing with a financial problem of one of its banks on such a scale. We extended loans up to $1¾ billion, but this did not affect our monetary policy because as these loans expanded we were able to contract our investment in securities to about the same degree.

I would add one word. Now that a decent marriage has been worked out for Franklin National, the entire financial world can breathe more easily, and it is breathing more easily, not only in this country, but also abroad.

Senator JAVITS. Mr. Burns, then I take it, and I don't wish to put words in your mouth, but those who deposit with institutions, no matter how large, and Franklin National was only the 10th largest—there are nine others ahead of them—have every reason to be confident that the U.S. resources, that is what you represent, are backing those deposits and will come through when needed?

Mr. BURNS. Not the slightest question about that.

Senator JAVITS. I think that is extremely important, and I am a kind of parrot of the question Senator Bentsen brought out.

What do you think would be the greatest influence in bringing back confidence, and I gather, and please correct me if I am wrong, and in our power we are a government, I have no illusions but that we may have a billion dollar budget, but there is $1.3 trillion out there. That is what guarantees every American's freedom, but I was going to ask you if you put the budget control as No. 1 for restoration of confidence within our power. Now, let me, in order perhaps to give you my whole thought, that is the way you deal with us and that is the way I like to deal with you. I have noted down the following as what you consider the top four budget controls, that is what to do with this monitoring board, conservation, and we all understand what that means, and taxation, not necessarily in that order. But I think it would be valuable to have your order of priorities as to what are the criteria for restoration of confidence.

Mr. BURNS. I would say to restore confidence at the present time the Government must convince the American people that it has a truly effective anti-inflation policy.

I would say, second, the Government must convince the American people as well that recessive tendencies in the economy, if they are extended, will also be resisted.

I would say, third, that the Government must convince the American people that the harsh effects that a restrictive monetary and fiscal policy may have on some sectors of our economy will be ameliorated, so that there will be a sense of equity and burden-sharing which the American public will recognize.

Senator JAVITS. May I take it you will class them as follows: Budget, controls, conservation and tax, altogether, by way of equalizing the burden or to redistributing, would that be a fair assessment, because that relates it to measures?

Mr. BURNS. Yes, if I may say so, the President's program may be evaluated one way or another. Although you haven't asked me the question, I think it is only proper for me to say sometime in these hearings that I think it is a well-balanced program. Whether it goes far enough as a whole or an individual direction, this is, of course, a complicated question that Members of the Congress may well answer differently. But I think it is a useful beginning toward a rebuilding of confidence.

Senator JAVITS. Mr. Burns, I thoroughly agree with you. I don't think it goes far enough, but I believe the temper of the Congress is such as to build on it and push it further. I could go into a lot of details, public service employment, the tax floor he has in mind and many other things, but I believe that will prove to be the end result.

I have just one other question. I notice with interest that you say that you like the guidelines of the Federal Reserve banks.

Mr. BURNS. I do, and I think it is only fair that I acknowledge publicly that these guidelines are a result rather directly of a conversation that you and I had at one of our recent hearings. I want to thank you for stimulating my own thought and what we did at the Federal Reserve.

Senator JAVITS. I am very grateful.

You say I would urge other types of financial institutions review their lending policies and so forth; in other words, adopt guidelines. Can you give us some suggestions in what we could do to promote that

idea. You are against credit application. What shall we do to try to extend the guideline concept?

Mr. BURNS. Well, I don't know that I can advise Congress on this. I do think that perhaps we at the Federal Reserve and the officials at the Treasury might be able to do something with regard to other financial institutions along the lines of what the Federal Reserve has done recently with regard to American banks.

Senator JAVITS. Couldn't the President, Mr. Burns, call on their Governors of States to instruct their superintendents of banking to do the same thing and call on the home loan banks and others we have in the Federal Government to move in the same direction? In short, isn't this worthy of united national movement, of the big test of the President's own feeling that we have got to move into this at all levels. Wouldn't this guideline thing for lending money be a very strong example?

Mr. BURNS. I am not sure about that. There are so many things that the President has to do. My own offhand opinion would be that he ought to move in only if the Treasury and the Federal Reserve prove inadequate to the task.

Senator JAVITS. And you will, I gather, or will try?

Mr. BURNS. We will try.

Senator JAVITS. Thank you, Mr. Burns. My time is up.

Senator BENTSEN. Thank you, Senator Javits.

Congressman Reuss.

Representative REUSS. Thank you, Senator Bentsen.

Senator Bentsen and myself believe it doesn't make sense that the resources of this country should be channeled as much as they have been to inflationary and speculative uses, and little as they have been to productive uses, housing, public utilities, and so on. We are, nevertheless, happy that the Federal Reserve has now recognized in principle that what we have been urging is a good thing. And I would say that your guidelines for September are just right. They delineate the bad ones, right, and they delineate the good ones, right?

Mr. BURNS. I appreciate that, but you give the Federal Reserve more credit than we deserve. These guidelines were drawn up by the Federal Advisory Council which consists of 12 commercial bankers.

