THE 1973 ECONOMIC REPORT OF THE PRESIDENT

597

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-THIRD CONGRESS

FIRST SESSION

PART 2

FEBRUARY 13, 14, 20, 22, AND 23, 1973

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THE 1973 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 13, 1973

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Carey, and Widnall; and Senator Proxmire.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Michael J. Runde, administrative assistant; John R. Karlik and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

Opening Statement of Chairman Patman

Chairman Patman. The hearing will please come to order.

I have laryngitis this morning, I hope it will go away. If it does not I will have to get someone else to do my reading for me.

This morning's hearing on the President's economic message to Congress is focused on the economic outlook for 1973. Estimates for economic performance for the year will be given by three distinguished economists:

Henry Kaufman, a partner and member of the executive committee of the investment banking firm of Salomon Bros., New York City; Wilfred Lewis, Jr., chief economist and director of research of the National Planning Association, Washington, D.C.; and Daniel B. Suits, professor of economics, University of California at Santa Cruz.

Welcome to the hearing, gentlemen. Your views will be listened to with much interest.

Before we hear your testimony I would like to place on the record of these hearings the committee's appreciation of the cooperation extended by Herbert Stein, Chairman of the President's Council of Economic Advisers, and his fellow Council members, Mrs. Marina Whitman and Mr. Ezra Solomon. As architects of the President's economic message, they were the committee's lead witnesses last week and agreed to appear a second time yesterday, Lincoln's Birthday, in order to give all of the committee members an opportunity to question them and hear their views in detail.

At the same time, I would also like to point out that Mr. Stein's remarks yesterday about consumer loan interest rate levels failed to present a complete picture of that situation. Mr. Stein, in effect, denied

the existence of consumer loan rates that run as high as 36 percent and higher. He cited new car loan rates of 9 percent and 10 percent in discussing consumer loan rates.

However, the real extremes of consumer loan interest rates are indicated by the recently released report of the National Commission on Consumer Finance dealing with consumer credit in the United States.

A series of schedules presented in the report discloses that finance company consumer loan interest rate ceilings established in 16 States had mean rates ranging from a low of 10 percent to 42.58 percent in 1971. Most of the 16 State rate ceilings were above 23 percent and half of them were above 32 percent.

The report also disclosed that most finance companies make loans at 90 percent or more of the rate ceilings.

As unconscionable as these rates are, the picture is still worse in some States which do not have usury rate ceilings. In fact, I do not know of a single State that had a satisfactory or a fair usury law or interest rate law. They have all been changed substantially in favor of the lenders or have no usury law at all.

In some States finance companies can and do charge rates as high as 240 percent on loans to the poor, who cannot obtain desperately needed credit from any other source.

The complacency with which Mr. Stein cited rates of 9 percent and 10 percent cannot go unchallenged. Nor can he and other members of the administration who profess concern about rising interest rates really fulfill their responsibility to check inflation and achieve economic stability while these fantastic charges on the cost of money remain in existence.

The truth is a person attempting to buy a $20,000 home today must obligate himself to pay interest rates and financial charges during a mortgage term of 30 years, an amount totaling the price of three homes of $20,000 each before he can get a title to just one home of $20,000. It is just that bad, gentlemen.

High interest rates spawn inflation and cause and perpetuate poverty. So long as they are allowed to exist we cannot win the battle against inflation or poverty for the people of this Nation who are most in need.

Now, gentlemen, in the interest of conserving your time and maximizing your presence, we will first hear your statements and then the committee will question you on various details.

Mr. Kaufman, you may proceed, sir.

Representative WIDNALL. Will the chairman yield to me?

Chairman PATMAN. Yes, I will be glad to yield.

Representative WIDNALL. Will the chairman submit for the record the documentation of the interest rates that you mention?

Chairman PATMAN. I will let then stand as they are, knowing that no one can dispute them. If anyone has the contrary information I would be very glad to consider it.

Representative WIDNALL. What was the source of that material?

Chairman PATMAN. The source is the State laws and the National Commission on Consumer Finance. I was on this Commission and I resigned from it because I could see it was going in a way I consider

to be in the wrong direction. That report is available. It is a mixed Commission. It was about half Members of Congress and half from the public sector or civilians, and I was apprehensive that there was too much self-interest on it weighted against the Congress and against the borrowers, so I resigned. But you can get that report. It is available, the National Commission on Consumer Finance. I assure you that you will find the information I obtained this from.

Representative WIDNALL. Thank you.

Chairman PATMAN. All right.

You may proceed, Mr. Kaufman.

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

Mr. KAUFMAN. Mr. Chairman, my name is Henry Kaufman. I am a partner and member of the excutive committee of the investment banking firm of Salomon Bros. 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 this opportunity to present to you my views on the economy.

Let me begin by summarizing my observations of the current and emerging economic situation. We are now in the midst of an economic boom that probably cannot be sustained for long. Late this year, or no later than early 1974, the real rate of economic growth may be only a small fraction of the current high rate and a complete lack of real growth for a short time span cannot be entirely ruled out. This volatility in the behavior of our economy will result largely from the imperfections in governmental stabilization policies, which nevertheless, on balance, have been implemented more timely than in earlier periods of economic recovery and boom.

Indeed, I do not want to belittle the accomplishments of this latest economic expansion. There have been many and they deserve to be recognized. Since the trough in economic activity in late 1969, the increase in our real gross national product totals 13 percent, significantly higher than for comparable periods of previous economic recoveries in the past two decades. Housing activity has surged in spectacular fashion with new housing starts for the past year averaging more than 30 percent above the previous peak levels attained only during short periods in 1968 and 1963. Our unemployment rate, now at 5 percent, has fallen to a lower level in the first 25 months of this current business expansion during the first 25 months of earlier recoveries with the exception of the 1954 to 1957 period.

These accomplishments, however, must also be judged on the basis of the costs which they incurred. An enormously stimulative fiscal and monetary expansion has been necessary to fire up the economic boom. This has resulted in far larger budget deficits and inputs of new money into the banking system than in earlier years when stimulative governmental policies were called for. In addition, the rate of inflation during the past 2 years has been very high for the early years of a period of economic recovery, even though some important inflationary indicators have receded from their peak rates of the previous economic expansion in 1969. While much attention has been focused on the rapidly rising prices of farm products, prices of

wholesale industrial commodities have also increased. During the first 2 years of earlier economic expansions, both food and industrial prices were usually extremely stable.

Now we are in the midst of an economic boom, moving to even higher utilization of real resources with our unemployment rate falling perhaps to 4.5 percent by midyear. If additional excesses are to be avoided and the boom is to continue, checking inflation is necessary but extremely difficult to achieve in a setting in which economic friction is quite likely. For example, the increase in the inflationary rate during the last few months will surely complicate the task of attaining reasonable wage settlements in the months ahead. Price stability now would have gone a long way to assure that inflation had been checked and that moderate wage increases, therefore, will be warranted.

Actually, I believe that it is probably too late to tame this economic boom without experiencing some dislocations. The discipline of economic booms must start in their infancy just as discipline of human behavior is most effective at an early age, when basic drives can still be channeled into desired directions. With respect to the economy, this must begin sometime in the recovery stage and with a very early recognition of the likelihood of a boom. This is because of the timelag between the implementation of governmental policies and their impact on the economy.

Economic booms, however, are frequently only recognized when they are in full bloom. The initial signs of an emerging boom tend to be examined skeptically, be they stimulative fiscal and monetary policies, the revival of consumer and business confidence or improved liquidity in the private sector. The full bloom of an economic boom is there for everyone to see when the economy is operating at a high level of resource utilization. Then, however, it is too late to shift to a less stimulative governmental policy without some disruptions. In essence, we know well the ingredients for moving an economy out of a recession. They are far more crude, however, than the mixture required to run an economy at high levels for a long period.

What have been the imperfections in stabilization policies? While the new economic program has been very helpful in getting us out of an economic and financial impasse, not enough emphasis has been placed on those measures that would help to discipline a boom. Wage and price controls of either the phase II or III variety are difficult to enforce effectively when strong economic demands press against limited productive resources. At high levels of economic activity, reasonable wage and price stability can only be attained with an improvement in the basic competitiveness of the wage and price structure. In this connection, we have made little, if any, progress.

In addition, the timing of the new fiscal posture is also questionable. I am not questioning the slowing of Federal expenditures—I approve of this effort—but rather the delay in fiscal restraint from the viewpoint of stabilization effectiveness. This delay is quite evident when the official projections for the unified budget deficit for fiscal 1973 and 1974 are recast into quarterly budget estimates as shown in table 1.[1] On a recast basis, these statistics reveal that for calendar 1973 as a whole, the unified U.S. budget deficit will total an officially estimated $22.4 billion, up to $5 billion from the previous calendar year. The def-

[1] See table 1, p. 282.

icit will be exceptionally large in the first quarter because of the sizable personal income tax refunds. The second and third quarters of calendar 1973 will be of seasonal proportion. Not until the final quarter of calendar 1973 will an improved budgetary picture begin to emerge.

The unified U.S. budget, moreover, reflects only part of the impact that the Federal Government has on the economy and the credit markets. By combining the market financing needs of the U.S. Treasury with those of the various Federal credit agencies, a more comprehensive picture emerges of the role of the Federal Government in our credit markets. This is demonstrated in table 2 [2] in which the calendar 1973 financing demands of the U.S. Treasury and the various Federal credit agencies, both budgeted and sponsored, have been estimated on the basis of data contained in the new budget document. In order to arrive at the net demands that the Federal Government would make on the marketplace, I have estimated the net purchases of the new Government issues by the Federal Reserve and other official accounts. According to my calculations, the budget implies that $9.6 billion of U.S. Treasury debt will have to be financed by the credit markets in calendar 1973 as compared with $14 billion in calendar 1972. The budget figures also suggest, however, a substantial increase in the financing requirements of budgeted and sponsored Federal credit agencies from $9.7 billion in 1972 to a record $19 billion in 1973. If the budget projections prove correct, the total net new financing demands of the Federal Government will reach $28.6 billion in this calendar year as compared with $23.7 billion in calendar 1972.

It is probable, however, that the total market demands of the U.S. Treasury and the Federal credit agencies in 1973 will be smaller than the $28.6 billion suggested by the official budget statistics. I estimate that they will be just slightly below the $23.7 billion required in calendar 1972. Nevertheless, these demands will still be exceptionally large in light of a booming economy and they suggest that fiscal restraint will be late rather than early in coming.

In the meantime, the Federal Reserve will have to assume a large share of the burden of checking inflation. This will be a trying task because economic participants are not readily willing to moderate their demands. Indeed, all major sectors are presently contributing to the galloping economic momentum and, therefore, to the pressures on real resources. In turn, these demands will strain the demands for credit, which monetary policy is now attempting to curb by slowing the availability of new funds. My analysis of credit flows in 1973 suggests a continued very strong demand for funds. Mortgage borrowers will require a near record volume of new credit, despite some slowing in new housing activity later this year. Business external financing needs will increase again as inventory and plant and equipment requirements accelerate. The new credit demands of consumers will continue to accelerate at a record pace. As noted earlier, the total net new cash needs of the Federal Government and the various credit agencies will continue at a high level. State and local governments will probably be the only major borrowers whose needs will not require as much net new funds in 1973 as they did in 1972. Curbing the overall large demand for credit will be complicated by the accumulated liquidity

[2] See table 2, p. 282.

which will first have to be significantly reduced before monetary restraint can become effective.

The efforts initiated recently by the Federal Reserve to slow the availability of credit are entirely appropriate. To continue a policy of rapid monetary growth is not the answer to a booming economy that is nearing its capacity. It would invite additional inflationary excesses that would be followed by a sharp economic contraction. If monetary restraint is to be effective, however, it will have to deny an appreciable amount of credit to some demanders. In the process, interest rates particularly money rates will continue to rise sharply. Thus, as in earlier periods when inflation had to be checked, our credit markets will again be an important focal point of this restraining process.

The economic slowdown coming later this year need not be long or pronounced if governmental stabilization policies continue to improve and to shackle inflation. Besides the urgent need to remove rigidities in our economic structure, we should strive to eliminate imperfections in fiscal policy. In this connection, the decision of Congress to establish a joint study committee on budget control is a move in the right direction but it still does not remove enough of the obstructions in the way of a flexible fiscal policy. There is still the need to remove some of the impasses between Congress and the executive arm of Government. These two arms of Government are not always of the same political persuasion and control of the purse is, of course, a cherished possession. I, therefore, would again like to suggest as a compromise, that a Federal fiscal stabilization board be established. Its members should be appointed by both the President and the Congress to achieve maximum independence and objectivity. At the start, this body might be given limited power to raise or lower taxes by 1 percent or 2 percent per year, depending on stabilization requirements. Such a board might also be asked to project each year the net budget surplus or deficit for the coming year that would promote sustainable economic growth, leaving to the President and to the Congress the task of filling in the revenue and expenditure profile. It should also be charged to study the efficiency and suitability of budgetary programs and to render periodic reports to Congress.

It is true, of course, that budget stimulation or restraint depends not only on the size of the deficit or surplus, but also on the composition of revenues and expenditures. In view of the large number of uncontrollable budgetary items carried forward from previous years, net budget surplus or deficit targets set by a fiscal board would still be a substantial improvement over the current arrangements. A quasi-independent Federal fiscal stabilization board would relieve Congress and the administration of some of the political pressures that sometimes disrupt the economy. It would serve until Congress removes its powers and acts autonomously only in a limited way to spearhead changes that politically might be difficult to facilitate but are urgently necessary for the country.

Mr. Chairman, this concludes my formal remarks. They exclude, of course, any remarks on the current international monetary situation. I would be pleased to comment on them if you so desire.

Thank you very much.

Chairman PATMAN. If you are unable to comment sufficiently on the present situation, will you take the liberty of extending your re-

marks in the record in connection with your statement. Is that satisfactory?

Mr. KAUFMAN. Thank you, Mr. Chairman.

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

ADDENDUM TO STATEMENT OF HENRY KAUFMAN

In view of the new international monetary crisis, I should like to append my formal statement (which I had prepared, of course, prior to the closing of the currency markets this week) with a few remarks on the dollar devaluation. The genesis of the current international monetary problems goes back many years but the aspects not covered by the Smithsonian Agreement contributed to it very importantly. An analysis of the shortcomings of the latter, which I issued to the financial community just five days after the Smithsonian Agreement was reached, may be of interest because it applies with equal or greater force to the current situation. At that time, I said:

"The new realignment of exchange rates and the decision to ask Congress to raise the price of gold has been profusely and loquaciously heralded. Indeed, it was finalized with great aplomb and in a way which attained the maximum of favorable public response judging by the reactions of the financial markets. To be sure, it was an unusual event and the favorable public response to it reflected a yearning for a return to stability, which the new arrangements do not assume.

"For the first time since the 1930's, the dollar is being devalued. While such a measure may have been unavoidable, it is rather unusual to greet the action as a measure of success when it is, after all, a penalty for past failures in our economic and financial affairs. It is also unusual to find that the devaluing country is adopting atypical measures for the post-devaluation period. Heretofore, devaluing countries adopted strong defensive postures including a tightening of fiscal and monetary policies or both. Now we are engaged in liberalizing these policies.

"Probably the most ominous aspects of the new currency arrangements are the features which it does not contain. It contains no disciplinary features or a regulatory adjustment process which would tend to force participants to protect the international value of their currency. Now it will have to be demonstrated that countries will defend the new parities even if it is against their own immediate interest. We, therefore, have an urgent need for reliance on the rules of proper internal and international financial and economic conduct and management, a virtue that has not abounded in the recent past, without an enforcing hickory rod or an enticing carrot."

In addition, I should like to supplement these remarks with the following observations on the latest dollar devaluation. First, the events over the past weekend suggest that the U.S. Government took the initiative to devalue after the run against the dollar accelerated. The acceptance by foreign countries of our decision represents a minimum concession to us. Secondly, the devaluation is likely to increase the demand for domestic goods and services because it will make foreign goods and services more expensive than heretofore. This enlarged demand, however, will occur against the backdrop of a booming domestic economy and, as a result, will contribute to economic friction and to a somewhat higher rate of inflation for the near term. Third, from the viewpoint of domestic stabilization policy, the devaluation of the dollar is likely to increase the burden of monetary policy. With an increase in domestic economic demands of all sorts and a somewhat higher rate of inflation ahead of us, monetary restraint will have to work very hard to straitjacket economic excesses. Fourth, the dollar devaluation will perhaps encourage foreigners to step up again their net new portfolio investments in U.S. obligations of all sorts. These were virtually at a standstill during the last two months. Finally, the latest devaluation cannot be considered as the final step towards achieving a new and lasting international monetary arrangement. We still have ahead of us very serious and difficult trade negotiations with our international trading partners. We must have the opportunity to increase our exports to these countries where we can do so efficiently and where our competitive strength excels. We should also encourage enlarged direct and portfolio investments in the United States through tax and other incentives.

We must also recognize that the dollar will have to continue to play a key role in the new monetary system and that we cannot abrogate our international responsibilities. Our domestic and international responsibilities are interrelated.

They both require that we make a strong effort now to maintain a stable dollar which in turn will further world economic growth. This can only be accomplished if we resolve our domestic problems by pursuing policies that will encourage a strong economy without inflation.

Chairman PATMAN. And you may insert the tables in your statement if you desire.

Mr. KAUFMAN. Fine.

[The tables referred to follow:]

TABLE 1.—NET UNIFIED U.S. BUDGET SURPLUS(+) OR DEFICIT(−)

[Calendar years, in billions of dollars]

Quarters	1969	1970	1971	1972	[1] 1973	[1] 1974
I	−2.0	−3.5	−8.2	−10.5	−17.3	−9.6
II	+15.3	+8.7	+1.8	+5.6	+5.0	+7.0
III	−2.5	−7.8	−7.8	−2.0	−5.1	
IV	−5.5	−8.9	−10.6	−10.5	−5.0	
Total	+5.3	−11.5	−24.8	−17.4	−22.4	

[1] Estimated on basis of official fiscal year estimates.

TABLE 2.—U.S. TREASURY AND FEDERAL AGENCY DEBT

[Calendar years, in billions of dollars]

	Annual net increases in amounts outstanding						
	1967	1968	1969	1970	1971	1972	[1] 1973
Gross direct and gtd. Treasury debt	15.4	13.4	10.2	20.8	34.9	20.7	28.0
Less holdings of—							
U.S. trust funds	7.2	3.4	12.5	8.1	8.9	6.6	10.7
Federal agencies	0	−.1	−.2	1.7	−1.5	−.5	.7
Federal Reserve banks	4.8	3.9	4.2	4.9	8.1	.6	7.0
Privately held Treasury debt	3.4	6.2	−6.3	6.1	19.4	14.0	9.6
Total debt of budgeted and sponsored Federal agencies	5.0	6.8	6.9	8.6	3.1	10.1	20.0
Less holdings of trust funds and Federal Reserve	1.3	1.5	−1.2	−.4	.3	.4	1.0
Privately held agency debt	3.7	5.3	8.1	9.0	2.8	9.7	19.0
Total privately held Federal debt	7.1	11.5	1.8	15.1	22.2	23.7	28.6

[1] Estimated on the basis of U.S. budget estimates for fiscal years 1973 and 1974.

Chairman PATMAN. Thank you very much, sir, for your statement.

Our next witness is Mr. Wilfred Lewis, Jr., of the National Planning Association.

STATEMENT OF WILFRED LEWIS, JR., CHIEF ECONOMIST AND DIRECTOR OF RESEARCH, THE NATIONAL PLANNING ASSOCIATION, WASHINGTON, D.C.

Mr. LEWIS. Chairman Patman and members of the Joint Economic Committee, my name is Wilfred Lewis, Jr. I am chief economist and director of research of the National Planning Association, a nonprofit economic research institution located in Washington, D.C.

Thank you for inviting me to comment on the 1973 outlook and the economic report of the President. My statement is brief, and I would like to read it in its entirety.

GENERAL OUTLOOK FOR 1973

At the moment, the economy is undergoing very strong expansion. Rates of increase in business investment and personal consumption expenditures during 1972, and continuing prospects for these sectors for at least some part of the current year, make the current expansion one of the strongest on record. Unemployment, which at long last began to decline in the closing months of 1972, should decline sharply further in the coming months. I expect unemployment to be near, or possibly below, 4½ percent by midyear, which, if so, will be the closest we have been to full employment in over 3 years. The economic report looks toward a rate of 4½ percent only by yearend, and, in truth, the path forecast by the economic report would probably be somewhat easier to manage than the more rapid pace I am forecasting from the standpoint of making a smooth transition from "recovery"—the phase we are now in—to sustained full employment growth.

In any event, with a strong recovery underway, it is an appropriate time to examine three important aspects of the economy:

1. The definition of the full employment target;
2. Policies appropriate for transition from recovery to movement along the full employment path, which will necessarily entail some slowdown from the rate during the recovery phase; and
3. Policies appropriate for staying at full employment once we get there.

Taking items 1 and 3 first, I submit that the target rate of unemployment for sustained and stable full employment growth can be very substantially less if accompanied by (*a*) aggressive price-wage controls and (*b*) a large-scale public employment program, than if we attempt to reach full employment without such aids. To be more specific, I doubt very much whether, in the absence of price-wage controls and a public employment program, unemployment can be reduced very much below 5 percent, which is where we are now, without touching off a steadily escalating rate of inflation that would soon require corrective action. On the other hand, the experience of last year as well as recent econometric studies done for this committee suggest that price-wage policies could reduce the noninflationary rate of employment by perhaps as much as one-half to 1 full percentage point. I estimate that an expanded public employment program along the lines of the successful experimental program now underway could also have a potential impact of roughly the same size. Thus, in order to reduce unemployment to anything like 4 percent without unsustainable inflation we would surely need at least one or the other of these policy tools, and to go below 4 percent, as this committee is on record as favoring, we would need both of them.

I turn now to the more immediate, and perhaps even trickier question, of transition from recovery to movement along a full employment path. First, it should be recognized that the required maneuver is about the trickiest act there is for fiscal and monetary policy managers, having been brought off successfully, in my opinion, only once previously in the postwar period, in 1950–51, in four previous attempts.

The intrinsic difficulty of this maneuver owes to the fact that some important sectors of the economy, notably business inventory investment and employment and investment in the capital goods industries,

are related importantly to the rate of growth, as distinct from the absolute level of demand. Thus, when the rate of demand slows, as it must when the economy is in transition from recovery to sustained growth, these important sectors slow down much more sharply than the overall economy and, if the transition is abrupt, can actually turn negative very quickly. This is, in fact, little more nor less than the essential cause of good old-fashioned so-called classic recessions. Indeed, the challenge facing policymakers in the coming year will be to avoid a recession of classic dimension.

At the present time, the signs are far from promising. On the one hand, we have a very rapid investment boom that we know has to taper off as we approach full employment. Second, State and local government budgets are becoming moderately more restrictive, and the Federal budget, under administration plans, sharply more restrictive. Finally, residential construction is already beginning to feel the pinch from tightening in credit markets, and will probably be declining anyway after last year's very strong performance. This sector can decline very sharply if an acceleration of inflation causes the monetary authorities to tighten credit further. It these forces all come together, as they show every sign of doing around midyear or shortly thereafter, a recession will be nearly unavoidable.

Because of the delicacy of the economy this year under the best of circumstances, the recent announcement of a relaxation of price-wage controls under phase 3 seems almost incredible to me. By escalating further the already virulent threat of inflation, such action risks a monetary clampdown at the worst possible stage of the business cycle.

There is an irony in all this, in that the present risky situation is owing in no small measure to the administration's abandonment of its own frequently expressed preference for the so-called even-keel approach to fiscal and monetary policies. Last year, in its desire to stimulate a long flagging economy in a hurry, the administration pulled out all the fiscal and monetary stops. Now we appear to be about to witness a sharp wrenching in the opposite direction of both fiscal and monetary policy.

Unlike a number of my colleagues, I thought the administration was basically correct in its professed even-keel approach to demand management, and I only regret its departure from that approach. It is true that virtually all the postwar instability of the economy has been due primarily to gyrations in Federal fiscal and monetary policy, and we appear to be on the verge of another replay of an old sad tale.

PRICE-WAGE POLICY

In assessing the impact of a further softening of price-wage controls at this time, we should look at the price record of last year a little more closely than the economic report does. According to the economic report, the salient feature of inflation in 1972 is the marked improvement for the year as a whole compared to 1970 and 1971.

True, inflation was down sharply in 1972, due in no small measure, it should be noted, to the controls program initiated in the fall of 1971. But the impact of this program, at least the way it was applied, was largely spent by the second quarter of 1972, and inflation has been intensifying noticeably since then, no matter which price index is re-

ferred to. The annual rate of inflation measured by the implicit GNP deflator increased from a low of 1.8 percent at an annual rate in the second quarter to 2.4 percent in the third and 2.7 percent in the fourth. The somewhat more meaningful fixed weight GNP deflator rose from 3 percent in the second quarter—also a low point—to 3.4 percent in the fourth.

Most econometric models have been forecasting sharp acceleration of inflation in consumer prices and the GNP deflator in the first and second quarters of 1973, partly due to lagged responses to increases in wholesale prices that have already taken place. It should be noted that this renewed acceleration of inflation has been taking place during a period of sharp improvements in productivity, associated with increased rates of capacity utilization and reductions in unit costs. So we cannot regard this as cost-push inflation. Nor, with unemployment above 5 percent until the very end of last year, and plenty of unused capacity still on hand in most industries, can we view it as excess demand inflation.

In truth, phases I and II of the controls program temporarily slowed the "expectational" inflation that has plagued us for several years, but fell far short of arresting it. We began 1973 with a serious and steadily worsening inflation problem. In this context, where the clear need was for more rather than less effective controls, the announcement a few weeks ago of a further relaxation of controls during phase III can only be described as foolhardy. I say "further" relaxation, because the Price Board had already been steadily relaxing its rules over the latter part of last year. If there is a less satisfactory condition of the economy than inflation simultaneously with recession, I do not know what it is. And if there is any single act that would have contributed more at this juncture to making just such an outcome probable, I cannot think of it.

Turning to the international aspect of the outlook for 1973, the headlines in the Washington Post this morning make my comments a little out of date, but I will read them the way I wrote them over the weekend anyway, Mr. Chairman.

INTERNATIONAL

With European finance markets once again giving off signs of panic only a little more than a year after the Smithsonian Agreement that President Nixon hailed at the time, surely with tongue in cheek, as "a second Breton Woods," a few comments on the international trade and finance picture appear to be in order.

In the new round of flight from the dollar, the international currency speculators appear to be reacting to some of the same fears that touched off the recent sharp decline in common stock prices; namely, a fear that a softening of price-war controls in phase 3 means a new round of U.S. inflation. While I share the belief that accelerated inflation is in store, the present currency reaction is an ill-considered, simplistic, and I believe temporary response. The improvement in our trade balance last year in response to the December 1971 devaluation was admittedly disappointing, to put it mildly. Still it must be remembered that there are long lags in the international adjustment process. Devaluations do eventually improve a country's trade balance, but it

always takes longer than expected. Moreover, while U.S. inflation was higher than desirable last year, it was less than that experienced by most of our trading partners.

In short, between the December 1971 devaluation and the comparative rates of price inflation during 1972, the United States has achieved a substantial improvement in relative price competitiveness, the effects of which have not yet been felt, and it is extremely hard for me to believe that anything approaching a new 7 to 8 percent devaluation of the dollar, as is being talked up in some quarters, is appropriate at this time. This seems particularly true if one looks a few months down the road. As the stock market knows, the real threat posed by renewed inflation is the strong probability that the current expansion in real output will soon have to be slowed sharply if not reversed. A recession would, of course, improve rather than worsen our trade balance.

Taking all these factors together, I would confidently forecast that a new 7 or 8 percent devaluation of the dollar, and this goes even more so for the actual 10-percent announced last night at this time, assuming we meant by that a movement to a new set of fixed rates, would be followed almost immediately by a reverse flow of speculative currency movements and a new panic. It would be a different matter if we were to simply cut the dollar loose again, as we did for a period in the fall of 1971 and which is what Mr. Reuss of this committee was recommending yesterday. In that case we might see a small temporary devaluation but I would expect that to be largely or completely reversed as we began to feel later this year the combined effects of lagged response to the improvement in U.S. trade competitiveness achieved in 1971 and 1972, and a slowing down in the U.S. economy.

I cannot resist observing that these repeated international currency crises are a kind of self-inflicted madness that can be, and should be, avoided. They are a built-in byproduct of the foolish persistence on the part of central bankers and finance ministers in the major countries in trying to fix exchange rates by fiat that will serve the needs of the international trading and finance community for more than a few months at a time. Fritz Machlup has warned us repeatedly, and correctly I believe, that so-called fixed exchange rates are a figment of the imagination. As Mr. Nachlup puts it, the only real options open to us are gliding exchange rates and leaping exchange rates, and those who profess to favor fixed rates are really advocating leaping rates and recurring crises. Of course, the more frequent the crises, the less severe the disruption at any one time, and we do seem to be making progress in the sense of moving toward more frequent crises. But it is surely a misallocation of scarce resources to have the world's central bankers and finance ministers shuttling back and forth to unnecessary exchange crises when their time and attention is badly needed at home on a whole range of real domestic economic problems that all the countries face.

Mr. Chairman, I would like to depart from my prepared remarks and add some comments about congressional fiscal policy and budget machinery.

The machinery for handling the budget at the congressional end has gotten badly outmoded from the standpoint of having Congress participate as an equal partner with the Executive in the important fiscal policy decisions in our society. I do not think that resolution of current

arguments over whether the Executive does or does not have the authority to impound congressional appropriations will by itself go very far toward what is needed. Congress will have to reform its procedures for handling the budget, to bring appropriations and tax legislation closer together, and both of these in the context of multiyear projections of expenditures and revenues for at least 3 or 4 years ahead.

I realize that to do this in a meaningful fashion strikes close to the heart of the committee system of the Congress, so what I am suggesting is certainly not easy to do nor do I make the suggestion lightly.

However, reform of congressional budget and fiscal policy decisionmaking machinery deserves very high priority.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, sir.

Our next witness will be Mr. Daniel B. Suits, professor of economics, University of California, Santa Cruz. Mr. Suits, you are recognized, sir.

STATEMENT OF DANIEL B. SUITS, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, SANTA CRUZ

Mr. SUITS. Mr. Chairman, I am in general agreement with the economic outlook as forecast by the President's Council of Economic Advisers. I expect the gross national product to pass $1,300 billion by the fourth quarter of 1973 and to average about $1,270 billion for the year as a whole. This constitutes a 10-percent rise over the level for 1972 and, after allowing for an expected 3 percent rise in prices, implies a 7-percent gain in the volume of real output. This gain in production will be accompanied by declining unemployment, and we may expect an unemployment rate well below 4.5 percent of the labor force by year's end.

Because I concur in the buoyant forecast, however, I have great misgivings about phase III. Not that phase II was any great bargain. Indeed, I believe that most of the success claimed for phase II was attributable not to the wage and price control arrangements but rather to the fact that a high level of unemployment finally caught up with us. Pressure on wages, production costs, and prices originates in the scramble of employers for the workers they need to supply rising demand for their products, but, once established, these pressures continue for some time after the tight markets responsible for them have disappeared. It is this lag in response that accounted for the apparently anomalous "inflationary recession" observed during most of the last 4 years. But wage, cost, and price pressures cannot maintain themselves indefinitely in the face of a substantial number of jobless workers, and the inflation rate has now settled to about the level that would be normally expected with 5 percent of the labor force unemployed.

But this does not signal any kind of victory over inflation. Rather, we are purchasing our moderated rate of price increase at the cost of a higher level of joblessness, just as we did during the period from 1958 to 1964. Likewise, the projected rise in output and job openings will again accelerate the competitive scramble for qualified workers and will produce again the inflationary pressures of the recent past.

This is not to say that I expect inflation to be a serious problem this year, for just as it requires time for inflationary pressure to abate after

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the underlying causes have been removed, it likewise takes time for pressure to build up once the conditions are present. We are, therefore, in serious danger of deceiving ourselves. A reduction of unemployment, unaccompanied by immediate revival of inflation, may very well reenforce our notion that we have conquered both unemployment and inflation and are entering upon a great new era of economic stability. But just as ever, tight labor markets will sooner or later be reflected in wages rising more rapidly than productivity, escalating costs, and a return to the inflationary spiral.

It cannot be emphasized too strongly that there has been little change in the basic relationship between unemployment and inflation during the past 4 years. Indeed, what evidence we have indicates that, if anything, inflationary pressure begins to accumulate at higher levels of unemployment than before and that inflation is likely to appear sooner this time than it did last time. In other words, inflation is no threat, and wage and price controls are superfluous only so long as we keep the economy sufficiently sluggish to provide a substantial pool of unemployed workers. A sustained level of demand and total output adequate to provide jobs for everybody ready, willing, and able to work will inevitably be accompanied by the reappearance of rapid inflation.

For this reason, it seems to me that the modest system of wage and price controls of phase II was established just about the time it was least needed, and that we are now in the process of complacently dismantling it just when it is most likely to be required. Rather than weaken or abandon controls at this point, we should be engaged in a serious systematic search for a more inclusive, more effective permanent mechanism to reconcile the present conflicting objectives of low unemployment and price stability.

There are several things such a system might embody. Out right, rigid controls are, of course out of the question. An economic system like ours that depends on wages and prices as the principal guidance mechanism for production processes can ill afford to have its steering gears locked. We know from ample past experience with wartime controls what happens when the price mechanism can no longer respond to shifts in supply and demand. But it should be possible to design a system that permits wages and prices to rise more rapidly in areas of scarcity than in areas of surplus, all within a context of overall stability. For example, Prof. Abba Lerner has suggested a plan whereby the average increase in wage rates would be limited to the projected average rise in productivity, say, 4 percent, but where rates in industries with below-average unemployment would rise more than the average, say, 5 percent, while increases in industries with more than average unemployment would be less, say, 3 percent.

Another attack on the problem is to mitigate the consequences of unemployment for the unemployed. One-half of the serious dilemma posed by the unemployment-inflation trade-off is the disaster that unemployment represents for people out of work. Consequently, one way out of the dilemma is to provide a better and more inclusive system of unemployment insurance. Such a system should apply not only to workers with a solid attachment to the labor force, as the present system does, but should also include workers with long-term inability to find jobs, and to new entrants into the labor force unable to find a

first job or unable to hold a job long enough to qualify under existing law. Needless to say, such a program of unemployment insurance should be combined with an expanded system of training, job location, and placement.

The existence of additional protection for the unemployed worker would greatly reduce the urgency for economic expansion purely as a way to provide jobs for people who would otherwise be without incomes, and would provide additional room for anti-inflationary policy without imposing the cost of stability on those least able to pay it.

A third approach to the problem is to explore ways to temper the bad effects of inflation itself. These evils come not from the fact that prices rise, but that some prices rise faster than others. In the final analysis, of course, prices and incomes are the same thing looked at from two different points of view. The price of farm products is the farmer's income, the price of medical service is the doctor's income, and the price of higher education is my income as a college professor. It follows that inflationary price increases are the same thing, overall, as inflationary increases of exactly the same magnitude in our incomes, and leave us—on the average—with exactly the same real buying power as before. If this were all, inflation would be no problem at all. But during the course of prolonged inflation, some price-incomes rise more rapidly than others. And those whose prices rise more rapidly than the average receive a transfer of real buying power at the expense of those whose prices rise more slowly.

If we cannot control inflation, then, we can at least spread it more uniformly over the community so that everyone participates more equally. This could be accomplished by widening the use of cost-of-living escalator provisions in contracts. They might be uniformly extended not only to wage and salary contracts, but also to social security, unemployment insurance, welfare allotments, and to debts, bank accounts, and similar instruments. Similar adjustments could be applied to the foreign exchange value of the U.S. dollar so that domestic inflation need not be accompanied by a balance-of-payments crisis.

When inflation is made uniform for all, it ceases to be an important issue for any, and the urgency to direct our policy to control it is sharply modified. While I am no great admirer of the fiscal and monetary courses pursued by some of our neighbors, it is worth pointing out that the rate of inflation in Brazil has averaged almost 25 percent per year since 1948 and has approached 100 percent during a couple of years. Even during the last half-dozen years—a period that the Brazilians consider to have been relatively stable—the rate of inflation never declined below 19 percent per year. The point, of course, is not that this is a performance that we should emulate, but it does clearly demonstrate that it is possible for an economic system to function without coming to pieces at inflation rates many times those we consider to be the maximum tolerable limit. It would be worth while for us to examine the institutions and mechanisms that make this survival possible.

Finally, a coordinated attack on inflation and unemployment should involve an effective program of job training and educational upgrading of disadvantaged workers. This is not only of direct benefit to the workers themselves, but contributes to control of inflation. One reason that U.S. inflation is so sharp even while 3 to 4 percent of the

labor force remains unemployed is that a large fraction of the workers still without jobs are inexperienced, or without marketable skill, or otherwise unemployable, so the number of qualified, desirable workers for employers to draw on is smaller than is suggested by the unemployment statistics. If a larger fraction of those 3 or 4 percent were able to provide service of a desirable quality, the scramble for workers would be correspondingly reduced and with it the attendant inflationary pressure on wages and prices.

In conclusion, I would like to summarize these points:

1. I agree with the outlook for a rapidly expanding economy in 1973.

2. At the same time, I see no fundamental change in the way our economic system reacts to low levels of unemployment. When we have reduced unemployment to a more nearly satisfactory level, we will again experience inflationary pressure, although probably not immediately.

3. It follows that this is not the time to dismantle inflation controls but to replace our existing temporary structure by a more permanent, far-reaching program.

4. Such a program should be directed not only at wage and price controls but should also involve provisions to mitigate the effects of both unemployment and inflation themselves, and to contribute to upgrading the labor force.

Thank you.

Chairman PATMAN. Thank you, sir.

Mr. Kaufman, I would like to ask you two or three questions. No. 1, do you think the huge amount of money held by American companies in this country and abroad has been used in any way to add to the present blight of the dollar in Europe?

Mr. KAUFMAN. That is a very difficult and complex issue, Mr. Chairman. I think the genesis of this situation dates back to a decade or so ago when many of our very productive corporations realized that there were substantial markets abroad. By building a productive capacity here in the United States to accommodate those markets in Europe and elsewhere, our corporations would have been preempted from these markets because of national barriers.

Consequently, the multinational corporations correctly assessed the situation, and became part of the national market scene abroad and were able, in this way, to participate in the demands for goods and services over there. They have, of course, generated substantial income, and some of this income has been repatriated in the United States.

There is the question, I think, underlying this, what should be done in our structure here to make investments more productive and more profitable so that our corporations abroad will invest in the United States that we provide sufficient inducements to foreign corporations to make direct investments as well as portfolio investments.

So, I think the problem you posed has many dimensions to it, and should not be only looked at in terms of our large corporations but over a broader segment of issues.

Chairman PATMAN. Is it a fact, though, that we encourage the companies by permitting them to take money overseas. If the money stays there forever why, of course, the United States does not get any tax on it.

Mr. KAUFMAN. That is correct, Mr. Chairman.

Chairman PATMAN. Well, is that not a great advantage to these companies that are operating in Europe?

Mr. KAUFMAN. Yes. Of course, there are some benefits to the United States to that.

As you know, we generate income abroad and some of that income does come back to the United States. We gain, of course, technical experience, world market experience, which we would not be able to enjoy if those corporations were not there.

I recognize this advantage which you point out, but at the same time, I think that there are broader aspects to this problem that have to be resolved by Congress.

Chairman PATMAN. I would like to ask you about the money, the effect on money, if this agreement goes through and results in devaluation. Like it is now, all of our money is legal tender, which means, of course, that if you owe a debt to anyone and you tender this money and it is not acceptable to the person to whom you tender it, the person whom you owe, and he does not accept it why then, you can keep your money and the debt is paid; is that not right?

Mr. KAUFMAN. This is right. This is part of the current international monetary problem, the buildup of dollars abroad and the unwillingness of foreigners to accept an enlarged inflow of dollars to their countries. This, I think, is one of the unfortunate aspects of the past 2 years.

We had a Smithsonian Agreement which, in my opinion, was only an arrangement, and was not a lasting monetary situation. I believe even the current situation is only temporary and we cannot call the new arrangements just announced by the administration last night as suggesting that we are on the road very quickly to a permanent arrangement.

Unfortunately, most of the countries in the free world are making efforts not to defend their currencies but to depreciate their currencies. This is not an environment of confidence. An environment of confidence can only be reached when countries are willing to defend their currencies even if it is not in their immediate best interest.

I think that will still have to be demonstrated, and some time will have to pass before we achieve a new viable situation. I think the current situation continues to be very complex.

Chairman PATMAN. We have about $1,700 billion in debts and taxes, public and private. Our money can pay any of those debts and those taxes. But if we pass this devaluation bill will not the ball game change? Will we not have to have a new currency that is legal tender, and this present currency will not suffice? Is that not true?

Mr. KAUFMAN. No. I think not, as long as our money is accepted internally as legal tender. Most of our debt is in internal debt. The Federal debt, the debt of the U.S. Government, the debt of the Federal agencies is held mostly internally. The debt of most of our large corporations, business corporations in general, is mostly held internally; the debt of our State and local governments is mostly held internally and, of course, the substantial mortgage indebtedness is an internal indebtedness so, consequently, the new international monetary arrangements should have very limited impact on that debt structure.

Chairman PATMAN. Should consideration be given to more than one

tier of money, two tiers, we will say, and have one tier of money, like we have now, that would be good for the payment of all these debts, public and private, the $1,700 billion, and the other money for foreign transactions?

Does any country in the world have any arrangements like that?

Mr. KAUFMAN. Yes, there are arrangements of this sort. As you know, France has a two-tier system, a financial dollar and a commercial dollar. I believe that this would be a retardation of a free market process, and I believe that it would tend to restrict not only the free flow of money but ultimately the growth of economic activity worldwide. I think that a two-tier curency system is only at best a stopgap solution to a more efficient international monetary system and not the most desired path.

Chairman PATMAN. I yield to Senator Proxmire, 10 minutes.

Senator PROXMIRE. I want to congratulate all you gentlemen for very interesting, helpful, expert statements, very useful.

I would like to ask each of you to comment further on the decision by the President to devalue the dollar by 10 percent.

One of the elements that occurs to me that has not been brought up, is that this could have an immediate adverse effect on the cost of living in this country. After all, if the cost of some of our imports is increased by 10 percent this could result in an increase of $5 to $6 billion gross, probably $2 to $3 billion net, the way it would work out in increase in the cost of living.

How is this devaluation likely to be accepted by the countries in the world? As I pointed out, Canada cannot possibly stand still. I doubt if England could.

How effective is this likely to be? We presume, of course, that Japan and Germany will not devalue but with that exception how do you view this? Mr. Kaufman, first.

Mr. KAUFMAN. Well, I would like to make six to seven points; let me enumerate them briefly.

This is an agreement that was reached more or less at our initiative and with the reluctance of foreign participants. That does not make it right and it does not make it wrong. But it shows that this was done with a minimum of cooperation rather than at a maximum of cooperation.

Secondly, I believe this new arrangement will contribute initially to increased domestic economic activity because it will slow down some imports and increase the demands for domestic goods.

Thirdly, I believe that this is likely to trigger at least initially some inflow of foreign money into U.S. credit markets, either into debt instruments or into equity obligations.

Senator PROXMIRE. How much do you expect in that area?

Mr. KAUFMAN. In the second half of calendar 1972 foreign new money going into U.S. equities was roughly in the magnitude of $2 billion. That inflow of new money into our stock market ceased at the end of December and throughout January and there were attempts by foreigners to actually liquidate.

Senator PROXMIRE. You would expect something like that $2 billion?

Mr. KAUFMAN. I would expect a new inflow to begin again.

Senator PROXMIRE. OK.

Mr. KAUFMAN. However, these new measures are bound to increase inflationary pressures, as the Secretary of the Treasury indicated last night. Moreover, as you indicated, we do not yet know the response of foreign countries to the proposed trade legislation that has been suggested by the administration.

Next, I believe that all of these developments are bound to increase the burden of monetary policy, because the need to stabilize our economic situation is now greater if we want to make this new devaluation stick and to become effective.

Senator PROXMIRE. Monetary policy has to be more restrictive.

Mr. KAUFMAN. It has to be more restrictive.

Senator PROXMIRE. How about phase III, does it have to be tougher?

Mr. KAUFMAN. Yes, it should be tougher, but the question is, will it be tougher, and I am convinced that the Federal Reserve cannot wait for the demonstration of the effectiveness of phase III, particularly now that we have——

Senator PROXMIRE. When I say could it be tougher, I am asking whether or not Congress can perhaps take action. After all, we are the ones who have to determine what the phase III law may be. The administration may or may not choose to administer it, and it can choose not to do so. We can toughen up the provisions. We can ask for advance approval if prices are to go up. We can provide a tougher guideline for wages and prices.

Mr. KAUFMAN. The requirement now, based on the international situation, is that we achieve more quickly a noninflationary situation, and this will have to come from Congress, through tougher wage and price guidelines and it will have to come, I think, in part from the Federal Reserve for more restrictive monetary policies.

Senator PROXMIRE. Will it mean a tougher fiscal policy? Would you say hold down spending at least to what the President has proposed and perhaps lower?

Mr. KAUFMAN. Yes, but I am very fearful, as I indicated in my oral statement, that the fiscal restraint, if any, will come very late while fiscal restraint will be required very early.

Senator PROXMIRE. You say we should do it, but it is less likely we would do it. We can act more promptly in the monetary and control area.

Mr. KAUFMAN. That is correct, Senator Proxmire.

And, finally, I, therefore, feel that we should consider this latest international monetary move as just one of perhaps a number of steps that ultimately may lead us to a better international monetary arrangement.

Senator PROXMIRE. What is the next step?

Mr. KAUFMAN. The next steps are trade talks, and very serious talks, on the realinement of the trade situation. This is the tough part. We are dealing now internationally with partners that are more equal than they were when the Bretton Woods Agreement was reached and, therefore, the bargaining is more difficult.

Indeed, the one item that we can perhaps export with great abundance and most efficiently, farm products, are not acceptable in most of the free world. That attitude has to be changed and, therefore, this is why I think the period ahead is still going to be a volatile period for the international currency markets.

Senator PROXMIRE. All right. Now, let me quickly move to the other gentlemen, too, include them both in this, and ask you to comment on this.

All three of you, I understand, believe that phase III in your view, is too weak. It is not strong enough. It does not have sufficient force so we need a stronger wage and price control program.

You all seem to feel we will have a rapidly expanding economy at least in the first half. Mr. Kaufman and Mr. Lewis felt after that the economy might tail off, and Mr. Lewis felt we might even have a recession. In response to this, Mr. Lewis and Mr. Suits felt we should be concerned not only about the inflation aspect but also about continuing to diminish unemployment by manpower training programs.

None of you call for any increase in taxes, none of you call for any tax reform program perhaps because you feel, as Mr. Kaufman indicated, on some of these other things, it would just take too long.

At any rate, would you agree with me that the fundamental problem we now have as far as the dollar is concerned, is inflation, and that we have to get inflation under control either with controls or a different kind of a fiscal policy, tax policy, something of this kind, if we are to meet the threat to the dollar in any permanent way.

Mr. Lewis.

Mr. LEWIS. I certainly agree that inflation is a serious problem, not primarily because of its international aspects but because of its domestic aspects, because I think, with the kind of inflation we have now, it is going to be increasingly difficult to reach acceptable levels of unemployment.

I agree completely with your suggestion that this devaluation could be inflationary if it were to stick. Devaluations are generally inflationary, other things being equal, and I see no reason why this one should be any different. But, as I said in my oral statement, I do not really see how this can stand. You see, I think what we are witnessing, what we have been witnessing, in the last few weeks is not a fundamental disequilibrium but rather a highly speculative flurry, and if I am correct, then we are going to see the speculation reversed.

Senator PROXMIRE. That is an interesting reaction because I have been struck by this and many others have. The Secretary of the Treasury pointed out that our inflation record is better than that of Japan, France, England, or Italy or other countries and this has been true for at least the last couple of years, especially last year, and yet we are the ones who seem to have a currency, that is under pressure, so that the speculative action in that sense does not seem logical. How do you explain it? Are they discounting the future? Does it look as if now we are going to move into a more inflationary situation?

Mr. LEWIS. Well, when you are talking about speculative movements, either in international currency markets or on the stock market, it does not take very much to get a number of people with big blocks of money all betting in the same direction simultaneously. My personal interpretation is that some people read the relaxation of price-wage controls in phase III and said, "Hah, hah, more inflation, and more inflation means worsening of the U.S. trade balance." Therefore, they began betting against the exchange rate.

But I think that is a very simplistic reading of the situation because I think the real consequences within not too many months, is the

increase, the intensification of inflationary pressures that the relaxation of controls is putting in motion, and that the real consequence of that will be a slowdown in demand here, which is favorable rather than unfavorable for our trade balance.