Representative REUSS. Considering some of the criticism recently visited upon the side of charity, it will be good for both of us.

Anyway, would you, in this euphoric mood that we are both in, do the following for the Joint Economic Committee: Report to us, monthly, if you will, on how those guidelines are working. That is, ask the 200 biggest banks in the country and the other very large financial institutions, such as you have mentioned, to give you their targets—that is, what their portfolios looked like on September 1, 1974, how they propose to aim them in a better direction—unless they claim they were perfect to start with—and how they are progressing month by month in meeting their own targets. Would you be able to do that?

Mr. BURNS. Well, there is so much that we have to do that I could not promise you in good conscience to do all that you have suggested.

What I can promise you is what I have stated in my formal presentation.

Representative REUSS. With all due respect, that doesn't tell us anything as to whether the financial system of this country is getting

away from feeding the fires of inflation and they have been the principal culprits and getting toward helping out on productivity, housing, utilities, small farms and the other things that the Fed mentioned in its September guidelines.

Mr. BURNS. I understand. I can promise you that we will devise a reporting system as far as the banks are concerned. I cannot promise you that it will be nearly as detailed as you have suggested, nor can I promise you that it will be done on a monthly basis.

Representative REUSS. When can this committee expect the first report from you on how did the banks look on September 1, what are their plans and programs for getting right with the Fed, and how are they doing?

Mr. BURNS. I cannot give you a date. This is a technical question that has to be examined with care by our staff. They are at present making plans; and once they present these plans to me, I may be in a position to answer your question. I can't do that now. I don't want to mislead you.

Representative REUSS. Well, I certainly hope you will be able to help, because meanwhile, Senator Bentsen, I would ask unanimous consent that this committee promptly prepare a questionnaire to the leading 200 or 250 banks that report to the Fed, asking them to report to us directly with the material that I have requested. I think we need it, with the understanding that we will discontinue it the instant the Federal Reserve starts doing what I must say, I regard as necessary.

Senator BENTSEN. I think it is necessary that we do some random checking to see what the impact is, and if some results are forthcoming I think that would be of value to the Federal Reserve, also.

If there is no objection, we will request it.

Representative REUSS. Thank you very much, Senator Bentsen.

Mr. Burns, I certainly agree with what you said on the last part of your statement, that it is also necessary to reform our regulatory structure so that the stability of the financial system may be enhanced. Having witnessed the story of the bad banking practices, inadequately supervised, which led the Franklin National to its recent death—the largest in our country's history—I am concerned that it doesn't happen again. I have read that the Federal Reserve put $1¾ billion into the Franklin National this year. Do you have a record of when those——

Mr. BURNS. Oh yes, we have a record by the day.

Representative REUSS. Do you have it with you?

Mr. BURNS. No; I do not.

Representative REUSS. In return for the $1.75 billion, what pieces of paper as collateral did you get from the Franklin National? Do you have that record?

Mr. BURNS. Yes.

Representative REUSS. Were those pieces of paper valued at their market value as of the date of the Fed advance?

Mr. BURNS. Well, I must at this point say that you are entering now on a line of questioning for which I am not adequately prepared. I did not appreciate that the Franklin National transactions would become a part of this hearing. If I had known that I would have brought with me the officials at the Federal Reserve Bank of New

York who have worked on this problem by the hour and through the deep, hard, long hours of the night, since last May. They would have all the detailed information. I don't think we ought to pursue this much further now, but when you are ready, I would welcome a hearing on this question.

Representative REUSS. Well, I am ready right now. I can understand why it is not possible for you to answer all the questions now.

Mr. BURNS. Your questions are always instructive and reasonable, Congressman Reuss, although at times a little troublesome.

Representative REUSS. Well, these will be troublesome but they will also be reasonable.

I will let my specific questions go, but obviously what I am interested in is that $1.75 billion, almost precisely the amount of the new tax program on the middle class. I want to make sure that Uncle Sam gets it back.

Mr. BURNS. Now, can I say this here, and my general comment will be supported very fully in the responses to your questions or at any public hearing that the Congress may institute.

We have engaged in prudent banking. While I am not ready to answer your questions in detail, I did devote a great part of my time and energy to this problem, attending not only to the need for preventing what could have been an international finanical panic, but also making sure that we at the Federal Reserve protected adequately the taxpayers' dollars. I think that you will be entirely satisfied with our performance, I will be very glad to have the opportunity to put on record precisely what we did and how we did it.

Also, I should say, and I want to take this opportunity to say that we had splendid cooperation from Mr. Wille of the Federal Deposit Insurance Corporation.

Representative REUSS. "Splendid" is hardly the word for it. I notice he has taken over the Fed's liability; hasn't he?

Mr. BURNS. He has.

Representative REUSS. Service over and beyond the call of duty.

I thought the FDIC was supposed to bail out small depositors, up to $20,000 on demand deposits.