Senator PROXMIRE. Mr. Suits, you gave us a very strong position on stimulating employment and recognizing our obligation to those who are unemployed and not neglecting their position. How do you square that kind of position with the fact that the dollar does seem to be under pressure, that we do seem to have inflationary elements? We have expanded our Federal spending enormously, the President has asked for a 7½-percent increase, $19 billion in one year, Congress does not think it is enough, many Members of Congress, how do you reconcile your program as a policy to helping people who are unemployed as a keystone with an effective anti-inflation program? Do you rely entirely on controls? How do you answer Mr. Kaufman's position that controls do not work if you get too much pressure on them from demand?

Mr. SUITS. I think I would prefer to say that the danger element in the situation is neither inflation nor unemployment but the tricky trade-off between inflation and unemployment.

As I read the statements about fiscal policy and the need to control the economy this year or to apply the brakes, I read that as a euphemism for a higher level of unemployment, and I do not believe that that is the way we should do business. I do believe that we should free our policies from concern with this trade-off.

For example, it would be much preferable if in establishing the budget of the United States, which is after all ultimately a statement of what the U.S. Government should do in governing the affairs of this country, if we could free that policy from concern about these overall magnitudes; that as it stands now, if we go too far in one direction then we find that while we have reached a position in which everybody who wants to work has a job, that same position means that prices are rising at an unacceptable rate, that in order to prevent that then we limit what the Government of the United States should do, not because there is less show of social need, not because there are fewer things that the Government needs to do, but because we have this strange phenomenon of rising prices. I prefer to break the relationship between those two things so that we can free the policy of the Government of the United States to govern the country, which is ultimately what it is designed to do.

Now, I do think in all of this that the role of the international position of the dollar has been greatly distorted by the fact that we talk about the dollar. This is not a problem of the dollar at all. What has happened this morning is that the price of foreign currencies, the yen and the mark and the Swiss franc have been raised about 10 percent. Now this has nothing to do with the dollar which we use for buying and selling things here in the United States at all. What it has to do with is the cost of imported goods and services. True enough, if I wanted now to buy a Volkswagen or buy a Japanese radio or buy some British woolens or a bottle of Scotch it will presumably cost me more than it did before because, in my view—and here I differ with Mr. Lewis—the dollar has been overvalued for this purpose for a long

time; I have been getting all kind of bargains abroad with my dollar because it will buy much more than it really ought to buy.

So that indeed, this change in the price of foreign currencies will raise the cost of these imports to me and to that degree will, of course, increase the cost of my living. But this is only rectifying a bargain that I have had for the last 10 years in getting much more for my money if I would buy abroad than I really ought to get.

Senator PROXMIRE. My time is up, Mr. Chairman.

Chairman PATMAN. Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

I have just heard the news, I do not believe it has gotten to you yet, that in the first 45 minutes of trading on the New York Stock Exchange over 6 million shares were traded and the Dow Jones averages went up over 20 points.

How do you interpret that, influx of foreign money or speculators in this country thinking that the decision made by the administration has been a wise one?

Mr. Kaufman, would you answer, please; I would like all three of you to comment.

Mr. KAUFMAN. Mr. Widnall, I think that reflects several things. First of all, an uncertainty has been removed for the time being and the uncertainty was the viability of the international currency markets.

As I indicated before, the inflow of foreign money into our equity markets probably has started again. It was substantial for a good part of the second half of 1972, it was completely halted in late December and throughout January. The accumulation of dollars abroad in private hands is substantial and, therefore, this is bound to be a plus factor for the equity market for the near term.

Second, I believe that the market is interpreting this as an additional economic stimulant, again for the near term, and that the likely slowing of imports and the enlarged volume of economic activity will have to be serviced by our domestic business structure.

And I believe, third, that the market, therefore, feels, that this allows us some leeway on the price and wage structure, rightly or wrongly and, of course, a 20-point move of Dow Jones, of course, reflects a substantial amount of participation and does not necessarily signify any indication of what the ultimate outcome of this situation may be.

I think it is a response that reflects partly near term euphoria and the other developments which I just mentioned.

Mr. LEWIS. If I knew how to interpret 20 points in the Dow Jones in 6 minutes I would be a multimillionaire vacationing in the Caribbean and not be testifying here today. I do not mean that facetiously, but I do not know how to interpret such things.

Representative WIDNALL. May I interpose this question? Would that not indicate to you some kind of restoration of confidence in somebody somewhere to have that pentup demand show itself that early in the market?

Mr. LEWIS. It would appear that way, yes, sir.

Representative WIDNALL. Mr. Suits.

Mr. SUITS. The whole question of values in the stock market, of course, is basically built on expectations. And not my expectations but my expectations about your expectations, and not your expectations

but your expectations about my expectations. So that ultimately the value of stocks depend on what you think I think you think I think. [Laughter.] If we knew just where to stop in that cycle we might come out very well in speculation. But news is news. I have noticed that all scholars of the stock market are prepared to explain exactly what happened as soon as they know what it was and I am sure if the market had gone down 20 points instead of up 20 points we could tell you why that was so, too.

Representative WIDNALL. In other words, you believe there are a lot of grandstand quarterbacks that are active in interpreting the stock market.

Mr. SUITS. Yes; I think so.

Representative WIDNALL. I appreciate the frankness of the statements made by all three of you witnesses this morning. I was asked before I came in here as to what I thought about the action of the administration. In part, I answered by saying that there were really very few experts when it came to foreign exchange and balance of payments and that I wished that the American people knew more about it, that the Members of Congress knew more about it, and also a lot of the members of the press knew more about it, because I think that we get some very strange viewpoints many times from all segments of the public; it is a very tricky situation. It requires considerable expertise to understand money and its balances and its changes and fluctuations, and a lot of us feel sort of hopeless when it comes to what did happen or what is going to happen.

Now, I think you have honestly given your own interpretations of the situation that we have now in the country and I am grateful that the committee has the benefit of those remarks.

I would like to ask this question of all three of you. What do you think an appropriate growth rate in the money supply should be for 1973?

Mr. KAUFMAN. Well, I would assume that the monetarists would say somewhere from 4 to 6 percent. However, I think that is a very simplistic answer to a complex credit market and a complex economic system. I assume that the Federal Reserve will move in that direction but I also believe that this committee and the country must recognize what that will ultimately entail.

In a strong economic market where there are strong credit demands, a slowing of the availability of credit as expressed in the money supply is going to produce substantial increases in interest rates this year. I think that is going to be unavoidable and, consequently, these sharp rises in interest rates, in an attempt to slow down the money supply, are going to be difficult decisions confronting the Federal Reserve in the months ahead because there is no one today who is willing to slow down his demand for credit rather willingly. Indeed, that slowing of credit availability will have to be coerced and that can only come about through rationing processes either of the quantitative kind of or the qualitative kind.

Representative WIDNALL. Mr. Kaufman, that was going to be my next question, what would be the effect of such agreement on the interest rates.

Mr. Lewis, would you now give us your interpretation?

Mr. LEWIS. Yes, sir. I believe we have something like 8-percent growth in money supply last year. That was too much, and I think an appropriate policy for this year would be to try to bring that down. But if you brought it down sharply, you would risk this recession that I have been talking about, and therefore any moderation of monetary growth should be very gentle, 7 percent or something like that.

Now, that, unfortunately, amounts to accepting a lot of inflation, because I think that is built into the situation at this point. Also, I think 7-percent money supply growth would mean escalating interest rates.

Representative WIDNALL. Your comments, Mr. Suits.

Mr. SUITS. I think the question had best be posed in terms of overall controls. If we control the economic system by taxes and expenditures then, of course, the monetary policy that we can pursue is more or less freed.

Now, in general, interest rates rise when the money supply rises more slowly than the total value of output of goods and services; that is, the ratio of money supply to GNP is a key indicator in what is going to happen to interest rates. So that if the money supply rises more slowly than GNP, say, something like 10 percent this year, we will certainly see increased pressure on interest rates.

Now, this would be moderated to the extent that we had higher taxes or lower Government spending as an alternative to controlling the economy, by means of high interest rates.

After all, we cannot get everything out of the economy that we might all want at the same time, and if something is to check the demand in some segment, it must be either the Government depriving you and me of purchasing its own demand for goods and services or it will have to be higher interest rates to check the purchases by corporate borrowers, State and local borrowers, and consumer household borrowers of bank credit.

Representative WIDNALL. One further question of all three of you. What is your estimate of the gross national product growth during 1973? What would such growth do to the unemployment rate by the year end?

Mr. KAUFMAN. I believe the gross national product this year will increase probably around what the consensus forecast now seems to be, $115 billion, but I also believe that a lot of that will come in the first 8 months of this year, and very little of it will come in the closing months of calendar 1973. I believe that the GNP deflator attached to that is going to be higher than what is now generally estimated, around 3- to 3½-percent range. I believe it will be around 4, 4½ finally, and I believe, as I said in my oral statement, that the unemployment rate as a result of the strong momentum now will fail to 4½ percent by about midyear.

Mr. LEWIS. I would identify myself with Mr. Kaufman's remarks almost precisely.

Representative WIDNALL. You would agree with that?

Mr. LEWIS. Yes.

Representative WIDNALL. Mr. Suits.

Mr. SUITS. I think that I would expect the gross national product to grow about 7 percent in real terms, and allowing 3 to 3½ percent

inflation, this should bring the unemployment rate to around 4.2 percent by the end of the year.

The question of inflation is more a question of lags than it is of the underlying pressures. The underlying pressures will certainly be there and are materializing now. The question rather is how long it takes before those underlying pressures exhibit themselves in actual price increases, and I do not think that we will find any noticeable increase in the rate of inflation before year end.

Representative WIDNALL. Thank you, Mr. Suits. Mr. Chairman, my time is up.

Chairman PATMAN. Mr. Reuss.

Representative REUSS. Thank you, Mr. Chairman. I note at the press-radio table the presence of a very distinguished radio commentator, H. R. Gross of Iowa, whom we are very honored to have appear here, and I am sure if he wanted to join us here the Chair would be delighted to invite him up.

Chairman PATMAN. Certainly.

Representative REUSS. Pending that decision, I want to thank the members of the panel for some extremely helpful testimony.

You three, each in his own way, have stated repeatedly that in your judgment, phase III is simply not adequately anti-inflationary, and that in its present form it is a mistake to relax controls to that extent.

I wonder if the House Banking Committee, which is shortly going to be asked to consider the basic legislation for phase III, would not be doing a public service if it asked the administration to redo phase III, to tighten and toughen it, before asking the Congress to act on it.

It seems to me a mistake has been made, a mistake incidentally, which played no small role in bringing about the international monetary crisis from which we have just partially extricated ourselves.

What do you think, gentlemen? Would it not be a good idea to serve notice, since there are 2½ months before the legislation expires, for the administration to do some rethinking?

Mr. Suits.

Mr. SUITS. Your proposal, Mr. Reuss, is sound. I would only make one additional suggestion. I wonder if it would not also be advisable for the committee itself to undertake a study of this problem. I think we tend occasionally to—I was about to say, let George do it. Shall we say let Dick do it? When we really ought to do the job ourselves, and I would like to see the committee undertake a thorough and extensive study of the entire problem.

Representative REUSS. Well, I agree completely. In fact, the committee, under Mr. Patman's direction, through its staff, is now doing that. But I would point out that Congress itself can go only so far in the adequate implementation of price-wage controls and, therefore, I take it, you agree with me that a firm notice to the administration that it is expected to buck up its part of the undertaking would be in order.

Mr. SUITS. Yes.

Representative REUSS. Your answer would be "Yes"?

Mr. SUITS. Yes; by all means.

Representative REUSS. What would you say, Mr. Lewis?

Mr. LEWIS. I certainly agree that phase III ought to be tightened very significantly, and that Congress should do everything in its power to bring about such a tightening.

Now, just what powers the Congress might have in getting the administration to do that you are far more expert in than I am, but I would say any handles you had, fine.

Representative REUSS. I thank you gentlemen for those answers, and since the chairman of the Banking and Currency Committee is right here I would ask you, Chairman Patman, to consider informing the administration that their phase III has been demonstrated to be inadequate in the marketplace of world opinion, and that it would behoove them before asking your committee to consider it to retire a while and see if it cannot repair it and make it meaningful. I would hope that you would consider that.

Chairman PATMAN. I would think it would be considered, but after conferring with our whole committee.

Representative REUSS. Of course.

Another aspect of your testimony, which I thought was very interesting, was the general expression, particularly by Mr. Kaufman, that we may be running into a situation where there may overheated activity with inflationary consequences in the capital goods industries here at home. That is your fear; is it not?

Mr. KAUFMAN. Yes, that is correct, sir. I believe that we have now generated a boom which is going to be very difficult to sustain by either new legislation, or by new fiscal or monetary actions. We have missed to some extent our timing, and if we are going to do anything we ought to prepare for the next round, and economic measures by Congress ought to be designed to make our economic markets more competitive and remove some of the rigidities on the business side and certainly on the labor side.

We also ought to look at our unemployment situation in more of a nonpolitical way. We ought to make the unemployed more efficient, so when they do come into the labor force they contribute substantially to productivity.

I think we should have reached that age of maturity in our Governmental decisionmaking process. I feel that we have missed the sequencing and, therefore, it is very important that the next time around we are better prepared.

Representative REUSS. I thank you for your remarks and particularly for your references to the need for structural improvements.

On this question of the overheating of business plant and equipment investment which we are now confronting, would not it be an excellent idea to repeal or at least modify the present rapid depreciation schedules and the investment tax credit which are in large part, if we are to believe the administration, responsible for the tremendous overheating of this, the most inflationary section of the economy?

Mr. KAUFMAN. I know that that has been suggested even by some monetary authorities. However, particularly in view of the international monetary situation, there is every need now to have our domestic business machinery highly productive and highly efficient and, therefore, if we do slow down a business boom in plant and equipment, which we have not had for some time, we have to ask very carefully what sector of the business community ought to slow down that kind of a boom or should it be universal. I believe if it were universal it would again retard our efficiency internationally.

Representative REUSS. Well, but is it not a fact that the present rapid depreciation and investment credit are blunderbuss weapons that, in-

stead of concentrating their favorable effect upon high technology industries, the kind of things which can really bring us back into the world, spatter their energies on the relevant and irrelevant alike. Thus a brothel owner in Nevada, for instance, is given an investments tax credit for new beds. Surely this cannot really improve our world bargaining power.

Mr. KAUFMAN. I would hope not in this area. [Laughter.]

Representative REUSS. Should we not get rid of the foolishness and if we are going to have tax bonanzas should we not tailor them at the kind of high technology, high productivity, industries where America's international future really lies rather than spatter them among the race tracks and brothels, as we now do?

Mr. KAUFMAN. I would agree. They should be channeled into the efficient areas of this economy.

Representative REUSS. Thank you, gentlemen.

Mr. Suits.

Mr. SUITS. Mr. Reuss, this is a good example of what I was talking about just a moment ago. The question of what depreciation schedules should be, what tax rates should be, are important, matters of grave concern to every taxpayer and every citizen in the United States. But it is anomalous to have this grave question of equity tied to the question of the level of unemployment or inflation. I think until we get to the point where we can separate these two questions then we are invariably tied up with using these blunderbuss weapons which have all kinds of absurd consequences merely because we cannot pinpoint the objectives which we want in terms of tax equity and fairness, because we always have to look over our shoulders at who is out of a job or which prices are going up.

Representative REUSS. Mr. Lewis, I thought you did a particularly good job of getting yourself out of the Phillips curve. Your suggestion for getting out of the Phillips curve is to use public service employment, which would not cause inflation in the inflationary-prone segments of labor, to get our unemployment down, and price-wage controls, a meaningful phase III, to get ourselves out of the inflation syndrome without just adding to unemployment.

I think that is the way of the angels and I am glad that you are leading.

Mr. Suits, you commenced a very interesting little catechism of who has been benefiting from an overvalued dollar in recent years, and you pointed out that somebody who has been able to buy a Japanese car at a discounted value because of the under valued yen has been benefiting. That is certainly true. It's also been true, has it not, though I certainly don't begrudge it to most foreign travelers, that Americans who travel abroad have had a rather easy time of it, and that many of us will now have to start seeing America first, but that won't hurt either. Wouldn't you agree?

Mr. SUITS. I completely agree.

Representative REUSS. Would you also agree that the great multinational corporations may have had an unwitting and undeserved subsidy from the average American, because they have been able to expand abroad and buy up plant and equipment all over the world with 70-cent dollars at a discount and thus fracture American jobs at home more than would have been the case with neutral exchange rates?

Mr. SUITS. That is exactly true.

Representative REUSS. Is it not further true that military swashbucklers, whether retired college professors or real ones, have been able to carry on foreign wars or the threats of war on the cheap because they were able to buy up bases and conduct other foreign operations with discounted dollars?

Mr. SUITS. That is true.

Representative REUSS. Therefore, won't it in general be a happier world if things in the international monetary field are allowed to float at least to the extent that last night's negotiations enable them to float and, better still, if we could get our French and German friends to see the light and join in the common floating exercise?

Mr. SUITS. That is right. The floating currency means essentially we can return to a regime in which Americans can make the things that Americans can make efficiently, and sell them abroad, and that Americans can buy abroad those things which can be better made and more efficiently made abroad.

We have for some time now been losing American, efficient American jobs to foreign countries not because they are more efficient than we are, but merely because of an artificial differential in the buying power of the dollar.

Representative REUSS. Amen. Thank you very much.

Chairman PATMAN. Mr. Carey.

Representative CAREY. Thank you, Mr. Chairman.

Mr. Suits, I am interested in your concern that the shape and direction of manpower training, and educational upgrading programs will have on those who are feeling inflation's rather cruel and severe effects. They will continue to be unemployed, job opportunities will not eventuate and they will feel the impact of whether it is excess demand inflation, cost-push inflation, expectational inflation or combinations of all three.

You have seen the President's budget in summary I believe and probably have looked at it in greater detail than I have, but isn't the impact of the Federal budget this year going to be less than satisfactory in terms of employment opportunities? One, the programs that are being cut, the programs that are assigned for reduction or dismantling, are in many cases the programs which picked up the least trained or most untrained workers and put them into the employment system somewhere. Aren't they going to be the first then to feel the impact of these cuts?

Mr. SUITS. Yes. I think the structure of the President's budget and, indeed, the structure of the President's cutback of the present budget, are precisely in the wrong direction; that is, they are affecting precisely the people that we should now be exercising the greatest concern about, and are worsening the overall problem of controlling inflation.

Representative CAREY. It is the overall problem impact on those least able to bear the loss of these programs which is my concern here. I think we share that.

Isn't the situation worsened by the fact that when we had the 8 percent devaluation of December 1971, price controls and wage controls were in effect? Under phase 3, I doubt if they are in effect to the same extent or will be, so even those safeguards which were avail-

able to the consumer on the secondary effect of the devaluation, as of December 1971, are not now in effect today.

Now can you say that this devaluation will be of negligible impact in this country? That is what's been broadcast today by administration spokesmen and friendly commentators.

Mr. SUITS. I think negligible depends on where you sit. If I am an importer, if I am a Volkswagen dealer, I am unlikely to think that it is negligible.

If I am contemplating, if I were contemplating last week buying an imported Japanese car I probably wouldn't think it was negligible, and if I were contemplating a trip to Europe next summer I would probably not think it were negligible.

But if we take the overall view, imports amount to about 5 cents on the dollar of final goods and services in the United States. Of these perhaps two-thirds represent costs to the final consumer, so that we have something in the neighborhood of 2 or 3 percent perhaps if it is spread over everybody.

But I do think we have to recognize that we have been importing Volkswagens at a very special bargain to the American consumer and that really part of what is going on here is rectifying the buying power of the dollar so that the Volkswagen is not a special paper bargain for something that has nothing to do with production costs or basic productivity.

Representative CAREY. I don't worry about dollar value rectification where a man has considerable equity funds in hand, where he can move into the stock market and experience a 20-percent, 20-point increase in his equity when he gets there fast enough this morning. He can offset the effect of inflation. That is exactly what he is doing right now.

But I do worry about the fellow who has few or no dollars. Some of those may be among the veterans who are now returning, and many of them will be, certainly they are, among those who have at last found their way into the employment system.

Now, the purpose of this committee in its inception, 27 years ago was to go in the direction of full employment and quarantee it. What is wrong with what was suggested by the administration when it was wedded to the notion of welfare reform? I suspect that notion of welfare reform has gone off to India with Ambassador Moynihan for the time being, but what was wrong with the notion that in return for family assistance there would be a guarantee of employment? That was inherent in the welfare reform bill. Many people forget that. It was the expression of the work ethic in tangible terms that we would guarantee a job.

Now what could be better than guaranteeing a job if we are going into a new inflationary push? We are going to have problems of credit, and if the effect of the Federal budget will be a reduction in numbers of people who are federally connected or secondarily federally improved by employment. What could be wrong with expressing that guarantee of a job, either through public service employment or phase-up employment, or job development in real terms where industry gets the credit or depreciation rank rehabilitation in exchange for providing a job. Why don't we express that in terms of what we should do in Congress?

Mr. Suits. I think we should.

Representative Carey. All right.

Isn't there another reason for the wage settlements that Mr. Kaufman foresees will be more difficult now? Is there any possibility that this whole problem of the difficulty of reasonable wage settlements is bound up in the latest administration decision? I read with interest that the President was accompanied in his return from the Western White House to the conference with Secretary Shultz by Mr. Fitzsimmons of the Teamsters Union. I suspect that he advised the President to go ahead with the devaluation, and I appreciate that advice, but isn't it probable that we are going to have more difficulty in reaching reasonable wage settlements now by reason of the expectational inflation or whatever the reason may be in the months ahead? Doesn't that pose a problem for Congress in terms of the impact on employment?

Mr. Kaufman. Well, I believe, as I stated before, that this will be a difficult year to reach reasonable wage settlements. The economy is booming, the demands for labor are strong, the effort now to slow down imports certainly is going to increase domestic demands and, to some extent, contribute to inflationary pressures. Consequently, the Government is going to have to yield a very big stick in the months ahead if we are going to achieve reasonable wage settlements. That is difficult to do in our society when you have two powerful forces confronting each other which are labor, on the one hand, and business, on the other hand. It would require really disciplining policies by Government that should have been initiated sometime ago when the recovery stage was in process. We should have really moved at that point in time to remove the rigidities in our business and labor structure, and we have not done very much in that connection.

Representative Carey. Well, anticipating the difficulty of a reasonable wage settlement which is so desirable, is it not true then that this is going to be an added and complicating factor in what kind of inflation we are going to have. The wage settlements that will result will be inflationary unless something else happens.

Now here is what concerns me. Many people paid attention to the devaluation news, but accompanying that was an announcement by the administration that they are prepared to send up now a trade bargaining bill or some kind of a trade policy bill which we can only speculate about. If I size it up correctly it would give the President a broad grant of powers to deal with, either in terms of nontariff barriers or the actual imposition of quotas or both; deal with the imbalance of trade and do so in a way that could be exceedingly protectionist.

Isn't that going to contribute to inflation?

Mr. Kaufman. The extent to which imports are restricted by the United States, in the immediate future it will contribute to new demands on the domestic economy.

I would agree that this has some inflationary impact, as the Secretary of the Treasury said last night.

Representative Carey. Foreseeing, agreeing then that those who are conducting the economy at this time foresee inflation, that it is going to be with us, that we have scanty mechanisms to deal with it, I certainly concur with my colleague from the Banking and Currency Committee, Mr. Reuss, that we had better take a hard look at phase III

and make certain it has a good dental therapy element in it before we hand it back to the President in some toothless form.

Thank you, Mr. Chairman.

Chairman PATMAN. I wonder, I would like to ascertain the wishes of the committee. Should we adjourn soon?

Senator PROXMIRE. This is such a good panel I would like to have an opportunity to ask some questions.

Representative WIDNALL. I have just a short question, Mr. Chairman.

Chairman PATMAN. What about you, Mr. Carey. What about you? How much time would you want?

Representative CAREY. I think I have exhausted my level of erudition for this morning, Mr. Chairman, I would rather listen.

Chairman PATMAN. All right. How much time would you want? I will yield to you for 2 minutes, Mr. Widnall. And give Mr. Proxmire 20 minutes and we will adjourn.

Senator PROXMIRE. OK.

Representative WIDNALL. Mr. Kaufman, shouldn't we, as a consequence of yesterday's devaluation, expect upward pressure on interest rates, and won't the consequences of such increased domestic interest rates be a large inflow into the United States of eurodollars causing still more pressure on our interest rates?

What can we do to protect ourselves from these large dollar inflows and the resultant effect upon our interest rates?

Mr. KAUFMAN. Assuming that the rest of the free world now comes to the conclusion that we have reached a viable monetary situation for the near term, money will be coming in from abroad, one, through equity investments and, second, some of the dollars that have accumulated in the hands of foreign central banks and governments in Japan and in Germany will probably still come into the U.S. Treasury, either through the form of nonmarketables or, as the Japanese have done, through the purchases of marketable U.S. Government securities.

That, of course, would increase the inflow of funds here, be a depressant on bill rates. As you know, last week bill rates fell rather dramatically as a result of the fact that foreign official money had to be invested in U.S. Government securities.

Then the question arises, after this initial impact is over, will the private sectors in Europe demand new dollars and begin to unwind some of the dollar holdings in the hands of foreign governments and foreign official institutions. When that materializes I would assume this is going to place upward pressure on short term interest rates here, particularly on the bill market.

There is a need, as perhaps is suggested by your question, that we also begin soon discussions with foreign countries concerning the funding of the dollar liabilities held in foreign official institutions. The short-term dollar claims are very large, and there is every need now to encourage foreign governments and foreign central banks to take some of those short term claims and accept for them longer dated obligations. particularly U.S. Government obligations of the nonmarketable kind but with long maturities. It would help to stabilize our money market domestically if such an event occurred. We have not pressed hard up to now to do so.

Representative WIDNALL. Mr. Kaufman, following that up, doesn't the existence of this large supply of Eurodollars make it extremely difficult for the Fed to control the money supply?

Mr. KAUFMAN. Yes, it does. It complicated the situation, there is no doubt about it, because one of the events that is likely to materialize, as the Fed slows down its availability of money domestically is that commercial banks here will again enter the market to bid for the Eurodollars abroad as a source of funds.

Representative WIDNALL. Thank you very much.

Chairman PATMAN. Mr. Proxmire. Thank you, Mr. Widnall.

Senator PROXMIRE. Mr. Kaufman, I am happy that you pinpointed a serious mistake that we have made in our anti-inflation policy, because I think it is so important, its been badly missed by all of us. We had expert witnesses appear last year who said the crux of whether or not we can get inflation under control is the performance of the economy in terms of prices in the first quarter of 1973, because this will set the basis on which negotiations involving some 4 million workers will be involved and, much more importantly, the pattern of wage settlements for the next 3 years or so because, of course, this will be a 3-year determination, rubber workers, auto workers, and many other workers.

Now, it appears on the basis of your analysis, confirmed by Mr. Lewis and Mr. Suits, that we are in great danger of a sharp increase in the price level in January, February, March, and April.

In view of what happened to wholesale prices in December, and in view of the phase III situation, in view of the international situation, there is every reason to expect that we are probably going to have an increase in prices.

Now, as you properly pointed out, phase III is likely to be a little long term before we get on top of this. What can we do, what would you do, if you were President of the United States or were in position of power in the Congress, what would you do to try to meet this very, very tough problem?

Mr. KAUFMAN. This is a difficult assignment, to say the least. But there are a number of things that would have to be done immediately. One is to inform the markets at large that excesses will just not be tolerated; that we will have to illustrate and use an example very soon of a governmental tough policy as we go into price negotiations and into wage negotiations.

I think the Federal Reserve, as it has already demonstrated, is trying to telegraph to the market that it is going to be very disciplining in the months ahead.

Senator PROXMIRE. Is there any additional legislative authority we could give the President or that we could provide, because you are going to have a situation in which, say, the cost of living goes up at an annual rate of 5 percent or 6 percent and, during this first quarter, it is going to be extraordinarily hard to get these people to accept a guideline of 5½ percent. It would mean no increase at all in real income after the inflation bite.

Mr. KAUFMAN. I think there is another measure, and that is for the Congress and the administration to act quickly to improve the market structure, not in terms of going through the legislation, which is difficult to do, but to make a decision that we are going to have more competitive economic markets, and to proceed very forcefully. I think this would certainly shake up expectations.

Senator PROXMIRE. Well, you said that. It is a good statement, we all pay homage to it, you know.

Mr. KAUFMAN. It is.

Senator PROXMIRE. We all like to see effective antitrust action. Every administration has said they believed in it, nobody ever does anything about it.

Mr. KAUFMAN. That is correct.

Senator PROXMIRE. We have a situation which is not much better or worse than it was 5 or 10 years ago. The administration has recommended very little in the way of what we can do in specific terms in the Economic Report.

What do you mean by improving the competitive situation in the markets? Do you mean we should have some action with respect to organized labor, make them subject to the antitrust laws?

Mr. KAUFMAN. That is correct. I think the labor practices should become more competitive, business practices deserve to become more competitive.

Senator PROXMIRE. We are not going to do that, I don't think we should. But even if we did I am not sure we can do it without a constitutional amendment in view of the *Danbury Hatters* case, but I just don't think this Congress—you could get 10 votes in the Senate for making labor unions subject to the antitrust laws, maybe you could, I doubt that you could, or 10 votes in the House.

Mr. KAUFMAN. Well, labor markets should become more accessible to all. After all, conditions have changed since the Employment Act. It was written in 1946. We are a different society than we were in the 1930's and in the 1920's. I think that has to be recognized by Congress and by the administration.

We have a more structured society, and we have to make up our mind whether we are going to have a country that will be increasingly controlled or a society that is going to become somewhat freer, and I think we are on the brink of having to decide this.

Senator PROXMIRE. All right.

Let me ask both you and Mr. Lewis, because you are the two who seem to indicate that you anticipate either a slowdown in the case of Mr. Kaufman or recession later in the year on the part of Mr. Lewis. You cite the restricted nature of the Federal, State, and local budgets, the possible tapering off of the investment boom, the fact we have a tremendous increase in Federal spending in the first quarter, first half of the year, and then it tails off badly. What can we do about this? We have this refund problem, I doubt if we can do much about this, unless we perhaps make some kind of saving available to those who would get their tax refunds back.

Mr. KAUFMAN. Well, certainly it is quite a peculiar situation when you have substantial tax refunds coming at a time of a booming economy.

Senator PROXMIRE. And they are enormous, what are they, $10 billion?

Mr. KAUFMAN. Well, as you know, the total refund has been estimated as high as $20 to $24 billion, but the amount that actually may be taken down by the public could be anywhere from $10 to $15 billion.

Now, we were aware of this tax refund coming quite some time ago, and it certainly would have been in the best interests of fiscal policy

to have tried to slow these refunds at this time when the economy is booming.

Now we have missed this. It is going to be much too late to tackle that particular problem.

Now, there will again be tax refunds coming a year from now, and we have not resolved that. I think Congress ought to consider the situation of substantial tax refunds in the first quarter of every calendar year. There has to be a decision made whether this kind of temporary forced saving is in the best interests of the economy, to the credit markets or to the U.S. Government market.

Additionally, it seems to me that we have to tackle this question of what is our theory of Federal agency financing. We have none. There is a Federal financing bank that has been recommended but, as you know, we have debudgeted many of the budgeted items after we reached the unified budget concept a number of years back.

I think it is time that we adopt priorities. Not everything can be first in the United States, and I believe that we ought to begin, as I said, with a unified budget estimate for the year ahead, and that Congress and the President work together in setting those priorities, and I recognize that there are political questions involved.

Senator PROXMIRE. You think Congress should agree to a ceiling, and do so rather promptly, because that might have a good expectation or psychological effect particularly on spending.

Mr. KAUFMAN. Absolutely.

Senator PROXMIRE. Mr. Lewis.

Mr. LEWIS. Well, it is rather late in the business cycle and I am not sure that there are a whole lot of tools available. I would not be opposed to slowing tax refunds and, in fact, I don't think it is too late for that.

Senator PROXMIRE. How do you do it?

Mr. LEWIS. Pardon.

Senator PROXMIRE. How do you do it, slow tax refunds?

Mr. LEWIS. The Treasury can simply drag its feet in writing checks. I mean the reverse of what they have done in recession periods in the past.

Senator PROXMIRE. Instead of waiting 6 weeks, wait 6 months for your refund.

Mr. LEWIS. What I am proposing is not really any strange animal. In previous recessions the Treasury has often deliberately speeded up checks.

Senator PROXMIRE. Bureaucracy doing what comes naturally; that is, slowdown.

Mr. LEWIS. It has been done before. This is not a radical proposal.

I would attempt to persuade the Federal Reserve that while the rapid growth of money supply needs to be moderated somewhat, that that should be done very gently. I would attempt to persuade the administration that while the budget deficit needs to be moderated, it too should be done very gently, and I would lean very, very hard on prices with a much strengthened phase III, and I think that is about the limit of what could be done at this time to try to slow the boom at this late stage in the business cycle and avoid any sharp slowdown later.

Representative CAREY. Would my colleague from the Senate yield?

Senator PROXMIRE. Yes.

Representative CAREY. I appreciate the Senator's yielding. I want to make the point that the record is quite clear in Congress concerning the impact of the excess withholding on the economy at this time. During recent hearings in the Ways and Means Committee on the new debt ceiling limitation last fall and spring, at that time, it was the express viewpoint of Arthur Burns, Chairman of the Federal Reserve Board, that this was a matter of concern and should be faced by the administration. He recommended at least one device to slow the impact of the big cash flow coming from the excess refunds. He suggested the issuance of a Federal high interest rate bond to encourage savings by the recipient of the refund. We were told at that time by the Under Secretary, Charles Walker, that this was within the capacity of the adminisrtation to do without legislation and they would contemplate it. We were led to believe that some substantial solution would be undertaken.

Viewing the present situation and the impact of the $15 or $22 billion flow of excess funds into the economy, I have to say the administration's record on this is either one of indifference or apathy. Perhaps we will be led to believe they wanted to hold on to these moneys. The administration did retire some debt obligation using, I don't know how they did it legally, but they used taxpayer's excess withholding to retire debt obligations when it suited them to do so. They may even have wanted it for a slush fund to introduce into the economy if it didn't boom along at the rate they anticipated. I have to say at this point that the record of the administration is somewhat wanting in coping with what they had previously recognized as a danger to our economy.

Senator PROXMIRE. Thank you very much.

Mr. Lewis.

Mr. LEWIS. A couple of comments. Mr. Reuss asked earlier about the investment credit. Although part of the problem is a very strong investment boom. I would not be in favor of suspending that for stabilization purposes. Now for long term resource allocation purposes at another phase of the business cycle, fine. But it is a very clumsy stabilization tool. We don't know what precisely the time lags are but to suspend the investment credit means a very large immediate increase in the price of capital goods and that could be impacting on investment decisions just when investment is beginning to moderate anyway, and I would not recommend that.

There is another tool which we have made very little use of in this country but at some time we might try to develop and that would be some kind of selective credit allocations.

Senator PROXMIRE. Let me get into that because Mr. Kaufman spoke about that, too. You talk about qualitative rationing of credit. If you are going to do that kind of thing I presume you might be thinking of something that has enticed some of us to some extent and that is considering a real crackdown on the rise of interest rates. You speak of the inevitability of the increase in interest rates, that is inflationary although it has a counterinflationary element, too, but one of the biggest increases in the cost of living a year or so ago, a couple of

years ago, was the rise in mortgage rates. At any rate what would you think of rationing credit and also providing for a price fixing, interest rate fixing in various areas.

Mr. KAUFMAN. Senator Proxmire, this may well come either out of the current posture that we are seeing in the economy and in monetary policy. Let me illustrate it. As you know, the Committee on Interest and Dividends is trying to retard the rise in the prime loan rate. That has two functions. One is a public function in trying to hold down interest rates. The second function is one of monetary policy implementation and monetary restraint.

Under the current system of holding down the prime rate and letting market rates rise, an increasing number of borrowers will be coming into the banking system as demanders of credit. As a consequence, of course, the commercial banks are going to be loaned up more quickly than heretofore.

Senator PROXMIRE. In other words, this jawboning of the prime rates is a formula for seeing that your funds flow into the corporate sector and even more away from housing and more away from State and local, and so forth.

Mr. KAUFMAN. Let me not oversimplify that, but what I am saying is that many demanders of credit will now come into the banking system. The banks will be loaned up more quickly under this approach and will begin to ration. Then the question has to be raised by the monetary authorities who will be rationed out.

Senator PROXMIRE. Right.

Mr. KAUFMAN. Under the current arrangement as it now exists, with the prime rate at 6 and other market rates rising, those who have financing alternatives certainly are oging to try to stay in the banking system longer because of the financing advantage and, therefore, the ones who may be rationed out are those demanders of credit who do not have financing alternatives.

Senator PROXMIRE. Now, this isn't theoretical. We have a long experience. What happens if the credit crunch hits housing, hits it hard, hits it devastatingly? That happened in 1966, it has in almost every credit strain we have had, and it is inevitable because housing is so sensitive to rising interest rates.

Under those circumstances what would you think of having a policy of an actual limit on the amount that corporations could increase their borrowing by?

Mr. KAUFMAN. Well, this question which you raise then gets complicated by the fact that some demanders who are regional and local demanders may have some alternatives. For example, the various Federal credit agencies will attempt to supply money to finance housing needs. However, they will enter the public market as demanders of credit, and consequently will contribute to the escalation of interest rates.

Now, at some point in time, therefore, the Federal Reserve will be faced with this dilemma. Who in the banking system should get the money? Who should not get the money? The Federal Reserve, either through moral suasion efforts or through more formalized efforts, may well have to send directives to the banks as to the allocation of their new funds. That is not an easy thing to do. Who is to get the money first? Who is to get it second? Are there going to be substantial

restraints across the board for business corporations? Well, does that apply to utility companies? Does it apply to the energy companies? Very complex decisions will have to be made as to the order of priority, and I think we are heading in that direction unless we can slow down this economic boom very quickly.

Senator PROXMIRE. So if we can't slow it down you think that might be an alternative that might be considered although it would have some very, very serious implications in the economy in the allocation of resources.

Mr. KAUFMAN. Absolutely.

Senator PROXMIRE. All right.

Now, you suggest, Mr. Kaufman, a Federal Fiscal Stabilization Board, and I welcome any kind of a new idea like this. It is helpful. We have to do something about establishing a ceiling and giving a little more flexibility perhaps in taxing.

The trouble with this proposal, however, is it takes from the Congress a clear constitutional authority that the Constitution gives us, and we are too weak as it is, and we are giving up too much as it is. We would give to the President, under your proposal, the right to appoint members to the Federal Stabilization Board which would in turn have two powers, as I understand it: One, to raise or lower taxes 1 or 2 percent, and the second, to recommend, although not put into effect, a ceiling on spending.

Why shouldn't Congress be able to do that itself? We have a Budget Review Committee now that is active, 35 representative Members of Congress, unanimously recommending that we put into effect a spending ceiling. It may not be in effect until next year but we have that kind of a basis; why should we give this up and share it with the President or with any other group?

Mr. KAUFMAN. I believe that this would not be an abrogation of power by the Congress. I believe the members of this particular Board should be jointly appointed and that Congress should have the say-so as to who is going to be on this Board, and any administration should also be able to submit candidates, and it should be jointly agreed upon as to who the members are going to be, and Congress should preserve the right to end this kind of a board.

Senator PROXMIRE. Why shouldn't that Board be made up entirely of Members of Congress appointed by whatever device the Members of the House and Senate decide to select?

Mr. KAUFMAN. I believe that there are some aspects of fiscal stabilization policy that are difficult to enforce through the current setup because there are strong immediate political pressures that bear down on Congress, but that would not bear down on a Fiscal Stabilization Board one step removed from Congress.

Senator PROXMIRE. We have this experience with the Federal Reserve Board. Theoretically, it is a creature of Congress, subject to our overview, and so forth; actually it is much more sensitive to any administration. The President appoints members to the Board, they are there for 14 years, and presumably they are insulated, but it is far more sensitive to the wishes of President Nixon and President Johnson and others than it is to Congress.

Mr. KAUFMAN. That is true, but you don't have to have a Federal Reserve Board whose members have terms of 14 years.

Senator PROXMIRE. For what?

Mr. KAUFMAN. Their terms could be shortened. In terms——

Senator PROXMIRE. Then they would be more subject to the President; he makes the appointment.

Mr. KAUFMAN. I think, as I said before, the Congress should play a dominant role in the appointment of the staff and in the appointment of the members of that Board. I think the problem you refer to reflects the current appointment procedure where, in many instances, it is the selection of the administration and it is the acquiescence of the Congress. I think that need not be so in the appointment of members to a Stabilization Board. I think it has to be a joint selection, not a selection started by the administration and then, of course, approved by the Congress.

Senator PROXMIRE. Let me ask just a couple or more quick questions, and I apologize to the chairman and to the witnesses for taking so long. Let me ask you this: I have proposed an amendment which I intend to press in the Senate Banking Committee to modify the phase III, to provide, No. 1, there will be advance approval before prices and wages can be increased; No. 2, to give that some effect and force there would be compulsory hearings, public hearings, in advance. When you have a corporation which has sales of over $250 million and they make a price decision which has a $50 million revenue impact they would have to, in that event have to, have public hearings so there would be a focus by the Congress, by the public, and by others on this decision, and we would be in a better position to resist either a big wage or a big price increase that might be inflationary.

What do you think of that?

Mr. KAUFMAN. I believe that that should apply to both the price and the wage side, Senator Proxmire.

Senator PROXMIRE. All right.

Mr. KAUFMAN. I also believe that we have to recognize that a good part of our economy is now service oriented and, consequently, you can get inflationary pressures from the service side that will impact our economy just as much as perhaps some of the big industries and big labor may have the power to do.

Senator PROXMIRE. What do you do about that?

Mr. KAUFMAN. I think this will complicate the task. Therefore, your suggestion would be helpful but I think you have to recognize that there are other sectors that would be free from this kind of discipline.

Senator PROXMIRE. Well, following this up, speaking of other sectors, are you satisfied with the administration's program with respect to food. That has a great degree of logic in it. They want to increase the supply of food and, hopefully, the result will be a moderation in food prices by the end of the year.

Mr. KAUFMAN. I think that is a step in the right direction and, as I indicated before, Senator Proxmire.

Senator PROXMIRE. What other steps should we take?

Mr. KAUFMAN. I think we should substantially increase our production of farm products not only for the domestic side but to help us turn around the trade balance.

Senator PROXMIRE. I would like each of you gentlemen to comment on a table which is on page 38 of the Economic Report because this was something that surprised me very much when I had a chance to look at it. It contradicts the position some have taken on the committee and some in Congress, which indicates in the last 20 years there has been a sharp drop in profit rates, very sharp drop, and this is adjusted for changes in the law. It is adjusted for changes in accelerated depreciation, and so forth. The adjusted profits have dropped 1950–54 average, 18.4 percent down to an average of around 12 percent in the latest 4 years, and even if you add interest the return on capital has dropped from 19 percent down to about 13 or 14 percent. Interest rates have gone up sharply and profits have gone down.

Now the question I ask is this, is there a tendency in our economy to move away from incentives, adequate incentives, for risk-taking for technological innovation, for innovations that would improve the productivity in our economy; is this a fundamental change?

Mr. KAUFMAN. Of course, the slowing in the profit as it is expressed here reflects many things: The stop-go kind of economy which we have had for some time here. Secondly, it seems to me that this slowing in the rate of profits in the long run does contribute to a lack of stimulation for the private sector. I think it has already contributed to some new developments in the credit markets. For example, we have seen an enormous volume of new equity flotation in the last 3 years, unprecedented. The net new issuance of common stock during the last year was $13 billion. The average yearly net new issuance of equity flotations in the early sixties was $1 to $1½ billion.

Senator PROXMIRE. That just contradicts what I have pointed out. You have more equity stock coming out, more capital being drawn into the equity area although profit rates have dropped.

Mr. KAUFMAN. By force, not as a voluntary development.

Senator PROXMIRE. I see.

Mr. KAUFMAN. Because the debt coverage, the interest and debt service coverage for many corporations has substantially diminished, and there was a great need, therefore, to bolster the equity position in order to protect credit ratings.

Senator PROXMIRE. I see.

Mr. KAUFMAN. And, consequently, for example, the utility companies have had to rush in here with a massive volume of equity flotations for fear of losing their credit rating and the loss of a credit rating would have meant higher cost of financing in the open market.

Senator PROXMIRE. All right.

Mr. Lewis, and then Mr. Suits, and I am through, this is my last question.

Mr. LEWIS. Well, part of the trend, this can only be part of it, but part of the apparent trend does have to do, as Mr. Kaufman suggested, with the level of unemployment, that is how close or how far we are from full employment. The profit share of GNP always goes down when we have high unemployment or less than full employment, and the last 3 years in this table——

Senator PROXMIRE. There has been a steady drop through in every one of the last 4-year segments.

Mr. LEWIS. That is true. I am saying this is not more than part of the explanation. I was about to suggest that another part of it might have to do with the liberalization overtime in various provisions of the tax code like accelerated depreciation.

Senator PROXMIRE. They say it is adjusted to that.

Mr. LEWIS. I read that footnote but, to be perfectly honest, I don't know what that means, and I would really want to study these figures.

Senator PROXMIRE. You have another table No. 12 on page 37 that is not adjusted, but table 13 is.

Mr. LEWIS. But I don't know what the adjustment means, whether that answers my point or compounds it, quite frankly. But it is true that changes in the tax code have an effect. I think from the standpoint of corporate decisionmakers it is really the sum of profits and depreciation allowances that become the target, sort of gross rate of return, that they aim at for their own internal investment needs, and that you can move funds back and forth between these two without really impinging on the supply of investable funds.

Now, they may or may not have corrected for this the way I would have. It sort of sounds as though they were cognizant at least of the point I am trying to make, but beyond that I don't know.

Senator PROXMIRE. Mr. Suits.

Mr. SUITS. I haven't had a chance to study this table in any detail, but one point that I think ought to be borne in mind is that there is frequently a tax advantage to debt financing just because the interest is a cost and dividends are not: that to the extent that this represents a shift in financing between debt and equity it merely reflects the reasons of the corporate sector, financing to the corporate tax rate. This would also perhaps account for the rapid rise in equity financing in recent periods accompanied by high interest rates.

Senator PROXMIRE. Well, thank you, gentlemen, very, very much. As I say, Mr. Chairman, this is a fine panel, one of the best I have heard in 3 years.

Chairman PATMAN. I agree with you and I am sure the other members do, too.

Gentlemen, obviously my voice is not in good condition today. I have five questions here, and I would like to file them with the reporter and have him put them in today's record and, if you will, when you look over your transcript make a reply to them, it would be appreciated very much.

Without objection, I will file them with the reporter to go into the record.

[The information referred to follows:]

RESPONSE OF HENRY KAUFMAN TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. As you know, the Committee on Interest and Dividends has made a large show of jawboning against any attempt to increase the prime rate. While apparently holding the prime rate at 6 percent, banks have begun to raise interest on loans made to what otherwise would have been prime rate borrowers. Among these are investment banking houses which are now required to pay a quarter to a half point above the prime, indicating very strongly that the effort to hold the prime rate down is nothing more than a sham.

Don't you think it would make far more sense for the Administration to at least jawbone against any interest rate increases in lieu of its failure to impose actual interest rate controls?

Answer. I do not believe that the Administration should use jawboning tactics to hold down interest rates of all sorts. This is because most interest rates in the United States are determined by market forces of supply and demand. Consequently, tactics that would coerce an interest rate structure would also contribute to very substantial distortions in our credit markets.

Question 2. It is my understanding that one of the basic elements in the monetary crisis centers on the lack of confidence in the Administration's economic stabilization program and the expectation of increased inflation.

Since there has been no change in the structure of the program or the way it is administered, presumably lack of confidence will continue to exist in Phase III and the dollar.

If this is true, then the largest benefits achieved by devaluing the dollar will have been achieved by currency speculators who made at least $600 million on the exchange of $6 billion for German marks alone during the past two weeks.

What are your comments on this observation?

Answer. I do not believe that the basic cause of the new monetary crisis was a lack of confidence in the Administration's economic stabilization program. Uncertainties concerning the stabilization program of the Administration may, to some extent, have contributed to the pressure on the dollar but there were also other important contributing developments. There was the announcement of a very large U.S. trade deficit in calendar 1972. There was also the continued large overhang of short-term dollar claims held by foreigners. In addition, the deliberations concerning the reform of the international monetary system seemed to have been proceeding at a very slow pace.

Question 3. It has been widely and repeatedly reported that the basis for the monetary crisis centered on lack of confidence in Phase III and the expectation that increased inflation would occur in the U.S. economy.

If this is true, wouldn't it have made far more sense for the Administration to have come down much harder than it has on inflationary controls?

For example, wouldn't it have been far better for the Administration to have checked the continual rise in major interest rates by imposing controls on the cost of money and demonstrating in other ways that it really means what it says when it insists that Phase III will be stringently conducted?