Mr. BURNS. Frank Wille can take care of himself. I can only say he is a very fine public servant, and a very good lawyer. I have had competent legal counsel as well. Everything has been done not only within the letter of the law, but within the spirit of the law.

We are getting into a range of questions that some of you will want to pursue very thoroughly, I think you should.

Representative REUSS. I will stipulate all the kind things said about Frank Wille.

All I am interested in is whether Uncle Sam—the Federal Reserve or the FDIC—is going to get its $1¾ billion back, what is the nature of the collateral, and how long will it take?

Mr. BURNS. It will take too long for comfort, but the expectation is that the taxpayers of this country will not lose $1.

Representative REUSS. I am glad to hear that, and I appreciate your answers.

No further questions.

Thank you, Senator Bentsen.

Mr. BURNS. May I say another word. When you take what was done by the Federal Reserve and the Federal Deposit Insurance Corporation in connection with the Franklin case, the standard to apply is not that of an ideal world but the kind of world we would have had if we had permitted that $5 billion bank to close. That would have caused, as a matter of probability, other bank failures and large losses to the Federal Deposit Insurance Corporation, to say nothing about the large losses to individuals and businesses, and to say nothing also of the deterioration of sentiment that would have taken place. We have to keep all that in mind.

Representative REUSS. It is precisely because you think the Fed did the right thing, and you may well be right. I am sure you understand that we of the Congress want to know what it is that you did.

Mr. BURNS. The time has come to report fully on this subject. The time has come for the Congress to interrogate thoroughly. That information will be supplied at public hearings. Let it all go forward, because I think this is—well, even if we had a poor record I would want it to go forward, but I think we have a marvelous record to report.

Representative REUSS. You say public hearings—this is the public hearing this morning.

Mr. BURNS. I know, but I do want——

Representative REUSS. There may be others.

Mr. BURNS. I know, but I do want to repeat that this hearing was called for another purpose. When you want to examine what happened in the Franklin National case you should have the Comptroller of the Currency here, since he is the chief regulator of that bank, and also officials of the Federal Reserve Bank of New York who made these loans with, I must say, our approval. I do not want to put the responsibility on them.

We at the Federal Reserve were kept fully informed. We will take that responsibility, but the New York bank has all the details.

Representative REUSS. Right, and I can't see a better way of enabling us to frame intelligent questions than to get the answers to the preliminary questions I shall put to you in writing.

Mr. BURNS. I welcome that opportunity, Congressman Reuss.

Senator BENTSEN. Senator Humphrey.

Senator HUMPHREY. Mr. Burns, I want to get to the question of public-service employment, because the President brought it up. That has been asked here before and stressed too much; I surely won't take your time on it.

The President asked, as indicated, his support for public-service employment. You have also indicated your support.

Today there is a supplemental appropriation bill that will be before the Senate. I wondered how you would look upon substantial addition of funding for public-service employment. Senator Javits has had a bill of which I am a cosponsor. I have an amendment which I intend to propose that would add $500 million for public-service employment. What is your view today of the situations that relate to public-service employment?

Mr. BURNS. Let me say two things, Senator.

First, I am delighted that the President has seen fit to recommend a new public-service employment program to the Congress.

I would say second that if I were doing it personally I would have recommended a slightly larger figure.

Senator HUMPHREY. Would you look upon, at this time, in light of the fact, as I have my figures, that over 700,000 have been added to the unemployment rolls since January and the projection is it may be up as high as 800, 900,000 by Christmas, that this is the time to set in motion the machinery for public-service employment at an expanded rate?

Mr. BURNS. I would agree with that, yes.

Senator HUMPHREY. What would you think about the figure that I mentioned?

Mr. BURNS. Since your figure corresponds to mine I have no quarrel with it.

Senator HUMPHREY. I would say there are two great minds working together on this this morning, and I want to thank you very, very much.

One problem I have with public-service employment as expressed by the President, you may recall, is that public-service employment would be available after persons had exhausted their unemployment compensation benefits. Now, it is entirely possible that new entrants into the labor force, let's say someone seeking a job, 3, 4, 6 months and has been either unable to accumulate unemployment rights or a job, should we have some mechanism that permits that person to obtain public-service employment?

Mr. BURNS. I think that is a good question.

I believe, if my memory serves me correctly, that the President has made some provision in his proposals to the Congress for looking after individuals who are not covered by unemployment insurance. I believe he has proposed a special plan of unemployment insurance for that group.

But the broad question that you asked, I think, is a very fair question, and I think it should be explored thoroughly by the Congress.

I might go further and say that the doubt that you expressed is one that has entered my own mind as well, but it is not a question that I am prepared to speak on in categorical fashion at this time.

This should be explored rather thoroughly by the Congress when you take up this legislation.

Senator HUMPHREY. I believe the President did make some provision for those who had previous work experience, but I am speaking of a new entrant who has had no real work record so to speak, and obviously this could apply to a number of young people who are either leaving the teenage group or in it.