Answer. As I indicated in my formal remarks, the problem with achieving an effective stabilization policy is partly one of timing. To prevent inflationary excesses from emerging in an economic boom requires that stabilization policies begin to move from stimulative to restrictive sometime during the economic recovery period and not when the economic boom is straining real resources.

Question 4. News reports this morning state that controls over the flow of capital will be removed as part of the Administration's efforts to reposition the dollar in the international monetary system.

Much of your testimony has strongly cited the expectation of heavy credit demands on the economy during the months ahead.

Won't the increased flow of capital out of the nation under these circumstances create even more severe demands for cedit and even higher increases in interest rates?

Answer. As I understand the proposals by the Administration, the lifting of controls over the flow of capital would not come in 1973 but in subsequent years. Presumably, this lifting of controls would occur not in anticipation of a substantial improvement in our international payments position but after we have made actual substantial progress.

Question 5. Despite devaluation of the dollar in 1971, Japanese exports to the U.S. continued at a very high level. Yet the Administration expects that the devaluation announced last night will have the effect of reducing exports to this country and creating a larger market here for U.S. made goods.

How valid is this assumption in view of what happened or didn't happen following the 1971 devaluation?

Answer. It would certainly seem that on the basis of the actual events in 1972 that the devaluation of the U.S. dollar in 1971 was not large enough to slow substantial Japanese exports to the United States. The decision of the Japanese Gov-

ernment to float the yen should improve our competitive advantage in our trading relationship with Japan assuming at the same time that our prices here remain unchanged.

RESPONSE OF DANIEL B. SUITS TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. As you know, the Committee on Interest and Dividends has made a large show of jawboning against any attempt to increase prime rate. While apparently holding the prime rate at 6 percent, banks have begun to raise interest on loans made to what otherwise would have been prime rate borrowers. Among these are investment banking houses which are now required to pay a quarter to a half point above the prime, indicating very strongly that the effort to hold the prime rate down is nothing more than a sham.

Don't you think it would make far more sense for the Administration to at least jawbone against any interest rate increases in lieu of its failure to impose actual interest rate control?

Answer. Interest rates are similar to prices in their response to supply and demand. In a period when demand for funds increases more rapidly than supply, rising interest rates are to be expected. Efforts to control interest rates, therefore, must be viewed in the context of the broader problem of controlling prices in general, and in this context the use of the jawbone is a notoriously ineffective weapon. Until a comprehensive attack can be made on all aspects of inflation, it is difficult to contain any aspect of it by any method.

Question 2. It is my understanding that one of the basic elements in the monetary crisis centers on the lack of confidence in the Administration's economic stabilization program and the expectation of increased inflation.

Since there has been no change in the structure of the program or the way it is administered, presumably lack of confidence will continue to exist in Phase III and the dollar.

If this is true, then the largest benefits achieved by devaluing the dollar will have been achieved by currency speculators who made at least $600 million on the exchange of $6 billion for German marks alone during the past two weeks.

What are your comments on this observation?

Answer. It is, of course, almost always true that the immediate beneficiaries of any sharp change in exchange rates are speculators—often, indeed, the very speculators whose own actions precipitated the change. But what provides the occasion for the speculative gain is really the underlying monetary crisis. If exchange rates were more flexible and could respond more readily to altered conditions as they developed, we could avoid these recurrent crises and hence the speculative activity that accompanies and contributes to them.

Question 3. It has been widely and repeatedly reported that the basis for the monetary crisis centered on lack of confidence in Phase III and the expectation that increased inflation would occur in the U.S. economy.

If this is true, wouldn't it have made far more sense for the Administration to have come down much harder than it has on inflationary controls?

For example, wouldn't it have been far better for the Administration to have checked the continual rise in major interest rates by imposing controls on the cost of money and demonstrating in other ways that it really means what it says when it insists that Phase III will be stringently conducted?

Answer. I believe my testimony shows where I stand on this issue. I completely agree.

Question 4. News reports this morning state that controls over the flow of capital will be removed as part of the Administration's efforts to reposition the dollar in the international monetary system.

Much of your testimony has strongly cited the expectation of heavy credit demands in the economy during the months ahead.

Won't the increased flow of capital out of the nation under these circumstances create even more severe demands for credit and even higher increases in interest rates?

Answer. Capital outflow would, of course, exert pressure on domestic interest rates. But a proper and stable foreign exchange value for the dollar should remove most of the pressure for capital outflow and might reverse the flow.

Question 5. Despite devaluation of the dollar in 1971, Japanese exports to the U.S. continued at a very high level. Yet the Administration expects that the devaluation announced last night will have the effect of reducing exports to this country and creating a larger market here for United States-made goods.

How valid is this assumption in view of what happened or didn't happen following the 1971 devaluation?

Answer. United States imports normally amount to 5 to 6 cents on the dollar of GNP, and as output and incomes rise, so do imports. So we can expect imports to rise more or less uniformly in pace with income. On the other hand, the falling foreign exchange value of the dollar raises prices of imported goods to American buyers and works against this tendency. The present crisis is, among other things, evidence that the earlier shift in exchange parities was inadequate and that still greater changes are required. Whether even the present devaluation is sufficient for the purpose remains to be seen.

Chairman PATMAN. Without objection, we will stand in recess until 10 o'clock tomorrow morning when we will have another panel. Thank you, gentlemen, very much for your appearance and for your testimony.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 14, 1973.]

THE 1973 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 14, 1973

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

The committee met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, and Windall; and Senator Proxmire.

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

OPENING STATEMENT OF CHAIRMAN PATMAN

Chairman PATMAN. The committee will come to order.

Through budget cuts in the fiscal 1973 budget and through its proposals for the 1974 budget, the Nixon administration has made it perfectly clear that it has either abandoned or retreated from the needs of most of the Nation's social priorities.

The administration has abandoned the national housing goals for low- and moderate-income families by termination of the federally assisted housing programs.

It has made drastic cuts in financial assistance for water, sewer, public works and urban and rural development programs urgently needed by States and communities through the Nation.

It has followed the same path for medical care, hospital and construction and manpower training.

With these actions, the Nixon administration has created yet another crisis for the Nation's economy and for the Nation's people—one which could be described as a priority needs crisis.

By the same token, the Nixon administration has brought into sharp focus the need for new methods and vehicles by which the Nation's priority needs can be financed. Essentially this means providing adequate funding at reasonable cost for housing, for economic development and for public works and facilities.

It is my hope that this morning's witnesses and later the Joint Economic Committee report itself will speak to the possibility of creating a national development bank for priority areas to provide ade-

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quate funding at reasonable cost for these and other national priority areas when such funds are not made available by the private sector.

Concerning the National Development Bank. I have in mind something like the RFC that we had, the Reconstruction Finance Corporation, except it would be about twice as big.

The RFC was capitalized with $500 million from the Treasury, and they were allowed to expand 17½ to 1, and this National Development Bank, it is contemplated, would be twice that big, a billion dollars, and could expand 20 to 1. That is a fractional reserve system, in effect, and it has worked long and well.

During the 21 years that the Reconstruction Finance Corporation was in operation from 1932 to 1953, that organization created, manufactured, generated, call it any name you want to, but created $41 billion in money credit on that base, and really saved this country. People who could not get loans from banks, could go to the RFC and get their loans at reasonable interest.

The National Development Bank would provide loans when credit is not available at conventional banking institutions. It would make it possible for the wheels of industry to go ahead, notwithstanding the fact that they cannot get money from local institutions.

On behalf of the committee, I welcome this morning's witnesses, Edward Hamilton, deputy mayor of New York City; Sol Linowitz, chairman of the National Urban Coalition; and Willard Wirtz, an old-time friend of mine, I have known him a long time, president of the Manpower Institute.

Gentlemen, we will first hear your statements and then the committee will discuss further details of your views with you. We will begin with Mr. Wirtz.

Mr. Wirtz, you may proceed, sir, in your on way.

STATEMENT OF WILLARD WIRTZ, PRESIDENT, THE MANPOWER INSTITUTE

Mr. WIRTZ. Thank you, Mr. Chairman, I have filed with the committee a prepared statement of some length and will, with your indulgence, simply——

Chairman PATMAN. Without objection, it will be placed in the record at the end of your oral statement.

Mr. WIRTZ [continuing]. Summarize it briefly, although with the recollection of, I think it was Antonius, in "The Life of Augustus," saying he never spoke to his wife without notes for fear of saying either too much or too little.

Chairman PATMAN. It is likely, Mr. Wirtz, you will be asked some questions about it by some members of the committee.

Mr. WIRTZ. I am speaking particularly to the impact of the economic and budget messages on the manpower programs.

Chairman PATMAN. Yes, sir.

Mr. WIRTZ. You can take any different combination of programs, any different combination of obligational comparisons and appropriation comparisons, and come up with a variety of answers. I think you get the best and fairest picture by taking a combination of programs traditionally considered the manpower programs. With respect to those, the cut as between the 1973 fiscal year appropriations and

the proposed 1974 appropriations is approximately $1.4 billion. That is something over one-third or about a 36-percent cut.

I make two points, Mr. Chairman and members of the committee. One is that it is essential that we get this discussion back onto the point of priorities, and away from what is, obviously, simply another form of what we have been hearing for 40 years: that we "can't do" something or other. It used to be we couldn't do it because it was communism, and then it was we couldn't do it because there was a war to be fought and paid for, and now it is the same thing—only the strategy has changed—we "can't do" it because the overall costs of everything are so high that we can't consider the value of anything.

We have been here before and we have won before and we will again if we make it clear that it is priorities we are talking about as well as overall costs.

The other point I want to make and press strongly, as strongly as I can, is that we will not win, those of us who have a different sense of priorities, if we go on the defensive. In the game of politics today a good defense is not worth a nickel. We will win only as we reassert an initiative that, for some reason or another, those of us who used to be proud to call ourselves liberals lost. We did not come up with a new agenda when our old one got adopted. So I should like to speak to the matter of manpower programs in the context of what seems to me is the importance of asserting a new initiative, a bold idealism, if you will. Recognizing the designated concern of the Joint Economic Committee, I am talking about the economics of our purpose, which seem to me the important thing.

Chairman PATMAN. Those are words that the members should be allowed the privilege of interrogating each of you gentlemen on. If you will tell me the time you wish to expound I will take the liberty of——

Mr. WIRTZ. If I am still talking at the end of 10 minutes, Mr. Chairman, I should like to be stopped.

Chairman PATMAN. Sure.

Then, the other gentlemen; what do you say?

Mr. LINOWITZ. That is fine, sir.

Chairman PATMAN. Can you abbreviate yours to 10 minutes?

Mr. HAMILTON. Yes.

Chairman PATMAN. That is fine. We will notify each one at the end of the time. In that way we will have more time to interrogate you gentlemen because this testimony is very important, and we want a full and complete record.

Mr. WIRTZ. I have already indicated that taking the grouping which seems to be most appropriate, we are talking about a cut in appropriation terms of from $3.7 billion for fiscal year 1973 to a recommended $2.3 billion in 1974. Most of that is in connection with the public employment program, which is referred to in the budget message as being phased down until you read the operative fine print which tells that it goes out. It is to be extended so long as there are previous funds available, but then it is to be stopped.

There is the issue of revenue sharing. I think there is real question whether there is legitimate use in these messages of two terms. One is full employment, and the other is revenue sharing. I will come back to full employment. I do not call it revenue sharing when you have

already cut the loaf which is proffered in half. As nearly as the figures permit refinement here and definite statement, the point on revenue sharing as far as the manpower program is concerned, is that the proposal is for a cut by 15 percent between the funds that were available for those purposes in 1973 and those proposed for 1974.

There are a number of other cuts. I call attention to one area particularly. The surest test of the inner decency of a budget is to check the provisions with respect to what we call handicapped people, those who, as a result of accident or sickness or war or whatever it may be, are at some physical or mental disadvantage.

I have in my prepared statement gone through the cuts which are made with respect to that particular constituency, and then, after doing that in millions of dollars, have pointed out that our minds do not really work that way. I called the Goodwill Industries to find out whether all of this really makes any difference to them. Why, it already has. They have been notified by the States that in view of these messages there cannot be and will not be handicapped people referred to Goodwill Industries because there is apparently not to be the support funds to back them up. You begin wondering just what kind of budget this is that we are balancing.

Evaluation of these proposals has to be on two bases. One is whether the programs are in themselves worth their cost, and the other is in comparative terms. This committee has the advantage already of the excellent staff study prepared by its Subcommittee on Fiscal Policy last November, and I can only say after careful reading, that I agree completely with the suggestions there: that, one, there ought to be more appraisals made, more evaluation; but that, two, what there is so far shows that there is a real return today on these programs. They are high-yield programs, high-yield human investment, but, quite a few changes ought to be made in them. The same judgment is made in the recent report of the national manpower policy task force.

Just in terms of what these programs mean to us even in dollars and cents, it is bad business and bad government and zero decency to cut these out.

Now, in comparative terms, in terms of our priorities, the statement also includes other ways in which we could economize without taking it out of the jobs of the people who are involved here. This whole thing comes home graphically to me when I read, as I have recently, your book, Senator Proxmire. I find in it a reference to the effect, which I had not realized before, of IT–4038, the Internal Revenue Service ruling of 1950 which permits foreign oil companies, among others, to pay their royalties in the form of taxes to foreign countries and then to take that as a deduction against their U.S. income tax. The cost to us of that tax expenditure, that loophole, is more than the total cost of the manpower program. If we want to save the money that is involved here, instead of cutting hundreds of thousands of people out of these manpower training opportunities, all we would need to do is to change IT–4038 of 1950 and we could support the present programs and be $1 billion ahead. The issue here is priorities.

Now, with respect to the matter which I should like to emphasize most strongly, I know it has become a cynical time and I know that there is perhaps something suspect about coming up here and talking

about idealism. I propose to do it just as strongly as I can. It is time, and there is room and there is reason for idealism.

In response to your suggestion, Congressman Patman, regarding a National Development Bank proposal, I would call it, new idealism, to start using the banking system through those auspices and for those purposes. It is tough-minded idealism, but it is bold idealism.

This commitee has argued week in and week out, month in and month out, about what full employment means. I do not know why it is such a mystery. A new idealism in this area starts from saying just what you said, Senator Proxmire, at the hearings last October 17. Very simply, full employment. It simply means a decent job for everyone who is willing to work.

In a country as large and an economy as complex as ours, there are always going to be between 1 and 2 percent moving from one job to another or just entering the work force. To the economists this is frictional unemployment. I have no trouble in simply saying in those percentage terms full employment means no more than the possibly 2 percent unemployment which comes from frictional movement of that kind.

The President has adopted the phrase. I take it, a new idealism ought to start from our saying, "OK, you have adopted the phrase, now let us get on with the program." We can move unemployment at least down to 3 percent, as we almost did in 1968, at whatever point we simply make up our mind to put it in the first place instead of some place else on down the line. If that creates an inflationary problem, as it might, there are other ways to take care of that problem than by pushing 2 million people off the bottom of the employment rolls.

I take it that a new idealism means some new measurements. I knew there is a division in this committee, and I respect the reasons for it, about S. 5, the Full Opportunity and National Goals and Priorities Act. Yet it seems to me the enactment of that legislation is one of the most important pieces of business before the Congress and the country. We have got to start developing our social indicators. We have got to start adjusting our figures not according to the changing seasons but according to our underlying ideals. There are a lot of things we ought to be measuring which we are not. We do in this country only what we measure. There are real changes to be made as far as the measurement of employment and unemployment is concerned.

In a more programmatic sense, I would concentrate a new idealism in manpower policy on two facts: Over a quarter of our unemployment is among our 16- to 19-year-olds. The unemployment rate is about 15 percent among that group, and you double those figures if someone suffers the double disadvantages of being young and black. I doubt that we ought to call it unemployment. It is a different problem, a transition problem. It is also a problem which reaches clear back into the educational system and back beyond that into the environment of a good many of the boys and girls who are affected. But that million boys and girls, 16 to 19 years old, out of work and out of school is a disgrace; it is a form of infantile paralysis which affects them all of their lives. No other nation in this world of comparable nature has anything like it, and we have got to get on to meeting that problem.

I have tried to suggest the outlines of what we are talking about as an education-manpower program. I have read with great admiration the testimony of Professor Feldstein before this committee. I would agree with Mr. Goldfinger of the AFL-CIO in objecting to the minimum wage differential. I think that is a mistake. It is a wrong answer here. But the rest of Professor Feldstein's testimony has a great deal to commend it.

We have been working at the Manpower Institute on the development of an education-manpower policy.

The other and final point I would make would be that as nearly as I can determine, and it is really no more than a guess, about half of the adult unemployment is traceable to technological displacement of one kind or another or new technological process. I recall Thorstein Veblen's commentary that the hardest problem the free society is going to face is reconciling the potentially suicidal stresses between scientific invention and the human purpose.

We have not faced up to the technological displacement problem. I have tried in my prepared statement to suggest some approaches. Collective bargaining cannot meet this problem. We have to meet it as a community.

That is it, mostly. It comes down to this, Mr. Chairman and members of the committee. We are well acquainted now, by habit and by custom, with what it takes to deal with labor as an essential element in the economy. We are just beginning to realize that work is an essential human value—and I mean work which includes work, and I mean work which includes leisure that comes as part of the benefit of working, and I mean retirement and all of those things. I welcome this new report by HEW about work in America.

In conclusion, I would like to say this: We are being presented with a problem posed primarily in terms of its tax implications. We are all taxpayers. But most of us are taxpayers second, and are citizens—of each other—first, in times of peace as well as in times of war. If we can get leadership in this country which tries to bring out the best in us instead of the smallest in us, then there is a great deal more that we can do. And so I speak only to the hope that in its consideration of economics this committee will recognize that behind all of the figures, the budgets, the reports of one kind or another is the fact that most of the people in this country care, and care greatly. Because if we did not we would be nothing.

Thank you.

[The prepared statement of Mr. Wirtz follows:]

Prepared Statement of Willard Wirtz

Mr. Chairman, and Members of the Joint Committee, you have requested my brief comment on the implications of the President's Budget Message and Economic Message, particularly so far as the national "manpower policy" is concerned.

The short of it is that the President proposes that the present "manpower" programs be cut back by about a third (approximately $1.4 billion in appropriation terms) on the ground that this is necessary to stay within the over-all ceiling he has set and because only four million people will be left unemployed by the end of the year anyway.

These Messages seem to me to present two basic questions, both reflected clearly in the manpower proposals:

One question is whether the President will succeed in what is an obvious effort to subordinate the issues of national *priorities* to the question of our over-all *capacity*—so that *his* priorities will prevail.

The President proposes to lead by saying what we *can't do* as a Nation. What he is really saying is that we *shouldn't*, as a matter of policy and choice, move ahead in the areas of social concern. The issue is the same as it was when those who opposed social advance first condemned it as "communism," and then turned to the argument that it couldn't be made because there were wars to be fought and paid for first. Only the strategy has shifted: to the effort now to so concentrate attention on costs . . ., taxes . . . that there will be no recognition of values; to such emphasis on the price of the whole that there won't be consideration of the worth of any of its parts.

It seems right to me that the budget processes of the Congress should provide a *self-imposed* limitation on the total of the funds appropriated for a particular year. Within whatever that over-all limitation may be, however, the vital questions of priorities will remain: whether the long awaited "peace dividend" is to be plowed back now into the military establishment (as the President proposes) or whether it is to go to improving the common lot; and how much of the bill for whatever we decide to do is to be charged to those who can afford to pay it and how much to those who cannot. I assume that in the days and weeks ahead the Congress will drawn on *its* mandate to re-assert these issues of the priorities of our national purpose and the allocation of fiscal responsibility.

The second question is whether those of us who believe in a different order of priorities from the President's will respond to his essential negativism—about what we can't do—with an equally tough-minded but bold and new initiative regarding what we can and want to do.

A strong defense isn't worth a nickel in today's politics, especially in the play-offs—which is where we are now. I draw on an expired license to recognize that "liberalism's" old agenda got adopted without our coming up with an enlightened but reliable new map of the horizons or even the frontiers of current and prospective human purpose. What used to be "liberalism," with enough excitement of promise and hope in it to carry the day, has become so commonplace (and made so many more people substantial taxpayers) that you think of Bret Harte's observing that no one will give up his life to defend a boarding house. Neither will he, or she, pay higher taxes to support yesterday's idea of a great society. The only thing that will work, or should, is a new Idealism.

So, recognizing this Committee's particularly designated concern in the "economics" of all this, I want to try to suggest—after summarizing the effect of these Messages on the present manpower programs—the broader policy they seem to me only prelude to; with the thought that it is the economics of our *purpose* that is most important.

The President's Budget Message actually says comparatively little of manpower policies and programs as such. There is a general reference to proposed 1974 outlays of $12 billion "for education and manpower, including those for veterans," and another to "revenue sharing" of $1.3 billion for "manpower training." It is stated that the 1974 budget provides for "continued emphasis on training disadvantaged veterans" and for "an increase in the work incentive program to help welfare recipients get jobs." The only direct suggestion on the face of the Budget Message of any intended cutback of present manpower programs is the mention of a proposed "phasedown of the temporary Emergency Employment Assistance program," but this is accompanied by the sedative assurance that this will be "consistent with the increase of new jobs in the private sector." In the context of some 22 references in the first section of the Message to "full employment," this all appears to offer reasonable assurance that at least on this front "human resource" priorities are to be adequately recognized.

The fine, but operative, print tells a drastically different story.

There is a question of what should be considered "manpower" programs. There is, depending on what combination of programs is taken, a proposed reduction of recommended appropriations here of between $1.25 billion and $1.5 billion. This would be, taking the grouping of programs most commonly considered "manpower training" programs, from a FY 1973 level of $3.7 billion to a recommended $2.3 billion for FY 1974.

The largest item in this cut—referred to in the Budget Message as a "phasedown"—involves what is in fact the proposed total elimination of the public employment (or Emergency Employment Assistance) program, for which the

1973 budget authorization was $1.25 billion. Under this program State and local governments have received Federal funds permitting their providing jobs to some 150,000 men and women. The proposal is that this program be continued for several months, while previously appropriated funds last, then cut out entirely. The principal explanations for this are that the State and local governments are better off than they used to be and that, according to the Economic Report, unemployment will go down to 4.5% by the end of 1973. (This would mean 4 million people out of work.)

Depending on what other items are included, the cut (in addition to the 100% reduction in the EEAA) is about 15% in the rest of the manpower program.

No appropriation is proposed, at least specifically, for the summer youth employment program, under which more than 500,000 boys and girls have been given work opportunities each year.

The President recommends a cut in manpower research and development funds from $32 million for FY 1973 to $20 million for FY 1974, and a reduction for evaluation from $7 million to $6 million.

It is illustrative that despite the Congress' enactment of P.L. 92–450 last October, with its provision (among others) for establishing Veterans' Employment Representatives in each State—and despite the repeated references in the President's Message to veterans' special equities—the Budget proposes no appropriation for these positions.

As nearly as I can follow the arithmetic of the proposed Budget, the total which the President proposes for "revenue sharing" for manpower programs in Fiscal Year 1974 is $1.3 billion. This would be $230 million (15%) *less* than the funds which were originally proposed for these same programs for 1973.

The surest test of the inner quality of a budget is to check to see whether anybody thought of that special constituency we call "the handicapped," those whom nature or accident or sickness or war have put at physical or mental disadvantage.

They were not overlooked this time.

Three programs under the Vocational Rehabilitation Act, affecting particularly the rehabilitation facilities program are marked for *cuts*—of, respectively (comparing FY 1974 appropriations with those for FY 1972; the 1973 figures are complicated), 22%, 31%, and 100%. Senator Cranston and Congressman Brademas and others have been pressing strongly against this course of action (of which these particular cuts are only the most recent part). Senator Cranston, presiding last week at hearings before the Sub-Committee on the handicapped, and referring to the proposed reductions of $30 million for FY 1974 in the Vocational Rehabilitation innovation and expansion grants and research and training grants budgets (compared with FY 1973 original request figures) summed it all up in one word: "Disgraceful."

The always gnawing sense that our talk about billions, or even millions, of dollars is actually beyond our real comprehension prompted my checking—with the people at Goodwill Industries—to see whether all of this will really make much difference. It already has. It drives home the real effect of this proposed carving that the State rehabilitation agencies in three States—with more almost certainly coming—have in the past few days advised the Goodwill Industries offices that no more handicapped people will be referred to them now because the President's budget proposal indicates that the accompanying support funds won't be forthcoming.

Add the fact—important only for what it reflects—that the budget proposal is that two staff positions be cut from the President's Committee on Employment of the Handicapped.

Proposed outlays by the Office of Education for education of the handicapped have been cut.

It is proposed that there be no new starts under the Community Mental Health Center program.

You wonder just what kind of budget it is we are balancing.

There are two necessary bases for evaluating these proposals: in terms of the worth of each program in itself, and in comparative terms.

The most objective evidence I can find is that the present manpower programs have proven a good investment—increasingly well administered and increasingly effective.

I know of material improvements made in the administrative process by those who succeeded me in the office of Secretary of Labor.

It is relevant that the present Administration has thought highly enough of these programs to enlarge them substantially beyond what they were in 1968.

The Joint Committee has before it the excellent Staff Study prepared for its Subcommittee on Fiscal Policy (Paper No. 3; November 20, 1972) regarding The Effectiveness of Manpower Training Programs. I would agree with the conclusions of that report: that preliminary evaluations of these programs show "relatively large internal social rates of return," that most of them much more than pay for themselves; but that a number of significant changes are indicated by these preliminary evaluations; and that there should be a good deal more careful appraisal made. The recent report by the National Manpower Policy Task Force, is to similar effect, suggesting certain changes in these programs but giving them what are in general high marks for "substantial increases in employability and income for enrollees."

There would be general agreement, I think, that the first ten years' experience with the manpower programs commends strongly that certain changes be made—particularly in connection with the distribution of administrative responsibility for them and with their still unmet identity crisis, whether they are to be training or employment or income maintenance programs. But I had thought, until two weeks ago, that there was general recognition that unemployment is one kind of waste we cannot afford to accept; that reducing unemployment means increased government revenues; and that one necessary way to move toward full employment—by whatever definition—with the least inflationary effect is to reduce "structural" unemployment, to improve the training of people for jobs that need doing. I still think these things are true—and that the President's proposed slashing of these programs—instead of insisting that improvements be made in them—is wrong . . . in his own dollars-and-cents terms.

There had also appeared to be, until two weeks ago, general and widely expressed concurrence that in terms of comparative priorities the allocation of between one and two percent of a national budget of over $250 billion to these "manpower" purposes represents less than minimal recognition of their comparative importance. To suggest cutting these programs—but increasing military procurement expenditures and leaving tax loopholes—seems to me bad business, misguided government, misplaced human concern.

This priorities issue, assuming any given over-all budget figure, is whether it is right to cut the manpower programs by over $1 billion when that same amount could be saved by closing the tax loopholes which are provided by the oil depletion allowance, the "fast depreciation" advantage given the owners of certain types of buildings, and the capital gains shelter provided for timbering operations. This seems to me not right, but wrong.

The issue is whether it is right to propose not to fund the Veteran Employment Representatives positions just established by the Congress, but to maintain the number of Generals and Admirals in the Army and Navy at World War II levels even though the troop strength has been cut by 80%. That isn't right.

The issue is whether it is right to put 150,000 disadvantaged men and women out of their jobs under the public employment program, and 500,000 boys and girls out of their summer employment, and handicapped people out of their places with Goodwill Industries when three times the cost involved could be saved by conservative reductions in military procurement. That is wrong.

The issue is priorities.

Returning now to the point that even if all of this is so, the case for preserving . . . and improving . . . the position of manpower programs on the agenda of national priorities will depend on revitalizing present policies with new and greatly enlarged purpose:

The debate may, from present indications, center on the public employment program. I would urge strongly the renewal and expansion of this program—along the new lines Senator Humphrey and Congressman Reuss and others are advocating.

But winning that particular point alone won't be enough. It will be necessary to mark out bold new frontiers of immediate purpose, and beyond that the horizons of eventual hope, for a manpower policy.

This isn't the place and there isn't the time here for detailed programming of a new Idealism in manpower policy; but I have a few suggestions.

The place to start is by making it clear that full employment means what it says, and by establishing new methods of measuring employment and unemployment. For we do whatever we measure.

Instead of claiming a foul in the President's use of "full employment," it would be better to say: "All right, Mr. President, you have adopted the phrase. Now let's live up to it. We don't mean by 'full employment' the four or five percent unemployment your economic advisers say is necessary to avoid inflationary

pressures. We are opposed to inflation, but we mean to take care of that in other ways than by pushing the bottom two million people into the street. We mean by 'full employment' what Senator Proxmire said so simply and rightly at this Committee's hearings last October: 'a decent job for everyone who is willing to work.'

"We know that in an economy changing as fast as this one is, two or three people out of every hundred will at any particular time be moving from one job to another, or finding their first job. We got down close to the minimal level—to 3.3%—in 1968. We can do it again—whenever we make up our minds to, and put full employment in the first place instead of someplace else on down the line."

We need new measurements, going beyond what we have been calling "employment" and "unemployment" and designed particularly to provide the architects and administrators of both manpower and education-manpower policy with more information about the where's and who's and why's of people being out of work, out of school, out of kilter one way or another.

One aspect of this need is emphasized in the recent succinct and invaluable report of Senator Nelson's staff study for the Employment, Manpower, and Poverty Sub-Committee, which redirects attention—as we tried to in the Department of Labor in 1966—to the implications of a "sub-employment" which persists in particular identifiable areas at a rate far in excess of the "unemployment" rate.

Then suppose we were to start trying to determine the rate of non-use or underuse of the whole human potential for productive, creative, or service activity. Without pressing the point, there is obviously a good deal more which can and should be done in the development of "social indicators." Knowing and respecting the differences of viewpoint within the Joint Economic Committee on the proposed Full Opportunity and National Goals and Priorities Act (S. 5; introduced by Senator Mondale and co-sponsored by Senator Javits), regarding particularly the establishment of a Council of Social Advisers, I express the strong personal persuasion that such legislation is of vital importance and should, in some form, be enacted.

We aren't measuring today, in the area affected by manpower policy, all we should and could be finding out—especially about our potential.

In a more programmatic sense, I mention really only by way of illustration two specific frontiers of mapower policy:

Over a quarter of our unemployment, as we now describe and measure it, is in the 16- to 19-year age group. The unemployment rate in this group is about 15%, and almost twice that among those who are both young and black. This is an inexcusable disgrace. No other comparable country suffers anything like it. It is a form of infantile paralysis, leaving lifetime debitilities.

The Administration's proposal to meet this situation by establishing a lower minimum wage for younger workers is the emptiest gesture. It is wrong. It wouldn't work. It won't pass.

We have to get at the real nature and at the *causes* of "youth unemplovment."

We probably make a serious initial mistake, which affects all of our thinking about it, by putting these young people down in the book as simply "unemployed"—out of work. In a good many cases, although not all, the more significant fact is that they are out of school—without the preparation they need for jobs which machines can't do better. This is a special "transition problem," but with roots reaching down into the educational system, and still deeper down in the environmental circumstances of a good many of those boys and girls.

We need an "education-manpower" policy.

The administration of such a policy would start most immediately—for the needs and opportunities are largest here—by setting up a vastly more extensive counseling and guidance and placement program—to provide at least as much assistance of this kind for young men and women who leave high school to go to work as we provide those who are going on to college. We are developing plans at The Manpower Institute for what we are calling Career Information Boards—largely privately supported and administered in significant part by volunteers. But if we were willing to spend $100 per young person—age 16 to 19 and out of work and out of school—just to give that boy or girl the guidance he or she needs to get into one or the other we would get every cent returned to us in reduced costs of juvenile delinquency. We could pay the cost in the meantime by closing up just the tax loophole we now provide those who make capital gains on timbering operations.

The "work-study," "cooperative education" and community college programs warrant close attention and broader support.

Part of the holding in *Serrano v. Priest* and other cases like it is that equality of *work* opportunity traces directly to equality of educational opportunity.

Assistant HEW Secretary Sidney P. Marland's proposal for "career education" illuminates a vital dimension of what ought to be an "education-manpower policy."

This country will be willing to do whatever it takes to stop the present incalculable drain on our resources, our finances and our morals, of a million teen-agers adrift. And they are not just "unemployed."

Another frontier of manpower policy involves recognizing fully—as we have only a little so far—the basic importance to manpower policy . . . and to unemployment . . . of the ceaseless competition between people and machines. You think of Thorstein Veblen's prescient reminder, eighty years ago now, that the free society's most serious testing will be in the handling of the "potentially suicidal stresses between scientific invention and the human purpose."

I hazard the guess—yet really without hazard, for we don't keep these figures—that half of the adult unemployment in this country is traceable either directly or indirectly to technological displacement or the development of new processes.

There is even less basis—but similar immunity from disproof—for the estimate that between three and five million people whom we list as "employed" are doing and being paid for work . . . or time . . . which is useless both to their employers and to themselves. They hold sinecures, as the alternative to being unemployed. The price is inestimable. It was one, although only one, of the factors which bankrupted the Penn Central. It caused last week's strike there. Its cost is probably largest in its corruption of whatever the "work ethic" ought to mean—and I'm not talking Puritanism.

This issue of how to deal with technological displacement has caused more "national emergency labor disputes" in this country in the past fifteen years than any other issue, including wages. Collective bargaining isn't, by its nature, able to cope at all fully with this issue. New technology means, in my understanding of it, more—not fewer—jobs, at least at the present stage of things. But the new jobs are often in other plants, belonging to other companies, often in other industries—not within the jurisdiction of the company and union representatives at a particular collective bargaining table where the question of the displacement of a particular person by a particular machine comes up. So those bargainors either don't meet the problem or they come up with answers which are usually wrong, or only half right.

This problem must be met, at least in part, by the community as a whole.

If change, which is in the public interest, requires taking a person's job, he or she is as fully entitled to compensation for it as when change involving the public's need for a new school or highway requires taking somebody's property. We should extend the principle of "eminent domain" to jobs.

The practical form of this is probably to provide fully paid leaves of absence—from the work force—to anybody about to be replaced by a robot; so that he or she could take a year or two, or whatever is required, of training for some other kind of work. This should be at full pay—to come partly out of the employer's increased profit from that new machine (half, perhaps, of the special tax advantage we give him for buying it) and partly out of the unemployment insurance fund. Visionary? Fine. Impractical? West Germany has had a similar leave-of-absence law for four years now, and it is reportedly working well.

Then we might go on (unless this is "chauvinism") to provide free education for every mother when she reaches forty or when her youngest child goes off to school; so she can catch up with what has happened while she was so busy and can get ready again for something else. Then we could move on from there, to consider sabbaticals for everybody in the work force—or perhaps first a two-year refresher course at age 60 or 65: in rejection of habit's absurdity of treating retirement—"the best for which the rest was made"—or "leisure" more generally, as an unskilled occupation.

The most significant recent document in the manpower policy area is *Work in America*, a report just issued (apparently having been held up until after the election) on a study made by the W. E. Upjohn Institute for the Department of Health, Education, and Welfare. Emphasizing the human values in Work, it will take its place beside the Club of Rome's *Limits to Growth* (which I find less persuasive), the National Urban Coalition's *Counterbudget*, and Christopher Jenck's *Inequality* as a mind stretcher important to our shifting our thinking

about the *ultimate* priorities—which are those between the individual and the system.

We got a fleeting glimpse of this last fall when Senator Mansfield and Senator Aiken proposed a Human Resources Depletion Allowance—to provide aging human beings with a tax exemption of up to 23%, which they identified—with what must have been wryness—as one percent more than the oil well depletion allowance.

Someplace along the line—sooner now than we realize—we will identify the elements of a "manpower" policy which will mock the baptismal blunder we made ten years ago when we gave it that title. For the dictionary defines "manpower" as "a unit of energy generally considered equivalent to 1/10 horsepower." We will redefine "manpower" to mean the power that lies within every human being—and the purpose of manpower policy as being to provide full opportunity for every individual's making the highest and best use of the life experience. And we will probably throw away the "manpower" phrase—as deriving too directly from "horsepower"—and substitute for it, as the President virtually has already, "human resources." We'll stop talking about the "labor market."

We have recognized fully and traditionally the importance of Labor as an element of production—essential to the system.

We are only beginning to recognize the importance of Work as a human value—essential to wholeness of the individual.

Yes, I commend to the Committee the recognition of the present manpower programs as being wise and already high yield investments. I think it would be a tragic mistake to cut them back. I think, at the same time, that they should as a matter of policy, and can as a matter of practical politics, be preserved and enlarged only as they are imbued with new initiative, yes, with a new Idealism—not apologetic or timid, but proud of itself and confident that it is the authentic American spirit.

So I make as strongly as I can the case for evaluating present manpower policies and programs, proposing new ones, by checking the stars of our reasonable purpose instead of by using lanterns to try to light the path immediately ahead.

We *are* all taxpayers. But most of us are taxpayers only second, and citizens . . . of each other . . . first—no less so in time of peace than in time of war. We need and will respond to a leadership which summons and draws upon the courage of our deeper convictions and our desire to do, together . . . for ourselves and each other . . . all we can do, and to be all we can be.

This Committee, and the Congress, will know—as it considers these "economic" questions—that both behind and beyond them is the critical truth that a working majority of people in this country still *care* greatly.

Else we would be nothing.

Thank you.

Chairman PATMAN. Thank you very much, sir.

We have as our next witness the chairman of the National Urban Coalition, Mr. Linowitz.

Mr. Linowitz, please proceed.

STATEMENT OF SOL M. LINOWITZ, CHAIRMAN, THE NATIONAL URBAN COALITION

Mr. LINOWITZ. Thank you, Mr. Chairman.

I first want to express my appreciation to you, sir, for this invitation to comment on the President's budget for 1974. As you know, the National Urban Coalition has a special interest in the budget and its pervasive influence on national policies and priorities. As you also know, in the coalition we encompass the leadership of many diverse and sometimes competing elements of our society, and our common goal has been to work together in order to improve the lives of the people in our cities, particularly the poor, the disadvantaged and the minorities.

It is about 2 years ago when I last appeared before this committee and, at that time, I presented a document entitled "Counterbudget," which I have here with me. In "Counterbudget" we had a comprehensive statement on national priorities adopted by the steering committee of the coalition, and alternative budget proposals needed to implement that statement. At that time I said to the committee we had issued "Counterbudget" in the conviction that "if future talk of new priorities is to serve as more than balm for social conscience, we must apply it to our single most important instrument for relating goals to scarce resources—the national budget."

That statement reflected our conviction as a coalition that the Federal budget is the most important political and social document in the country, defining in specific terms national goals and priorities and charting a course to achieve them.

It is in these terms that we must judge President Nixon's 1974 budget today. Viewed in this context, I submit to you that it reflects a deeply disconcerting lack of concern for the poor, the working people, the welfare recipients, the minorities, the untrained, the unemployed of our society. In my view, this budget bluntly rejects the concept that a responsibility of Government is, in the words of the Constitution, to "provide for the common welfare." To cite one example, welfare reform is completely absent from this budget, despite the critical importance which the administration gave it in the first term.

In this second term, the President has exhorted Americans to look not to Government for help, but each to himself. The budget reflects this philosophy, and represents a clear departure from the administration's approach to social problems during its first term. For those millions of citizens caught in a web of poverty in this country, in our central cities, this new approach has serious and dangerous implications.

I want to talk this morning about three assumptions underlining the budget proposals as they have been presented. The first is that the budget does indeed provide a way for the National Government to meet its responsibilities, but through local instead of Federal control. But that begs the question. There is indeed a legitimate context within which the issue of Federal versus local control can be argued, but that argument becomes moot when funds are unavailable to run programs aimed at dealing with those problems.

Under its new approach, as you know, Mr. Chairman, the administration proposes to replace some 70 existing social programs through which funds are presently disbursed in local communities with four special revenue-sharing measures and these are in the areas of education, law enforcement, manpower and urban community development. These special revenue grants, as you also know, will be in addition to the general revenue sharing which is already in operation.

But the plain fact is that the level of funds made available for these purposes may result in a lower level of program operations than existed before. In the manpower area, Mr. Wirtz has already spoken eloquently on what the problems are there and what the deficiencies are there, and I will not go over that material again except to say I fully share his concern and I am particularly dismayed on what has happened to the public employment program which provides presently socially useful jobs to about 150,000 unemployed persons, 38 percent of

whom are disadvantaged and more than two out of five of whom were veterans, and it seems to me that there is no logic to reducing or eliminating such manpower programs during a time of high unemployment.

In the case of special revenue sharing for urban community development, as you know, no revenue-sharing funds are requested at all. Some existing programs, such as Model Cities and neighborhood facilities and community planning programs are to be lumped together under a revenue-sharing rubric, but these programs will have to draw on funds authorized under previous budgets. No new authorization is requested for these programs for 1974.

These cutbacks come on top of the previous administration's suspension, to which the chairman has already referred, for 18 months of new commitments for low and middle income housing programs. The impact of these actions is to make a mockery of our announced housing goals.

The general revenue-sharing funds which were intended to provide much needed fiscal relief for the cities and States are, under this concept, regarded apparently as a substitute for existing programs. To the mayors of this Nation, to the Governors, this appears to be a direct contravention of the President's 1969 promise that general revenue-sharing would not substitute new funds for old.

When the administration claims that its program for the next 2 fiscal years, as outlined in this budget, represents a return of Government to the people, I submit it is indulging in a kind of semantic exercise.

I do not mean to sound presumptuous but I do want to suggest that a more realistic method for accomplishing the administration's goal of local control and, at the same time, discharging the Federal Government's responsibility to meet the needs of the people, could have been embodied in a kind of proposal I ventured to make myself last year. I called then for the creation of federally chartered metropolitan development agencies controlled locally which would receive and administer Federal funds upon development of a satisfactory overall plan for local use of those Federal resources.

It is worth noting that the budget, as presented, goes precisely in the opposite direction. That funds which were hitherto available to the Council of Governments for metropolitan planning have now been turned over to the States for such use as they think appropriate.

A second claim of the administration in connection with the budget is that the budget, that this approach is the only way to meet the Nation's economic problems. We are told the cuts and the impoundments are essential; that prescribed spending ceilings are mandatory; that the deficit must be cut in half to avoid inflationary pressures.

Accepting the premise that fiscal policy is the Government's single most important economic weapon, and that reduction of the Federal deficit is counterinflationary, it is obvious that there is more than one way to reduce the deficit. One is the way the administration has chosen—by reducing expenditures, especially expenditures aimed at helping meet the pressing needs of those at the bottom of the economic scale. The other is by increasing revenues through tax reform and, if need be, by increasing taxes. It is time for us to face the fact that if we are going to meet the human needs of this Nation, we will simply

have to increase our revenues through intelligent tax reform, and if necessary, by a tax increase.

When I appeared here 2 years ago I indicated that in "Counter-budget," leading businessmen, labor leaders, minority leaders, religious leaders, local government officials, and others on our steering committee of our National Urban Coalition recommended at that time that following indicated cuts in expenditures and reform in our tax structure, we should put into effect an increase of about 10 percent in individual and corporate income taxes about the middle of 1974.

I want to face that tax issue squarely this morning. I hope the President and the Congress will be aggressive in accomplishing meaningful tax reform this year. Following that, I propose the enactment, as may be required, of a 10-percent surcharge on personal and corporate income. I would welcome this proposal becoming part of the public debate. I remain confident that the American people, if they believe the tax structure is fair to everyone, will be willing to pay what it costs to be a great nation. I believe they will respond if properly summoned to do what must be done to make us the kind of nation we can become. And the simple fact is, which seems to be ignored in this budget, if Federal taxes are not used in order to do these things which have to be done, then State and local governments will simply have to resort to property and sales taxes and the taxpayer will simply be paying out of his other pocket.

A third claim employed in this budget is that the decisions made were the only ones that could have been made by responsible Government in the name of fiscal responsibility. But I submit that a responsible budget must be responsive to public need.

In the budget as proposed, national priorities have been reordered in the name of macroeconomics while the problems and needs of the people seem to have been subordinated to other concerns.

As you know, the defense program budget has been increased while civilian programs have been reduced or eliminated. The administration lists the total of all savings from a program reduction and termination for fiscal 1974 as $16.8 billion. The savings from program reduction and termination for the Department of Defense for military purposes are shown as being at $2.7 billion. Since national defense accounts for 30 percent of the total budget dollar the question must be raised—why are civilian programs cut so disproportionately when we are no longer engaged in a war on foreign shores, and when a 55,000-man reduction in military personnel is planned?

Moreover, if we take into account the projected population growth and projected rate of inflation, expenditures for the civilian controllable programs would have to increase by at least 4 percent just to stand still. Thus, when the defenses and civilian budgets are compared, we see a reordering of priorities that certainly was not contemplated when the phrase became popular—a reordering of which is a far cry from our goal of narrowing the distance between what we have and what we want in this country.

This outlook is further blurred by the commitment for the reconstruction of Vietnam, a commitment which we, of course, must fully and in greatest of spirit of cooperation comply with, but this could cost billions of dollars not contemplated in the budget. OMB Director Roy Ash has reportedly said that any such expenditures would have to

come from further cuts in the budget because the total will not be increased. I cannot help remarking what a final, tragic irony it would be if we could somehow find the funds to reconstruct cities we have bombed half a world away, yet declared ourselves powerless to find the resources to rebuild our own cities.

Before concluding, I want to add just a word about a deep basic concern I have with respect to the kind of action taken in the domestic area during the past 2 weeks. The Office of Economic Opportunity, OEO, was the flagship of the war on poverty. In a unique way it was a symbol to the unfortunate that this Government cared about them, and was at least trying to help. To them, it was, therefore, a harsh jolt to learn that it was to be abruptly torn apart and dismantled. Let me just say, I know this from my own talks with representatives of minority and poverty groups throughout the country and from reports from our 35 local coalitions across the United States, because to these people its death became another symbol, a symbol of surrender, a symbol that their Government had agreed to capitulate in the war against poverty without requiring the kind of "peace with honor" which we have been insisting on in Vietnam.

I am hopeful, Mr. Chairman, that we can yet do what we must, what we should, as a nation to restore the sense of hope, which we are in grave danger of losing at this time, and that somehow we can at long last rekindle for these millions of Americans the promise which has been America.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you, sir.

After the next witness each member will be allowed to interrogate the witnesses 10 minutes.

Our next witness will be the deputy mayor of the city of New York, Mr. Edward K. Hamilton. Mr. Hamilton, you are recognized.

STATEMENT OF HON. EDWARD K. HAMILTON, DEPUTY MAYOR, NEW YORK CITY

Mr. HAMILTON. Thank you, Mr. Chairman.

What I would like to try to do is to give you some notion of what this budget and this economic report and this general strategy the President has proposed means to a city. It happens to be the largest city, but all of our experience suggests that our feelings and our general priorities are not unique, that they are in fact typical of cities across the country.

I think we would all agree with the President there is a very real problem of priorities posed this year, probably the most serious problem we have had at least in the last 25 years. The elements are no mystery. I think most of us knew, as we were going through the sixties, that the year of crossroads or of reckoning would eventually come.

In the 1965–66 period we, and by we here I mean the Federal Government, the States and localities, essentially redefined government. We redefined the obligation of government to its citizens. In the Federal case, in 2 years, 1965, 1966, more than 180 new domestic programs were enacted. Their significance is far from being expressed simply in the fact that great numbers of dollars were added to the

domestic side of the Federal budget. You may recall that the Federal budget for 1965 was $97.5 billion; the Federal budget proposal this year is $268 billion, and the defense element has not changed greatly in terms of absolute amount.

Now, obviously there was a change to a unified budget in that period so that those numbers do not quite express the degree of the change; they overstate it somewhat, but there clearly has been more than a doubling in the Federal budget which reflected a different notion of what government was about and gave to people a different set of expectations about what government would provide them.

Now, while we did that or at the time that we were launching those programs with all of the extremely broadly stated, some might say grandiose, objectives expressed in the Housing Act, in the Economic Opportunity Act, in the Manpower Development and Training Act, in all of this landmark social legislation, all of which I support, incidentally, we stated goals which we knew would require major investments of the national income. At the same time we were enacting them, however, we were in fact setting up competing objectives in the military area, with Vietnam particularly, but also in terms of ordinary baseline military expenditures. In the field of revenues, we were systematically eroding the Federal revenue base, usually in the name of tax reform.

Tax reform is a subject which has become a very bitter and irritating one for many of us, not because we do not support tax reform but because the cost of tax reform is so enormous, witness the Tax Reform Act of 1969.

Now, what that set up was an inevitable confrontation between the mandatory inexorable growth of the costs of Federal domestic programs designed to meet these extremely ambitious objectives, that on the one hand; and the cost of defense and of the increasing bounty to the taxpayer in the form of tax cuts, de facto tax cuts, on the other. That is the confrontation we are in now, and what I would like to present to you as a proposition, which I will try to support, is that essentially it is a question of life and death for the cities of the United States, particularly the inner cities but increasingly the outer suburbs as well.