Mr. BURNS. Yes. I think that is a very fair question.

I would, I think, in administering a program like that, and when you write legislation that you might consider it desirable to give priority, as far as the public-service jobs are concerned to men who have family responsibilities. But I don't think I would want to neglect individuals, those without a job or family responsibilities, who recently entered the labor force. I would not want to neglect them, but I also would not give them the highest priority.

Senator HUMPHREY. You would give the highest priority to men and women?

Mr. BURNS. And who have family responsibilities.

Senator HUMPHREY. With family responsibilities.

We appreciate that, Mr. Burns, because I think the time to act on this is now. When you said the Congress should study it, in the meantime somebody is without a job and wants it desperately, but we will look at the implications of it.

Mr. BURNS. In Government circles the term "study" so often means postpone action. That is not what I mean. I mean look into it in, say, 2 days, spend long hours at it, and get the job done.

Senator HUMPHREY. That is a very good formula. I hope that every agency of Government, Mr. Burns, will adopt that, including the Congress.

Mr. BURNS. Well, you might set an example for us.

Senator HUMPHREY. I try to. As a matter of fact, I am often accused of wanting to move too rapidly.

I know that Senator Bentsen asked a question about reference to the statement of the President in his message on the supply and credit, that it will be expanded sufficiently to meet the needs of our economy, and I understand that you have made some response to it.

What precisely does your commitment mean? Will you only allow the money supply to increase by let's say 1.3 percent as that has increased since June, or will you do better than that?

Mr. BURNS. Well, that is an easy question to answer, because the short-run changes in money supply are sheer noise. I have to emphasize that time and again. We don't have the technical power to carry out our monetary policy objectives in very short periods.

Certainly the rate of growth that you have just reported is not the rate of growth that we aimed at and it is not the rate of growh that will apply to a period of 6, 9, or 12 months. I think that is the way to judge monetary policy.

Bear in mind, Senator, that if we didn't create one additional dollar over a period of a month or two or three, the dollars that we created previously are still around, and we have created plenty of them.

Senator HUMPHREY. The figure that I quoted was, of course, a quarterly figure.

Mr. BURNS. I realize it. That still is much too short a term.

Senator HUMPHREY. I understand it is a short time, but in that short time a large and substantial number of people will find themselves in what we call a credit crunch, and I want to be a little more precise because I know when you give a commitment to the President that is a commitment that will be fulfilled.

I am wondering just what rate of money supply increase you think is necessary now in light of your knowledge of the overall economic conditions of our country to alleviate not only what appears to be, but what is a very tight money situation?

Mr. BURNS. Well, I don't think I could appropriately give a specific figure, because circumstances change.

Let me only say this: That if you look at the narrowly defined money supply, and I take it that is what you have in mind at the moment.

Senator HUMPHREY. Yes, sir.

Mr. BURNS. Then for the purpose of regaining general price stability, the rate of growth ought to be, perhaps, only about 4½ percent.

However, in view of the need to taper off inflation gradually, the rate of growth in the months ahead must be significantly larger than that. I assure you that we will make every effort to do that.

Senator HUMPHREY. I appreciate that answer. The word "significantly" means something to me, and I know it means something to you.

I asked this question because of certain others that I would like just to follow up on, particularly as it relates to housing, Mr. Burns. Right now, in fact, in the Senate we are working on a housing bill, the bill introduced by Senators Brooke and Cranston and presently managed by Senator Sparkman in the Senate debate.

I am sure that we would agree that the money supply, the tight money supply, for whatever reasons was necessary for, has had a very serious adverse effect upon housing. In fact, the housing industry, as we heard all during the days of the economic summit conference and the present conference is in a serious depression.

Mr. BURNS. It is.

Senator HUMPHREY. The paper this morning cites what has happened in the metropolitan area of Washington, D.C.

What do you specifically plan, Mr. Burns, in your important role as Chairman of the Federal Reserve? What do you plan to do to help housing? Might I even be more exact, have you any steps to encourage more bank loans for housing?

Mr. BURNS. In the communication that we sent out to every member bank, after we received a report on priorities from the Federal Advisory Council, we pointed to the need for closer attention on the part of banks over the country to lending on residential mortgages. We have done that.

Senator HUMPHREY. What has the banks' response been to this? Bankers are sort of hardheaded people when it comes to loaning, I hope.

Mr. BURNS. I can't answer that question adequately at the present time. I would only say this, that these guidelines were drawn up by a group of bankers. They must have consulted with some of their colleagues in the banking industry. I don't know that as a fact, but that is a reasonable assumption. I have heard from a number of bankers, certainly not a representative number, but they do tell me that they think well of the guidelines.

Senator HUMPHREY. Are they acting on them? Is there any increased activity on the part of banks in loans?

Mr. BURNS. I cannot answer that at the present time because I do not have the information. This was a question that was discussed before you arrived, Senator. We at the Federal Reserve have been planning a surveillance system. Congressman Reuss has taken the ball out of our hands; that is, he intends the committee to proceed with that. That is something for the committee to decide, and I will not express an opinion about that.

Senator HUMPHREY. Just another question on this.

What about the interest differential between the savings and loan associations and the banks? Would it help to reduce that differential, let's say, one-half to 1 percent?

Mr. BURNS. To increase it?

Senator HUMPHREY. Yes.

Mr. BURNS. It is one-half of 1 percent for some types of deposits and one-fourth for others. These are questions that a coordinating committee, which includes representatives of the Board, the Comptroller's office, the FDIC and the Treasury, is exploring. That committee is also

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exploring ways of increasing the flow of funds through other devices to the thrift institutions.

We have been a bit slow in doing it. You know, when you have four agencies involved, it is not the easiest thing in the world to get quick decisions.

Senator HUMPHREY. You are a very persuasive man. In the meantime, I understand that the S. & L.'s are in extreme difficulty.

Mr. BURNS. They are in difficulty, but the problem has eased recently. The report that I have for September is encouraging. This is an estimated figure, and perhaps will turn out to be erroneous. But for the savings and loan associations, let me give you the run of figures in recent months.

Going back to January, the rate of deposit growth was very satisfactory. In January, annual rate of increase, 9.4 percent; February, 8.9; March 11.9.

Later, with the exception of the month of June, you had low figures. In the month of August the figure fell to 1.8 percent, but the estimated figure for September is 6.5 percent.

Now, short-term market interest rates have declined significantly since July, and this is easing the pressure on the savings and loan associations and mutual savings banks. It would be premature to say this, but there is a fair chance that the worst is now over for the savings and loan associations and mutual savings banks. I hope that is so.

Senator HUMPHREY. The President indicated in his message measures to be taken to improve the savings institutions, and there is just a brief sentence, and that is why I think some specificity would be very helpful in terms of what is to be done to particularly provide greater inflow of savings into the savings and loan associations, what can be done to get banks to make more housing loans, what can be done to bring the mortgage rate down and the accessibility to mortgage money.

Mr. BURNS. The first is easier to handle than the second, Senator, that is, to increase the flow of funds to these institutions. Now, as I indicated, discussions are taking place on specific ways of accomplishing that objective.

As for reduction of the mortgage interest rate, I wish I could speak with confidence on that subject. I can't. Long-term interest rates have stabilized, fortunately. But I very seriously doubt if there will be a significant decline in those interest rates until the financial community is persuaded that an effective anti-inflation program is in place.

Senator HUMPHREY. I am finished, Senator Bentsen.

Senator BENTSEN. Thank you very much, Senator Humphrey.

Let me say, Mr. Burns, I very much agree with you on the point that I don't want to see the Federal Government in the position of allocating credit to individuals and citing the collateral and credit and cash of an individual, or particularly the creditworthiness of a particular corporation. What I had recommended was the guidelines that you put forth, and I also agree with you that we ought to try to get that kind of a program across to other types of financial institutions.

I remember a few years ago a President called on, for example, the insurance companies of this country to make long-term loans available to depressed urban areas.

Mr. BURNS. I remember that.

Senator BENTSEN. I recall the presidents of the companies coming together and redirecting substantial sums of money, and I would hope that type thing could be done again.

One of the questions I asked you was do you believe that the increase in the tax credit would result in an appreciable increase in capital investments; did it truly correlate, and you said that is a fair question. I don't remember the answer, though. Do you think it would help?

Mr. BURNS. I do think it would help. What gives me some pause is that one of the President's proposals was to increase the general corporate-income-tax rate. So the overall effects on a 1-year basis are not easy to judge. However, if the Congress followed the President's recommendation and raised the corporate income tax rate for 1 year but increased the investment-tax credit permanently, not just for 1 year, I think that would probably have a beneficial effect on the volume of investment.

Now, when I spoke of your question as being a fair question I had in mind, the joint effect of these two tax proposals, and I also had another point in mind.

The investment-tax credit is general in its application. It will stimulate investment, not only in industries that clearly need or could benefit from stimulation. It would also stimulate others.

Now, this is a very difficult question, and I don't know the answer. Congressman Mills and I have struggled with this problem for a long period. At one time he was in favor, just as I was in favor, of some proposal similar to the accelerated amortization plan that we had during the Korean war.

The difficulty here is not on the question of principle, but on the question of administration. How do you pick the industries? Is your industry to get the benefit of an accelerated amortization, or the benefit of a higher tax credit while my industry does not? What are the criteria and who is going to decide? I find these administrative questions extremely difficult. Not having a solution that I consider workable, I have fallen back on the kind of general proposal that the President has made. But I am not very comfortable with it.

Senator BENTSEN. Are you talking about the disintermediation of the outflow and then the ebbing of the outflow? Did that correlate to the degree that they decreased the denomination in Treasury bills? Then, of course, your yield on Treasury has gone down substantially, too, hasn't it?