Now, we probably over the last 6 or 7 years have beggared the language by overdramatizing or at least dramatizing the problems that we face, fiscal and social, in cities and, therefore, it may be that there is a feeling that "wolf" has been cried too often. But may I say that at this point, at this juncture, with this budget and with this year, that the Congress is going to be, I think, the principal protector of the interests of the people, that this is a year of a life and death decision.

Now, I think the basis of that is in the fact that we in the cities are trying to deal with what has to be the most dramatic social transition that the country has experienced in its history. We are trying to be the place where very large numbers of low income people are trained, educated, brought into a labor force which can one way or another meet the requirements of a technology and of a general profile of labor needs which emphasizes education, which emphasizes training, which emphasizes all the inputs which people who normally have led disadvantaged lives simply do not have.

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Put simply, that means a fantastic interchange of people. In the city of New York in the last 10 years we have interchanged 1 million people; that is to say, we have approximately a stable population of 8 million people but there are 1 million different people in New York than there were 10 years ago. In terms of sociological characteristics, they tend to be younger, tend to be less well trained, they tend to be nonwhite, and they tend to be lower income. What that adds up to in terms of the load on public services is a fantastic upward pressure on costs.

It starts with workload. If you have a city in which fire alarms are doubling every 4 years then something is going on besides the simple aging of structures. Take fire alarms as an example to give you a sense of change in lifestyle. Fire alarms in the city of New York for fires have stayed constant at about 110,000 for the last 5 years. Emergencies that are not fires have risen slightly. False alarms have risen on a curve that is very hard to believe, to the point where now 40 percent of all fire alarms in the city of New York are false. That is not nearly as bad as Chicago and some other cities, but the pattern is clearly there. That kind of workload increase for everything, for police calls, for park maintenance, for transportation load, for everything that a city provides, the workload numbers are simply skyrocketing.

Beyond that, there are the other factors that you are all aware of: The inflation, the general inflation, in the economy hits cities in many ways worse because they tend, once they get on economic trends, to stay on them. There are no inflationary expectations like inflationary expectations in cities. Cities tend to believe prices will rise as a matter of general principle and they tend to be terribly conscious of any economic trends in that direction. As a result inflationary expectations in cities, particularly in cities like New York, are very hard to break.

There has been an explosion of functions, as I said earlier, that States and local areas are supposed to perform many, many functions never performed before. The rise in interest rates and continuing high rise of interest rates have been of enormous importance to us. You know, many cities did very little in the way of replacement of capital structures for 20 years, just before the war. All of this needs to be replaced. We built more police stations in the city of New York in the last 5 years than were built in the previous 65 years.

The salary revolution in the public sector: The Federal Government accepted, I think rightly, in the early sixties the proposition that public sector salaries ought to be set by comparability measurements with the private sector. As I say, I think that was the right proposition. But the effect was what an economist would call the revaluation of the public sector which is now extended to virtually every progressive jurisdiction. Put simply, it means that public salaries have essentially doubled in the last 8 years.

Now, that, of course, also has gone to the universities, to the foundations, to the whole quasi-public interest sector, and that brings with it, of course, an equal increase in fringe costs, in pensions, in all of the fixed costs that go with salary increases.

Now, the net effect of all of those factors on costs produces what here in the District of Columbia, Mayor Washington likes to call the 15–5 problem; that is, the fact that in any given year the mandatory costs of running the same services at the same level for another year in a large city will probably require 15 percent increase in expenditures, it may be 14, it may be 15 and a half depending on the inflation rate, but somewhere in that range. Whereas, on the other side of the equation, the natural growth of the tax revenues that most cities have available to them, which as you know, are still primarily in the property tax, the slow growing tax area, the nonincome responsive taxes, that growth will be about 5 percent.

So that in any year a city faces the problem of a 10-percent built-in budget deficit on the operating side.

Now, in the city of New York, for example, we run an operating budget of $9½ billion, a capital budget of $2½ billion. The capital budget is not terribly relevant to this discussion, so let us stick with the operating budget. So it means any year we know if we are to maintain the mandatory increases in costs to operate the same services for another year we have 10 percent of the budget to find which, in very round terms, will be between $900 million and a billion dollars.

Now, this has been true for 15 years, and one may raise the question how was it that it is only in the last 3 years that things became quite as critical as they have been?

The answers essentially are three. One, general growth in the economy which in the sixties did produce a larger fiscal dividend than 5 percent annual growth in revenues and did take a little of the pressure off.

Two, rapid increases in State and Federal aid. In the case of my own city State aid multiplied by about five during the sixties and Federal aid by about 12.

And movement toward income-responsive taxes. City income taxes, city stock transfer taxes, city corporate income taxes, a whole list of those of that kind.

Now, all of this produced a major crisis in 1969–71 which I am not sure from Washington, is quite as visible as it is in the cities.

In 1969, 1970, and 1971 we went through the worst fiscal crisis which probably has ever been inflicted on any jurisdiction, because all three of those growth elements I have talked about, that allowed us to keep our heads above water when faced with a 15–5 problem, all three of them dropped dead at one time. There was no growth in the general economy, it was dead in the water, no fiscal dividend. There was no increase in State and Federal aid, because State and Federal Governments were in the same situation, in fact, worse due to their dependence on income-responsive taxes. Therefore, when the economy is in bad trouble they are in worse revenue trouble than the cities.

Finally, the movement toward income-responsive taxes did pretty well run its course. You can only invent an income-responsive tax once.

After that you can play with the rates, but there were very few taxable incidents to find.

Nevertheless, cities and States in the years 1970 and 1971, which as a political fact were the hardest years probably ever to raise taxes, cities and States found themselves in the position of having to raise taxes. And more than 40 of them did raise taxes in 1971, more than 40 of the States and most of the cities, but the results were still austerity budgets, which it is hard for the Federal Government—and I am a veteran of the U.S. Bureau of the Budget, and I have some sense of how tight things look from Washington—but it is hard to understand how tight they really are at the city level.

I will give you an example: We have lost in the last 2 fiscal years in New York, despite those workload increases I was talking about, almost 2,000 policemen, 700 firemen, 700 sanitation men, 4,500 teachers, a thousand parks maintenance workers, et cetera, et cetera, we have lost more than 15,000 city workers in the last 2 years because we could not finance them.

Now, some of that we have been able to offset with what we think is a pretty comprehensive productivity program, but nobody's productivity program can make up for a hemorrhage of those proportions.

Now, that is the plight we now find ourselves in. Now, the President comes with a proposal which essentially says to us never mind the sacrifices that you have been through and never mind that anything by way of a decent level of local service depends primarily on what the Federal Government does, we intend to cut back on the existing Federal programs.

Now, that produces two kinds of results which I would like to summarize briefly and then I will end this. First, in the specific program cuts, just to give you an example, the housing freeze: the housing freeze cuts off the principal avenue by which it is possible to build moderate- and low-income housing in a city. If you want to build conventionally financed housing in the city of New York most of which is multifamily, of course, you are talking about housing which comes in at $140 a room per month. That is to say, a four and a half room apartment would cost somewhere on the order of $700 a month for rent. You see what segment of the income profile can afford that kind of housing and what cannot. As a result, conventional housing has a very limited market and it has what in most cities would be regarded as a decent vacancy rate, that is somewhat on the order of 5 percent.

Moderate income housing; that is, housing which has tax rebates and assorted other tax assisted benefits, comes in now between $80 and $90 a month, which still means on the order of $400 a month for an ordinary 4½-room apartment.

The only way that one can deal with the huge needs, and here we have a vacancy rate of less than one-half of 1 percent for low-income housing is through Federal section 236 subsidies.

Now, last year in New York we built 35,000 units of tax-assisted housing. That is an all-time record. It is a third higher than it had ever been done before. The previous year was a record over the year

before that. We can build tax-assisted housing if we can get the interest subsidy to do it and, of course, it rents immediately. It is not a problem at all in terms of the market.

But only about 10,000 units of conventional or privately financed housing were built. Therefore, one is talking about basically the housing supply of the cities when he talks about Federal subsidies. Without that and without help on interest rates we are dead as far as housing is concerned. It is just that simple, and if you cannot supply housing then you cannot supply anything in terms of the services that a city is designed to supply.

Now, that is an example of specific cuts. There are others of a kind that Secretary Wirtz has talked about, the manpower cuts and all the rest, I will leave that for the question period.

But I think there is a second element to this which you ought to know about as you consider this. I am sure you get this from your constituents at home.

The most serious problem the budget presents is what is regarded on several levels as a very serious breach of trust. People feel lied to in the most serious possible way. I think, first, you have to understand that the thing that really is volatile in a city, the thing that determines whether or not it is possible to do something constructive, is the degree of hopelessness. If there is despair, if there is disillusionment, if there is a general feeling that nothing can be done, then you have got a dangerous problem at that point.

The usual methods of trying to maintain reasonable order and to maintain reasonable progress starts to drop out and then you get the Brownsvilles, the South Bronxes, the Houghs, the Watts, the areas which look to many people who see them, at least for the first time, beyond repair.

Now, that is what happens when you cut something like Community Action or Model Cities or the social services programs which provide day care and senior service centers. Those are community initiatives. Communities have been told "If you mobilize, if you develop a plan, if you develop a set of proposals, then the Federal Government will help."

Now it takes some leadtime for that to set in, because you are talking there about attitudes, you are talking about people's general view of life. It takes, therefore, 4 or 5 years before they begin to believe you, before they begin to really think if they did that it is just conceivable that the help they have been promised will come around.

We started most of those programs in the late sixties, and it is only now that the Model Cities policy councils, the Community Action poverty corporations, and the senior service design centers, are beginning to appear in a strong and intellectually defensible way, and yet it is now that we are cutting the water off.

If we go to the Model Cities people, to the Community Action poverty corporations and tell them "very sorry, we have changed our minds, despite the fact that you have organized, you have done everything that has been required of you, you have gone over and over and

over the propositions. the proposals you have put forth but all of that simply no longer counts because we have a general fiscal problem in the country," then you have got a problem in the cities that is quite beyond anything that has happened up to now. It would almost be better not to have it at all than to have presented people with that kind of opportunity for disillusionment.

I must say that the city governments feel lied to. in addition. We supported revenue sharing very strongly and there is nobody, I think, in our city who feels more strongly about it than I do. However, we did it on the specific understanding, stated many times, that general revenue sharing was not being passed as a way to cut categorical grants. There is not a mayor in the country who believed that any administration would be so perfidious as to turn around on that proposition.

Finally, then to sum up, the mood in the cities, in response to the President's proposals is sullen; it is suspicious; it is unresponsive, and it is profoundly dangerous; I would like you to consider that very seriously as you go through the budget and the economic report.

That leads me to make a number of specific recommendations which I hope will be mildly constructive. Our business is not simply to load you with impossible choices but to try to give you some sense of where we think the priorities are. Mr. Linowitz said a minute ago he would propose a tax increase this year. My own feeling is that the long-term crisis that you are dealing with here is basically a question of what percentage of the national income is going to be applied to the public sector. I think that the erosion in the Federal tax base over the last 8 years has left us in too low a position. However, my own hunch is that this is not the year for a tax increase. I think the economics of that, as the recovery is only gaining. recovery from the recession is only gaining strength. now the economics of that—

Chairman PATMAN. Your time, Mr. Hamilton, has expired. You will be permitted to extend your remarks in answer to inquiries, I am sure. If you are not we will give you further time later.

Mr. HAMILTON. Can I have 45 seconds?

Chairman PATMAN. Yes, sir.

Mr. HAMILTON. My recommendations are these. No tax increase this year. I think the defense budget can be cut by at least $7 billion. I think there ought to be a 2-year moratorium on space expenditures. I think elimination of price support subsidies to middle- and high-income farmers should come this year. I think it is necessary to increase the domestic side of the budget by about $8 billion, and I would risk a full-employment budget deficit of at least small proportions if the alternative is the President's proposals.

Chairman PATMAN. Thank you, sir.

Mr. Hamilton mentioned housing and high-interest rates. and I just want to make one comment.

Under existing conditions a person desiring to build a $20,000 home with a 30-year mortgage, a term which is traditional, will have to obligate himself to pay for three $20,000 homes in order to get the title to one $20,000 home. In other words, the interest and carrying charges

on his $20,000 home will be twice as much as the cost of the home. This illustrates the kind of practice that is happening in broad daylight and should be stopped.

Senator Proxmire, I will ask you to lead off in interrogating the witnesses.

Senator PROXMIRE. I want to thank all of you gentlemen for excellent statements. They were all top quality. Mr. Wirtz's statement is one of the most eloquent I have read in a long, long time. We could use you in this town as a speech writer for the President [laughter], which I doubt that you would be pressed into that service, or would accept if drafted.

But your eloquence is most impressive and, of course, the substance of your argument is very powerful, too. I can say that for all of you gentlemen, Mr. Linowitz and Mr. Hamilton, the substance of your arguments are very compelling.

However, we have to recognize that in this tough real hard world in which we live, when you look at the facts and figures the Federal Government has grown, it has grown at a very, very rapid rate. It is growing this year. The President is not asking for a cut. He is asking for a $19 billion increase in spending, a 7½-percent increase in Federal spending this year, and if Congress goes higher than that I think Congress is going to be way out of step with the sentiment in this country. We simply cannot do it. We have to recognize not only we are spending to much in the military area but some of our domestic programs are also fat and have to be cut down and can be improved.

I think it is very compelling to hear these arguments about how we need funds in all kind of areas but I think we have to be much more specific and precise and recognize we failed, when we have thrown money at some of these problems we have not succeeded and we have to cut them out. I am talking about problems in urban renewal as well as the moratorium on space that Mr. Hamilton referred to. I think we can cut down some of our medicare expenditures. I think we can cut some of our educational assistance, higher education, and some of these other areas, but I think the fundamental thing we have to get at is what Mr. Wirtz was working towards when he said what we need is a full-employment attitude, full-employment program and policy.

Former Budget Director Charles Schultze suggested that we might think about the possibility of working toward 2-percent unemployment with controls tight enough to prevent excessive inflation. We had a study made of that, as you know, by Mr. Otto Eckstein, Mr. Feldstein did the principal work, and testified on it, as you indicated, Mr. Wirtz.

We feel so strongly that there are all kind of benefits in this. Everyone who can feel needed, wanted, can have a job; work is, as you say is, a virtual human value and we could have an opportunity to work. The level of human contentment would be greatly increased, the standard of living raised sharply, the welfare problem far easier to handle, the tax burden lightened, poverty would be on its way out.

Despite all the efforts we have made to combat poverty the one really significant progress was in World War II when we had 2-percent unemployment and when we had a situation in which there was a real redistribution of income for the first time.

Now, to get at this, to get at this problem how do we achieve it? It seems, No. 1, on the basis of the Eckstein-Feldstein study, we have to do something about the area Mr. Wirtz referred to where we have 15-percent unemployment of young people, 25 percent of our total unemployment is concentrated there. What do we do about it? As you indicated, it is different in nature from some of these other problems. We have very limited apprentice opportunity in this country, as Mr. Feldstein pointed out, compared to what they have in England. In England they have less unemployment among people 16 to 19 than they have in the rest of the population. Here unemployment is five times as great.

Do you have any specific suggestions, Mr. Wirtz, as to how we can handle this better?

Mr. WIRTZ. Yes, sir. Just in very summary form, I would start first on the counseling and guidance. It sounds unimaginative, but the truth of the matter is that most of these millions just have no help at all in trying to get placed. We are working on a program which will involve setting up what we are going to call career boards in each community. Today, there is in this country one counselor for every 400 high school students. He or she is spending almost all of his or her time on those who are going to college. Those boys and girls who are going directly into work have almost no help at all. I think attention to that problem would probably cut that million almost in half.

Senator PROXMIRE. That sounds most encouraging.

How about recognizing the irrelevance of much of our education? We lavish more money and time on our young people on education than any other country in the world and when our young people are graduated they are unemployed. In other countries they go to work.

Mr. WIRTZ. We should press three sets of programs: the work-study and cooperative education programs, the curriculum redevelopment programs, and the community college program. The elitism of training everybody to go on to college has been terribly expensive to us. There are many among those who got training for college who did not need it. And along the lines you are suggesting. I am not talking about sending everybody to college, far from it.

I am very much interested in the career education idea which Commissioner Marland has been pressing. Part of the answer is that we have got to start training from kindergarten on through, in terms of work opportunities as well as going on to college. And then we must push on even beyond, and in back of, that. This inequality study of Christopher Jencks is significant. But in short answer to your question, I would start with counseling and guidance; then move into the education-experience exchange area; and, along with both of these, press for revision of the curriculum to include fuller reflection of the needs of those who are not going on to college.

Senator PROXMIRE. I am delighted to hear that. I was most impressed by an article that I read in a magazine just this last month. It is a magazine called Money and it is about a young man living in Connecticut, 17 years old. Connecticut has very high unemployment. This young man found eight jobs in the course of a summer. He made up to $500 a week, his average income was about $400 a week. He was a rare kind of individual, 1 in 100. He was a Chuck Percy or a Willard Wirtz, Sol Linowitz. He was not like most of us, he was not just an ordinary fellow. But I think we can inculcate in our young people in

guidance perhaps not only the notion of how they should be trained and skilled in some kind of work but an attitude of looking for work and of being willing to adapt to it. This kid, for example, among other things, he got a job in a local radio station by going down to the station at 6 o'clock in the morning to find out how late the Penn Central was and then he would telephone the radio station and make a broadcast about it, and make money that way.

He made money giving tennis lessons, although he did not know how to play very well.

But the attitude for looking toward work and developing ways of making money is one we have kind of lost and in a free society, with reliance on individual initiative, it seems to me we have to find a way of inculcating that kind of attitude among our young people rather than by getting job by sitting on their fanny and wait for it.

Does that go along with part of your——

Mr. WIRTZ. Yes, sir, and I would add another specific. This whole problem of motivation is now finally getting the attention it deserves. This problem shows up in connection with high turnover and a lot of other things. You have made the point, and I only emphasize it.

Senator PROXMIRE. Mr. Linowitz, your statement is most welcome, and very, very helpful. But I do wish that you had done what you had done 2 years ago and given us another counterbudget. It was very helpful. It was a dramatic demonstration of a different set of priorities, in detail, worked out in a way that balanced and that gave us a notion of where the money was coming from, where it was going. People might disagree but it was a very useful thing. Is there any possibility you can do that this year? It is late but no matter how sketchy it was it would be most helpful. Can you do something for us?

Mr. LINOWITZ. Yes, Senator. We are taking a crack at that. We have observed your own counterbudget which does say a number of the things we would undoubtedly say if we were formulating one but we are having an analysis made and we are hopeful that even in very fragmentary fashion we can present to you some changes in the allocations which would be at least helpful in consideration of how the resources might be used, because we certainly agree with you, as you know, Senator, that the whole question is not whether we are going to have to reach out for some more money. I am not talking about a tax——

Senator PROXMIRE. We are on weak grounds when we do that. It is a hard one to win, I doubt if we can win, we can win on some other grounds.

Mr. LINOWITZ. I understand.

Senator PROXMIRE. We have to convince the Congress and country we can do this job within a reasonable level of expenditures.

Mr. LINOWITZ. I fully understand, sir.

Senator PROXMIRE. I think a counterbudget this year would be even more decisive and effective than it was 2 years ago because there is this mood up here. The President has said no tax increase.

Mr. LINOWITZ. I must say, based on what you just said, we have been working at it but we have not been sure it would serve the same purpose at the present time, but based on what you said, we will take a crack at it.

Senator PROXMIRE. There are a couple of alternatives. You suggest, and I think your colleagues at the table seem to dispute this, I think at least Mr. Hamilton did and perhaps Mr. Wirtz did, the notion that a 10-percent surtax is a realistic possibility this year. I do not think it is. In fact, I think it is going to be hard to get any kind of tax legislation through this year for 1974, at least for the 1974 budget, that would be an increase in revenue possible, but unlikely. We should have it, but do not have it.

Mr. LINOWITZ. Let us add what I am saying.

Senator PROXMIRE. Maybe we can have a tentative kind of budget.

Mr. LINOWITZ. Let me make clear on that point a word of clarification. What I was taking issue with was the President's firm point of departure that under no circumstances must we, as a nation, consider a tax increase. It seems to me if it should develop that there are things that have to be done, and that there is no other way to fund them, we ought not to say that you must take away funds from essential programs in order to find resources. That one other avenue for those resources is indeed a tax increase. It should be the last resort. It should come only after the most careful reallocation, after the most careful analysis of tax reform, but should not be entirely removed from our arsenal is what I was suggesting.

Senator PROXMIRE. My time is up. Let me just conclude by saying we are at the end of a war, as you know. Never in our history have we ended a war and spent more money after the war is over. We should find a way of reallocating our resources without a tax increase now.

Chairman PATMAN. Mr. Widnall.

Mr. Widnall reserves his time.

Mr. Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Wirtz, in your extraordinarily helpful presentation, you make a couple of statements which seem to be in some collision with each other. I am referring to the prepared statement. In your prepared statement you hazard the guess that half of the adult unemployment in this country is traceable either directly or indirectly to technological displacements or the development of new processes.

Then you say, "New technology, in my understanding of it, means more, not fewer, jobs, at least in the present stage of things."

Of course, this has always been the question of the age ever since the industrial revolution. And I think we can start by stipulating that up to now, it certainly has been true that machines in the long run have not displaced human beings, but have simply added to productivity and general welfare, which is why we are for machines and against throwing wooden shoes in the machinery.

But, what about the situation nowadays whereby governmental policy, the wisdom of which I cannot fathom, but there it is, is to enormously excite the rate of capital growth by rapid depreciation and DISC and investment tax credits, and so on—14-percent increase in business fixed investment 2 years running—and, at the same time, to cut out entirely, as Mr. Linowitz has so well pointed out, all the programs that provided little jobs for little people—emergency unemployment, regional economic development, OEO, Model Cities, the rest of them.

I will now ask my question: How do you reconcile your two statements, and if they are irreconcilable, which grammatically they seem to be, is not the situation right now changing from what it has been?

Mr. WIRTZ. First, I express complete agreement with your suggestion that the approach which has been taken to this economic policy in terms of its creating job opportunities seems to me, to borrow Mr. Hamilton's phrase, a case of perfidy. For the President to call in the new economic policy of August of 1971 for a Jobs Opportunities Act, when the form it took was to provide a tax advantage to those who purchased labor-displacing machinery, was simply an affront to the people who read that. The same point applies on the use of the "full employment" phrase.

But to come back, along the line of your questioning, I am still content, although I have added the qualification "at the present stage of things" because I do not know about the future, that there is an enlargement of the job potential as a result of technological improvement, and that the problem is rather in the difficulty people face in getting from the old job in which they are displaced, to one of the new ones.

Representative REUSS. That sounds good, and I wish it were true, but where are these new jobs? I know that in the heavy sectors of industry, we have got close to full, in some cases almost overfull, employment. We are beginning to get bottlenecks.

But I do not find, maybe you do, that skilled widgit makers in area A are prevented from taking skilled widget making jobs in area B simply because there is some distance between the two. What I find is what you so well delineated—that a quarter of our unemployed are teenagers.

Mr. WIRTZ. That is the clearest point.

Representative REUSS. Another great percentage of our unemployed are women and girls, shocking percentages of our unemployed are blacks and Chicanos. I think you could train them to be skilled widget makers until you had spent tens of thousands of dollars on each one of them, and they still would not get a job making widgets because there are not that many widget-making jobs available.

Mr. WIRTZ. As between the two points I would attach indefinitely larger importance to the first.

I would add on the second one only that the truth of the matter is that we know very little about the job vacancy situation in this country.

I think that there are between half a million and a million job vacancies around.

Representative REUSS. My sole point, I want to come at you a bit, is that we very much need programs like emergency unemployment programs which are now unfortunately, completely eliminated.

Mr. WIRTZ. I agree.

Representative REUSS. Because it may well be that the old job-creating power of new machines and equipment is getting thinner than it once was.

Let me throw at you a couple of new things under the sun which may have something to do with that. It used to be that we had a great and expanding export industry in American manufacturing. We supplied, or could, if we had ever wanted to, the whole rest of

the world, and for a while did so. Then, guided by misbegotten tax preferences and equally misbegotten, too longly held overvaluations of the dollar, we let our multinationals buy up factories all over the rest of the world, in Belgium, in Hong Kong and Singapore and Korea and Taiwan, and Spain, and you name it, and so now much of our export business is shot, gone forever, because we make the stuff abroad. Well, there goes what used to be an important segment of jobs.