Mr. BURNS. Yes, that is so. The Treasury practice has varied. As you know, the minimum denomination on Treasury notes for a long period was $10,000. For the last issue it was $1,000. The issue before that, it was $10,000. The issue before that one was $1,000. The Treasury has struggled with this problem, as the rest of us have. If the minimum denomination is low, you tend to pull funds out of the thrift institutions. On the other hand, you are dealing fairly with individuals in the low-income category.

Now, an individual having great wealth can buy certificates of deposit in the open market at a high rate of interest, but the individual of modest means has to be content with or from a very modest rate——

Senator BENTSEN. He is discriminated against?

Mr. BURNS. Yes, he is discriminated against. The Congress has struggled with this problem and we have struggled with this problem.

This moving back and forth reflects our desire to somehow do the fair thing by the savings and loan associations and also by the individual saver of limited means.

Senator BENTSEN. We are in a different position from the savings and loans, but the long-term aspects and savings and loan can be whipsawed on it.

I recall back in August you were testifying for a more active incomes policy and you were talking about reestablishing the Cost of Living Council. As I recall at that time you talked about being able to put restraints on excessive wage-and-price increases in selective industries. We have had the reestablishment of a Stabilization Council. I am really not sure how equitable it is going to be.

Would you still think that it ought to have the ability to impose a restraint for a period of time on an excess wage-or-price increase and perhaps even have subpena power to take a look at the numbers?

Mr. BURNS. Well, I would say since the Congress has just legislated on the subject, since the Congress was not in favor of my plan, and since the Congress has considered this carefully, let's live with the present legislation for a few months and see how it works. But let's not live with it indefinitely if it doesn't work.

Senator BENTSEN. Fair enough, Mr. Burns. I favor your viewpoint on that, and went down to defeat on that particular vote.

The Wholesale Price Index for September just released this morning shows that overall wholesale prices were stable in September, the farm prices were down, industrials up, about washed out; would you feel that that is an encouraging sign? Is that a sufficient showing of easing of inflation rates?

Mr. BURNS. No, I don't consider that more than one of the ripples on a wave.

Senator BENTSEN. What do you think about the level of the tax surcharge on the family, a single person of $7,500 and a family at $15,000; do you think that is an appropriate level for that?

Mr. BURNS. Well, I think the concept is appropriate. Whether the specific numbers are ideally chosen or not, I wouldn't know. The President has made a proposal to the Congress, and the Congress will have to think seriously about the specific numbers. You may want to lower the figures or raise them.

As far as I am concerned, they are reasonable. But I would say the same for a range of figures.

Senator BENTSEN. Mr. Burns, I hope you are correct in your statement, and I know—long-term mortgage rates have stabilized, but when I look back at the FHA mortgage rates in September they reached a high. Would you feel reasonably confident they have stabilized?

Mr. BURNS. I believe that is the case, but I have learned from hard and long experience not to make categorical forecasts, and I don't want to make one today.

If the rate of inflation should intensify, then I would expect long-term interest rates to rise further. That is, unfortunately, what could be the case.

Senator BENTSEN. Mr. Burns, your statement a while ago about our taking over the responsibility on monitoring lending, Congressman Reuss made it quite clear that we would only do so until the information was available from the Federal Reserve, that we do it on a tem-

porary basis, and I would assume we will do so in seeing whether or not the banks were responding to your leadership on guidelines, and if that is being effective, that we would try to do that in random sampling to give us some input.

Mr. BURNS. I want to say in fairness to the truth, as I see it, that the kind of questionnaire that Congressman Reuss seemed to be sketching is not one that I would want to send out to the banks.

Senator BENTSEN. Well, I am not sure what he has in mind yet, and we will be working in cooperation, the staff here and if your Federal Reserve wants to give us some input, we will be delighted.

Mr. BURNS. If you come to us and ask us some questions we will certainly do everything we can to assist you in that task.

Senator BENTSEN. I have no further questions.

Senator Humphrey.

Senator HUMPHREY. Just a couple of questions, Mr. Burns.

In reference to the President's proposal to the expending of dividends on new issues of preferred stock, would this not have the affect of degrading the quality of currently outstanding common stock and causing their value to decline further?

Mr. BURNS. The chief advantage that I see is that if a proposal like that were adopted by Congress it would tend to improve the balance sheets of corporations. Instead of financing themselves with equity capital, they are financing themselves increasingly with debt instruments. The President's proposal would move us in the direction of reducing the emphasis on debt in our business operations. I believe it is a sound proposal.

Senator HUMPHREY. You do not believe it would at this time with the market as shaky as that is, be any adverse affect on the values of the currently issued stocks?

Mr. BURNS. I do not.

Senator HUMPHREY. That is reassuring. I had real serious doubts about that. When you get a category of such new issues of preferred stock which I can charge off as business expenses to dividends I was wondering what it might do to a stock market that was anything but vigorous at the time?

Mr. BURNS. Senator, if you are concerned about that you can correct that very easily, and that is by setting a minimum dividend rate of, say 3 or 4 percent, and treating common stock dividends up to that figure the same way as preferred stock dividends would be handled under the President's proposal. The difficulty with that is that it would cost the Treasury too much money right now.

Senator HUMPHREY. Yes, and I am afraid some of us might want to classify that as another loophole. What I worry about is not only the loopholes, but the loop-de-loop.

Mr. BURNS. Well, Senator, I have admired over the years your compassionate nature, but also your interest in finance. What you and your colleagues in Congress have to consider is the profitability of our corporations. This is a problem facing our economy. The debts that our corporations are assuming relative to their equity position may cause us great difficulties in the future. Therefore, I think the President's proposal, I don't mean necessarily in that specific form, but what the President is getting at through this preferred stock proposal——

Senator HUMPHREY. On that matter Senator Bentsen brought to our attention again—may I say, first of all, I have supported the investment tax credit in the past because I thought it was necessary for plant improvement, for competitive purposes, for foreign countries, et cetera. I worried very much about the general application of it, as you have indicated, but never was quite able to come up with a formula how to make it more specific. So I guess the way out was to permit it to be on the general side.

Now, the President has recommended a further increase. I can see how this would be helpful in certain types of industry, particularly, when they are under great pressures.

Didn't I understand from your statement that business investment in plant and equipment is still very high, and that the equipment makers, people that provide these machines and tools, have the order books really quite full and some of them have long backlogs; so, therefore, given the fiscal restaint on the real extent of capacity expansion, do you really believe that further tax incentives, that is increased tax incentives are necessary?

Mr. BURNS. Well, looking to the long future, I would say it would be a wise thing to do. We should also take into account the formal processes of tax legislation. I would not expect a bill of this sort to be adopted for another few months and then the forecast may not be as cheerful as it is today.

Senator HUMPHREY. Well, I have a very open mind on the matter, because I do recognize the need of both flow of capital and the necessity of improved capital plant to increase productivity and efficiency.

May I put a final tabby that you may know one of my main interest is in the field of agriculture, and I have had it for a long time. Now it seems to be a much more acceptable topic than in the past to serve on agriculture. You were a third class citizen. Now people come up to you and say what do you think. It is kind of nice, flattering that at long last people think you know how to spell wheat and when you mention concern it isn't necessarily related to your thoughts or language.

Today we will have the crop report and I imagine you are somewhat familiar with it. The crop report will be out this afternoon. It is always dangerous for any person to give forecasts, particularly in terms of categorical ones. But I am going to predict from this podium now that the crop reports as revealed this afternoon will be substantially worse than they were as of September 11, and September 11 corn production was 11 percent below 1973, feed grains were down 14 percent, soybeans down 16 percent, wheat 5 percent, fortunately above 1973, but we have had unbelievably bad weather particularly the feed grain areas.

I will say now that I think as one who has his so-called agricultural financier up there in the air and sniffing around as to what's happening that you are going to see a bad crop report. What do you think that will mean to the forecast for inflation control, Mr. Burns?

Mr. BURNS. If you turn out to be right, this would be very bad news for all of us concerned about the inflation problem, more particularly for individuals in low-income categories who have to spend such a large fraction of their income on food.

Senator HUMPHREY. There would be a happy day—I hope I am so terribly wrong that somebody should say, Humphrey should be eliminated.

Mr. BURNS. Oh, no, nobody is going to say that.

Senator HUMPHREY. I made that statement because I don't think I will be that wrong, but I respect you, Mr. Burns, greatly and I know the President looks to you for counsel, and I know he does.

I have had a kind of a running argument with the Secretary of Agriculture, who is my neighbor, by the way. We have a good social relationship and some ideological differences, economy differences. I worry about what we do on exports. I very much oppose the general principle of what we call export controls as such, but we will have to take a look at what's available and without pressing an answer, I want to say publicly that if the reports were not as good as they were in the past or if they are less than we had anticipated, that you will give counsel and advise in the economic—in this field to the Secretary of Agriculture and to the President, because I think we are going to be in a bind; I really do.

Mr. BURNS. Well, I certainly will do my best, Senator. I am keenly aware of the problem.

Senator HUMPHREY. My final question to you is on the petrodollar. I will take the liberty of sending you a copy of the letter that I wrote to the President. I think that is proper now in light of the fact that the letter went last week and has been made somewhat of a public notice.

I surely know very little about petrodollars and my letter was somewhat of concerned urging that a task force be set up in the Department, possibly under the Secretary of the Treasury, including the Secretary of the Treasury, you, sir, as Chairman of the Federal Reserve, Secretary of Defense, Secretary of Commerce and the Director of CIA, to find out what is the flow, what has happened to the flow of the petrodollar and what are its implications. I wonder, Mr. Burns, is the present financial—are our present financial institutions on top of this issue? Do we really have a handle on it? Do we really know how to handle this huge amount of transfer of capital? I think this is the most serious problem that confronts the international economic community.

Mr. BURNS. I agree with you.

Senator HUMPHREY. I don't feel any sense of confidence that we really quite know—I don't mean just we, but the traditional money markets quite know what to do with it.

Mr. BURNS. I agree with that as well.

Senator HUMPHREY. What do you see? Do you have any counsel or advice for us, because I think that is going to be a question for this committee?

Mr. BURNS. I think, first of all, we ought to drop the word "recycling" from our vocabulary. That term is not conducive to clear thought. What it means is piling debt on top of debt, and more realistically bad debt on top of good debt.

I don't think nations of the world are facing up to the problem, and all the talk about recycling is an escape in my judgment from reality. If you put the matter as I have, then you will at least have stated the matter correctly and you have a better chance of dealing with it.

Let me say, next, that I believe that the price of oil, leading as it will to an increase of approximately $80 billion in the revenues derived by OPEC countries in 1974 from their sale of petroleum, I believe this has created a problem that is simply unmanageable. In order that the problem become manageable the price of oil will have to come down.

Therefore, I think first of all that we and other countries around the world must practice greater conservation. By reducing the demand we will be putting downward pressure on the market.

The President has made some proposals in that field, and I think the Congress ought to examine them very closely. Congress may want to do just what the President has proposed. It may want to do more to promote conservation.

I would say, second, that looking to the long future we must push ahead with Project Independence and turn our rhetoric into reality.

I would say, third, that just as the oil producing countries have established a cartel and are acting in concert, so the oil consuming countries must develop a common policy. And I am glad to say that there is more recognition of this need, both in this city and the capitals of other oil consuming countries today than existed earlier in the year. I believe there will be increasing recognition of the difficulties before long, and I would hope also action by foreign and finance ministers of the leading countries.

Senator HUMPHREY. Mr. Burns, we started our conversation today by stating we were in agreement, and I want to say that what you have said is so much my thinking and my commitment and I feel that is to be said over and over again. I am pleased you brought to our attention this word "recycling" and put it in its proper perspective because that's been an easy out. All of us who make speeches can also talk about recycling the petrodollars, but it doesn't get at the problem, and sometimes it is putting bad debt on top of good debt. It is evasion.

I have also felt, Mr. Burns, and I just want to say it for the record, that one of the ways that you get the OPEC countries to understand that we mean business, as a collective community, hopefully, of the oil importing countries is not only to use rhetoric, and we have had some tough rhetoric, even coming from our own country, not only to have conservation, and the French, by the way a year ago were surely of a different mind, have now put on the 10-percent limitation, reduced their imports by 10 percent, but I think we need to announce a massive research program, and I mean something that has dimensions to it of such a degree that it proves that we mean business.

Whenever you say around this town that you will do something like that, people say, oh, the cost, but we spent some $20 billion as I recollect in the space program, closer to $30 billion, but we accomplish our objective. I happen to be one that believes that basically the investment is worthwhile. The spinoffs have been fantastic, if nothing more than the communications satellite, the Earth research satellite, the communications, and other things.

If we would outline a program, hopefully, in concert with other oil importing countries of an international dimension of research, pooling all of the technology that we have, I think we would be able to get some reduction in oil prices. Then the OPEC countries would know that we meant business, that we weren't threatening them particularly, but competing with them. As of now I see very little of it. I put it on the line. I think "Project Independence" has become Project Dependence, the largest amount of oil imports I think this year was last month where that has gone up appreciably and our own oil production has gone down.

Now, there is something wrong and I believe when you talk about inflation and all the things we are going to do until we get a handle on oil prices that we are just going around blowing bubbles, because all of this is related in a large way, makes this whole package of super-inflation that crippled not only the country, but other countries.

Much of it is directly related to the energy costs, and I see no relief from it until we do something more than we have done. As much as I believe in appeals to the public, and I am sort of a political evangelist at heart as you have undoubtedly heard, and I like to go out and appeal to people, and I like to get large participation of the public. I think the President's message in that was good. But I think there was something else. There has to be a policy, both domestically and internationally. Instead of coaching the OPEC countries, which is good, and negotiating with them as Secretary Kissinger is good at, I want to say that I believe unless the importing countries get together in concert that we are all going to be in dire financial trouble beyond anything ever dreamed of on this date in October 1974. That is my exhortation. That is a loud way of agreeing with you, Mr. Burns.

Mr. BURNS. I want to thank you both.

Senator BENTSEN. Let me say I am sure the Congress will give very serious consideration to the proposals, all of them offered by the President, and certainly along with it the question of preferred stock and the dividend being a tax deductible item, and I assume with the x ratios would be particularly adaptable to that.

I know you and I, from time to time, have tried to find a proper tax credit. I hope someday we can. I would feel more confident than with the arbitrary 10 percent across the board.

You have been helpful and we are very appreciative of the contribution you have made. You are always most generous with your time with the Congress in dealing with these important issues facing the country. We are very appreciative of your coming.

Thank you very much. The committee stands adjourned.

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