A second cloud, not much bigger than a man's hand, is the environment. It used to be that we could say, and did say, "Look, the more large tailfin motorcars that can be made and sold the better. We have got limitless resources." Now, you know that we do not, so that it may well be that in the future we are not going to be able to be quite as materialistically showoffedly affluent as we have been and, if so, that is going to make the old style manufacturing job less abundant than it once was.

So we need to do more by way of compensation for the work of the machine than we used to do. I am not suggesting becoming a Luddite.

Mr. WIRTZ. I have said in my prepared statement that I would unqualifiedly support the enlargement, which you and Senator Humphrey and others are proposing, in the public employment program. I know Mr. Linowitz has an additional point which, with your permission, he would like to make.

Representative REUSS. Yes; I would like to hear from him.

Mr. LINOWITZ. Thank you. I would just like to add a comment on that question. I am on the board of the National Alliance of Businessmen. As you know, the national alliance summoned by the President, has been given the job of trying to find jobs for the disadvantaged, for the untrained veterans, and minority groups.

It has put thousands of such young people and middle-aged people to work. The reason the national alliance has undertaken this project is because the Government has attached the highest priority to manpower training and to taking young apprentices and developing them for future usefulness in American industry.

It is of the greatest significance that if that seems to be a copout on the part of the administration in terms of this priority, in terms of the importance of doing what must be done in training future manpower, then American industry is not going to have the same kind of commitment and leadership which led it originally to come together in the National Alliance of Businessmen.

Representative REUSS. Let me turn now to Mr. Hamilton on a related matter. What use has New York City been making of the public service employment program and how will the proposed elimination of the program at the end of this fiscal year affect you?

Mr. HAMILTON. We have about 3,300 slots under the Emergency Employment Act which are divided throughout the government. The largest single use of them was about 500 teachers, but the rest of them are among every possible pursuit in the government ranging from transportation workers to health workers, to the off-track betting corporation which has a few. They are all over the place among our labor force.

What it would mean very simply if the Emergency Employment Act is allowed to die at the end of this fiscal year, is that about 3,000

people will be out of work and we have no reason to believe, we certainly have no funds of our own or of anybody else's to pick them up, we have no reason to believe——

Representative REUSS. How kindly do you take to Chief Economic Adviser Stein's assertion that you will be able to take care of this with general revenue sharing?

Mr. HAMILTON. Absolute nonsense, Mr. Reuss. In our case the general revenue sharing adds up to a little less than 2 percent of our budget. I tried to say a few minutes ago that in any single year we usually have a 10-percent gap to fill. General revenue sharing, therefore, is a useful but certainly not overly large increment, and it is swallowed in any single year's problem so there is no possibility of funding these people with general revenue sharing.

Representative REUSS. Thank you very much.

Chairman PATMAN. Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Wirtz, until recently you were a trustee of the Penn Central Railroad, and the following questions are addressed to the fact that you are now in a position to speak out more freely on the Penn Central than when you were a trustee.

First, do Penn Central's labor contracts differ in any significant way from the contracts of other railroads?

Mr. WIRTZ. I will be glad to answer that question, Mr. Widnall, although there may be others about the Penn Central situation which I would feel presently unqualified to speak to.

So far as I know, there is no substantial difference between the Penn Central labor contracts and those of the other major railroads, with the possible exception of a somewhat larger employee protection arrangement which came about as the result of the merger. But that is a relatively small point. The general answer to your question is "Yes."

Representative WIDNALL. The labor problems faced by Penn Central, are they really any different from the problems of any other railroads?

Mr. WIRTZ. The labor problem is more acute with the Penn Central than with other railroads because there is a much larger number of employees per ton-mile or by any measure of that kind. There are a great many more yard crews, for example. I can illustrate the point by referring to the fact that no railroad has ever made a profit serving New York City, because there is such a high concentration of yard costs. In that sense, Penn Central's problems are more acute.

Representative WIDNALL. Indirectly, you are saying New York City should be given back to the Indians.

Mr. WIRTZ. I leave that to Mr. Hamilton.

Representative WIDNALL. They have got problems that just seem unsolvable in so many areas.

How come there are railroads which run at a profit? Don't profitable railroads like the Southern, have labor problems similar to the Penn Central?

Mr. WIRTZ. That was the point of my reference to New York. The money is made in the railroad industry when the situation is one which permits the running of a freight train a long, long way without stopping or going through a yard, and you will find a close correlation between the profitmaking of certain railroads and the length of the

uninterrupted runs. It is when you have to stop every 5, 10 miles or something of that kind, to pick up a car, to break up a train or something of that sort, that the labor costs mount. So there is a difference there, Mr. Widnall, and the Penn Central's problem is more acute in that respect.

Representative WIDNALL. I was bearing down a little bit on Penn Central because this goes up in my own area and the metropolitan area of New York, and I am acutely aware of some of the problems that stem from it.

As I understand it, there are three prerequisites for profitability of the Penn Central and they have been put forth by the trustees on various occasions. Substantial abandonment of unprofitable ones, No. 1; reduction in the labor force, No. 2; and full compensation for passenger service, No. 3.

Mr. WIRTZ. Yes, sir.

Representative WIDNALL. Are you free to comment on how far along the Penn Central is in attaining any of these goals?

Mr. WIRTZ. I should make it clear that I have had little active association for a period of about 8 months now with the Penn Central but, yes, I think I can, just from having read the reports, give you the present situation on that. As far as the first condition is concerned, the present Penn Central system is 20,000 miles of line. It is estimated that it should be some place between 11,000 and 15,000. We have, I should say they have, presently before the ICC a request for the abandonment of 3,000 miles of track; 800 of them have been approved. So on the cutting from 20,000 down to either 15,000 or 11,000, so far it is about 800 that have been approved.

On the second condition as far as labor costs are concerned, there has been a substantially larger change. The employment at Penn Central in mid-1970 was about 95,000. That figure is down now to about 80,000 from 95,000. A good deal of that has been in the nonoperating employees, but it is also true that the fireman dispute is now settled. They are going off on an attrition basis, and that problem has been met.

The so-called full crew laws in three States, which 2 years ago required very large crews, have been repealed. There has been that gain. The train crew issue, setting it off from the engine crew question, is presently in dispute. It caused a 1-day strike and is now before Congress. So there has been a substantial gain made so far as labor costs are concerned, but the rest of that story is there are still about $100 million a year of train crew costs which, in my judgment, cannot be justified.

In respect to the third condition, the arithmetic is roughly this: The loss to Penn Central in 1970 from the intercity and local commuter passenger service was about $132 million on an ICC basis. The Amtrak legislation cut that, but still left intercity losses at over $30 million last year. There is still remaining what I think, on the fairest accounting, amounts to a loss properly allocable to all passenger service of about $87 million a year, which has not been picked up.

So, in short, there has been virtually no gain with respect to the first condition of viability. There has been substantial improvement with respect to the third remains only a little better than it was when the Amtrak legislation was passed, and there is still a short fall of $87 million a year in costs.

Representative WIDNALL. Thank you. I appreciate having that for the record.

Mr. Wirtz, we are talking about jobs and the people who are in the various categories who are unemployed today. Isn't it true there is a hard core of unemployed of about 1.5 percent? And when we are talking about 5 percent unemployed today, the difference between 1.5 and 5 is a shifting population in that group. There are people who are not unemployed for a long period of time, and they are not a group that needs all the help that comes with much of the legislation that we have passed. So that our real main problem is that hard core and whether or not they are employable, whether or not they can be retrained, and what can be done for the future.

You said, I think I understood you to say, that we just don't understand what jobs are available yet. I can remember a number of years as a Congressman saying why isn't a job inventory taken and there was a reluctance on the part of those who were in the administration, I don't care what administration it was, to have a job inventory, to tell us whether the jobs were available and the type of jobs that were available, and I think there is a reluctance of labor to have this taken because if there was a showing that a great number of jobs were available it would remove some of the pressures for increased rates and benefits in order to get people to work in the job force.

Isn't it true that there still hasn't been a true job inventory taken?

Mr. WIRTZ. My recollection of the record is a little different but it is substantially the same on the background, Mr. Widnall. We came up here all through the sixties every year to the Appropriations Committee asking for an appropriation to make a job vacancy study. It was not the administration, either administration, that was opposed to it. The labor people did object to it and through the Appropriations Subcommittee were able to get it stopped. That is the background.

Now then, that picture changed in about 1969 or 1970. There is now a job vacancy study being made. It is apparently showing a much smaller number of job vacancies than was expected.

But, in answer to your question, we are now approaching an understanding of what the job vacancy situation is and it is turning out to involve fewer job vacancies than we had expected.

On your first point, I would agree that there is a real problem of people untrained and unprepared for the work which is available. I guess it is one of the advantages of having my future behind me in my business, that I can say a little more pointedly than was always politic that our emphasis on the economy being in default sometimes leaves out too much of the fact that our training system is incomplete.

Representative WIDNALL. Mr. Chairman, might I have unanimous consent to proceed for 1 more minute?

Chairman PATMAN. Yes; without objection, so ordered.

Representative WIDNALL. It has been my own observation that there are hundreds and probably thousands of people who are working today of whom there is no record, who are being paid in cash, they are not carried on any ledger, they are taking jobs that are paying them pretty well, for instance a lot of landscape people, gardeners and the like, and people who perform personal services. Yet they are added in the total of unemployed, and the unemployed figures do not reflect the thousands that are doing very well and by choice they don't

want to be covered by the various umbrellas we put over their head.

Would you have any observations on that?

Mr. WIRTZ. It is true that some of the work which is done is not recorded. It is also true, Mr. Widnall, that quite a lot of unemployment is not reported. In the present form we report those who are "looking for work and unable to find it," but we do not count as employed those who have given up and are out. My guess is that the two omissions may just about wash.

I would like to make the point that we ought to be talking about the use of the whole human potential, and then the unemployment rate is 50 percent instead of 5.

Representative WIDNALL. Thank you.

Mr. WIRTZ. That is ahead of us.

Chairman PATMAN. I would like to interrogate the members of this distinguished panel but I am unable to do so on account of laryngitis, and I ask unanimous consent that my time may be transferred to Mr. Proxmire so he will have 20 minutes, and without objection it is so ordered. Mr. Proxmire.

Senator PROXMIRE. Along that same line, Mr. Wirtz, isn't it true that the real disgrace and shame of our unemployment picture is that when we compare it with any other industrialized country in the world, except Canada which is dependent on us——

Mr. WIRTZ. That is correct.

Senator PROXMIRE. The fact of the matter is our unemployment is twice as high as most of the rest of the countries, and literally five times as high as in Germany, three times as high as in Japan, and they have problems too of people who are in one way or another hard to employ or don't have much skill or don't have much intelligence or don't have much self-discipline, and yet Germany has had unemployment which has been less than 1 percent for 10 consecutive years, and our unemployment has been consistently five times higher than that.

It is just clear to me under those circumstances that we are not providing sufficient, adequate demand, effective demand, so that we can provide jobs. You may be right in your frictional unemployment being as high as 2 to 3 percent because of the nature of our society, maybe that is possible.

Mr. WIRTZ. Two percent.

Senator PROXMIRE. But I don't think there are another 1½ percent who are unemployable.

Mr. WIRTZ. No; I don't either.

Senator PROXMIRE. Now let me ask Mr. Hamilton, you gave us a very helpful list at the end of your statement of areas where we could cut, and I would like to ask you if you could add a few.

I agree with you on defense although I think $7 billion is too deep, if we keep it at its present level we would be doing fairly well. That would give us a $5 billion cut that would help us with other priorities significantly.

Foreign military and economic aid—I was the head of that Foreign Appropriations Subcommittee of the Appropriations Committee for several years and I made a study of how much foreign aid we had, nobody knew. We finally found out it totaled $10 billion, not the $3.8 billion or $3.4 billion in the budget, but $10 billion; $6 billion of foreign military aid, $4 billion of foreign economic aid.

There are a lot of wonderful programs, Peace Corps, food for peace, some of our technical assistance programs but there is also a tremendous amount of waste here especially in the military foreign aid sector. There it would seem to me, we can cut at least $3 billion. You see this is scattered in various budgets not just in the aid budget, it is in the defense budget. We have $2.5 billion there for Southeast Asia with the war over.

In addition we have, in various other budgets scattered all over the place, $10 billion. Would you add part of that?

Mr. HAMILTON. Just on that point, I would agree with a good deal of what you say. I spent a long time in the foreign economic aid business. I was Executive Director of the Pearson Commission, you may remember.

Senator PROXMIRE. Yes.

Mr. HAMILTON. In 1969.

Senator PROXMIRE. Yes; and the multilateral agencies, I would say we can provide even more assistance perhaps.

Mr. HAMILTON. That is right. I have a history in this area and, therefore, my views are somewhat more specialized, but so far as the part of your point that had to do with military aid, I couldn't agree more, particularly Southeast Asian military aid. I think most of that is easily dispensable and, on the whole, would not hurt the foreign policy stance of the United States at all.

Senator PROXMIRE. It is in this budget, in this 1974 budget.

Mr. HAMILTON. That is correct.

On the question of official development lending, which is, I regard as the single most important foreign aid program, I don't think the President's proposals are too high, I think they are too low.

Senator PROXMIRE. For the what?

Mr. HAMILTON. I would argue that the President's proposals with respect to official development lending in the budget are not too high, they are too low. I think that priority is a reasonable competer against the ones I was talking about.

Senator PROXMIRE. If we can find a place where we can make it efficient, development aid, I would be for it but I think it would be hard to find.

I think technical assistance has proven itself with these underdeveloped nations. I doubt if the development aid is a real winner now.

How about highways. We have pumped $4½, $5 billion a year into highways and it is just choking our cities. We go on and on in this trust fund. It is kind of a mindless situation, we don't consider it. Can't we cut $1 billion of our highways spending?

Mr. HAMILTON. If you mean highways; yes. If you mean transit——

Senator PROXMIRE. Not cut $1 billion out of our highways, and transfer another $1 billion to transit.

Mr. HAMILTON. I believe what the President proposes for transportation could be spent very well if we devoted a good deal of it to mass transit.

Senator PROXMIRE. How about urban renewal which has displaced as many homes as it has housed. It is a good way for mayors to pretty up their cities, to provide luxury apartments and office buildings in place of where the poor lived, but it has not done the job. It has created

a situation where you have land laying idle for years and years; it its a slow-moving program and a program of very serious questions as to whether it is a good use of our resources.

Mr. HAMILTON. Well, the President has already cut out a good deal of urban renewal.

Senator PROXMIRE. Why not cut all of it out?

Mr. HAMILTON. You don't feel it for several years but you have to keep in mind if you are in the practical business of trying to get sites for new housing or new projects in cities, urban renewal turns out to be, with all its problems and all its delays, the most effective single thing.

Senator PROXMIRE. I think public housing is fine. I think that is a program we could invest more in but urban renewal, you don't end up with sites for poor people to live in.

Mr. HAMILTON. Well, in my particular——

Senator PROXMIRE. Very rarely.

Mr. HAMILTON. In my particular area if you were choosing between public housing and urban renewal you would certainly choose public housing, that is correct.

Senator PROXMIRE. How about Hill-Burton? Can't we cut that out?

Mr. HAMILTON. Well, the Hill-Burton program does not affect our jurisdiction very much; therefore, I can't speak in terms of its direct effect.

Senator PROXMIRE. We have indications from GAO which indicate there are hospitals which have wasted a whale of a lot of money in this area.

We also have a serious medicare abuse; room care in New York is $200 a day, and in the country it is rising, but people who don't need to do so stay in hospitals because their insurance covers it.

Mr. HAMILTON. I would agree with you, Hill-Burton is one of the places where it can be cut but I must say very quickly it is not my ox being gored in that process.

Senator PROXMIRE. Just yesterday, there was a story of a doctor in Washington who got $200,000 in medicaid payments last year and a whole flock of doctors got more than $20,000, and there is a lot of abuse where doctors can make visits and charge where the sky is the limit. Isn't this a place we can make a cut?

Mr. HAMILTON. Yes, but keep in mind the things that distort medicare and medicaid programs are penny wise and pound foolish, the things that make doctors have huge contingents of medicare and medicaid patients is because the fee schedule is so low the only way they can make what is regarded as a fair income is by treating fantastic numbers of people. The Federal and State Governments tend to set the rate so low that nobody but the machine assembly line doctor will come into the area. As a result you will get a small number of doctors handling most of the medical workload. It is a big loss factor, you are right, but you don't solve it by the obvious ways of cutting fee schedules.

Senator PROXMIRE. Well, I do think that there are areas where we can provide some disincentive for what seems like a flagrant cost overrun.

Mr. HAMILTON. Yes.

Senator PROXMIRE. How about the Law Enforcement Assistance Agency? Here is a program that has expanded geometrically in costs. The Federal Government in an area where every Member of Congress votes for it, all of us do because we are all against crime and in favor of law and order, but instead of providing for a program which was supposed to be aimed at national research in this area, we simply provide money that localities can use for any purpose—increase the chief's salary, buy another squad car, whatever they wish.

Mr. HAMILTON. Well, our experience has been that the LEAA money has been very useful; that it has been a little too concentrated in terms of the priorities the Federal Government applies on hardware and not enough on the software, that is increasing the capacity of the individual policeman, but I certainly am not going to make a case against LEAA money because it has been terribly useful to us in an area where there is a greater concern than probably any other single program area.

Senator PROXMIRE. How about economizing on our environmental program by providing for effluent charges or tax?

Mr. HAMILTON. For it 100 percent.

Senator PROXMIRE. There you would put the burden on those who use the product that produces the pollution.

Mr. HAMILTON. That is correct, and I think that is a much more effective way than the administrative tribunal.

Senator PROXMIRE. So water wouldn't be a free goods.

Mr. HAMILTON. That is right, and air and noise, et cetera.

Senator PROXMIRE. How about eliminating sugar subsidies?

Mr. HAMILTON. Excellent idea, Senator.

Senator PROXMIRE. How about a proper discount rate on government projects. Instead of having this artificial situation in which government projects are funded if they will yield 4, 4½ percent, they would go up to 7, 8 percent as virtually every economist, conservative, liberal, agrees misallocation of resources.

Mr. HAMILTON. Quite correct.

Senator PROXMIRE. How about maritime subsidies?

Mr. HAMILTON. Maritime subsidies have been a national scandal for a decade at least.

Senator PROXMIRE. How about the airway charges? Air travelers are about the most affluent people in our society, they should pay closer to the real cost of air fare transportation.

Mr. HAMILTON. Well, our feeling is the ease of air travel to our headquarters type city operation is essential; we don't want the load on air travelers to be higher; therefore we don't want, as Newark has testified, to enact an airport tax.

Senator PROXMIRE. You can't testify for that from an equity standpoint. User charge would be more——

Mr. HAMILTON. Well, remember the national interest and equity to the taxpayer across the country is in part a function of the economic activity is the major centers, and the major centers depend enormously on air travel. I would be very careful about choking that off or in any way restricting it.

Senator PROXMIRE. We are not going to choke that off the way it is growing.

How about this budget, it contains not $28 million, as the press continues to call it or $32 million, but actually $42.5 million for the supersonic transport.

Mr. HAMILTON. That is correct.

Senator PROXMIRE. $28 million which the NASA Subcommittee, of which I am chairman, handles and $15 million in the Transportation Department budget. That is $42 million for the SST when just yesterday American Airlines canceled and we recently had all these other airlines canceling the Concorde, so we don't have this competition factor. I think maybe we could go along with a $15 million of research in the area of environmental problems but the rest of that money is development money for the supersonic transport. You agree that ought to be knocked out too?

Mr. HAMILTON. That is correct.

Senator PROXMIRE. I agree.

Mr. HAMILTON. I agree with you.

Senator PROXMIRE. You referred, in your statement, to the lack of credibility, the disappointed expectations on revenue sharing, that you had been promised a revenue sharing program, that it wouldn't be reduced by cutting other programs. Yet we hear that overall there is a $12 billion surplus that the cities and local governments have. We have a big deficit in our Federal operations but the cities and local governments as a whole have a surplus. Maybe that isn't true in the big cities.

Mr. HAMILTON. No.

Senator PROXMIRE. But it is certainly true overall, and from that standpoint it seems to me revenue sharing, I voted against it, it doesn't make any sense.

Mr. HAMILTON. Let me try to explain that. There is overall a surplus, that is correct, but it is terribly important there to distinguish between the States and cities in the first place.

Senator PROXMIRE. Yes, but it is your problem with the States. The Federal Government can hardly intervene there; can it?

Mr. HAMILTON. Well, if you take our State, for example, our State is 60 percent dependent on income taxes. That means in a very bad year, as 1969 and 1970 were, the State is in very serious trouble. You may remember the government had 30 percent less money than needed to finish the fiscal year about halfway through the last fiscal year. Therefore, there were two very large State tax increases in order to make up the deficit.

Now, this year, New York State has a surplus of something between $250 and $400 million.

One of the ways that he was able to get through the deficit years, aside from raising taxes, was by rolling forward expenditures through a series of fairly complicated borrowing mechanisms .Therefore, what appears as a surplus in this next year's budget from his point of view is simply enough revenue to get back into what might be called accounting honesty or accounting, good standard accounting practices for the 2 years in which he skated through or rolled over expenditures.

Now a lot of States have that problem. Our particular State, of course, has a very, as you know, high tax structure. A New Yorker is taxed more per capita than any other jurisdiction in the country. So that a lot of that surplus is simply unreal. But in no case does it extend

to the cities because the cities are not that dependent on income taxes. Therefore, they do not get the big fiscal dividends in good years and the huge fiscal problems in bad years. So that we have no surplus at all. We have a very serious gap.

Senator PROXMIRE. We have a problem here, we had testimony before the Joint Economic Committee last year or the year before last in which mayors would come in from Newark and Cleveland and from other cities just singing the blues and it would break your heart to listen to them. And yet these are some of the richest States in the country. They have all kinds of money, far more than Wisconsin has. Wisconsin has a very high tax rate, one of the highest, very high property tax rate and yet we are required to pay higher taxes because these rich States like New York and New Jersey and Ohio can't do the job themselves.

Mr. HAMILTON. Well, New York's tax rate is a good deal higher than Wisconsin's.

Senator PROXMIRE. New York I would observe is not a good deal higher, it is about on a par if you look at the taxes.

Mr. HAMILTON. As I recall, the total per capita tax burden is about $700, the total in Wisconsin is about $550.

Senator PROXMIRE. We relate it to income, and our income is lower than yours so tax rates are comparable.

Mr. HAMILTON. Well——

Senator PROXMIRE. At any rate, I would ask you to consider if you could do this, and perhaps you could file this as an additional statement to your remarks, consider the possibility of going over your budget in the most realistic way you can and see if there are programs that can be reduced, and it would be especially telling and effective if you could give us any program that would affect the city of New York directly in a way that we could have more efficiency.

Mr. HAMILTON. Happy to do that.

Senator PROXMIRE. I say that because we get the impression that if you gave New York twice as much or three times as much or four times as much you would still be in terrible difficulty, financial difficulty. There would be just no end to it. We would just go on and on. Somehow it is a city that is unmanageable, ungovernable. There is no amount of money that can solve your problems, and I am sure there is not; that attitude may not be correct.

Mr. HAMILTON. Well, let me respond very quickly.

Senator PROXMIRE. But it is a tough one——

Mr. HAMILTON. To overcome, certainly.

Senator PROXMIRE [continuing]. To avoid or to counteract.

Mr. HAMILTON. Let me respond very quickly to that. New York's financial situation this year is considerably better than it was at the time that you had the hearings you are talking about. Mayor Lindsay appeared at those hearings.

However, what I have been trying to convey is there is a chronic problem with respect to cities in general, and New York in particular. Although New York's problem is not as bad as Newark's, or Cleveland's or Philadelphia's or some of the others proportionately, still there is a chronic problem and the only way that chronic problem is eventually going to be met is by a change of labor and responsibility among Federal, State, and local levels.

We in New York City are still paying $700 million a year in city tax money, the only city in the country that pays its own tax money, to support the public assistance program.

Now that kind of thing multiplied several times will produce an annual chronic problem. I have no apology for that, but I would match our efficiency in solving these problems against any jurisdiction you would wish to name, and our ability to manage our programs against any public or private enterprise.

Senator PROXMIRE. Mr. Linowitz, do you see any cuts recommended by the President that you would want to approve? For instance, the educational impacted area that I would approve?

Mr. LINOWITZ. Yes.

Senator PROXMIRE. There are some other areas where the President is making cuts that are constructive and useful——

Mr. LINOWITZ. Yes, there are a number of areas where the President has acted quite properly and said these programs are no longer worth continuing. You mentioned some in your interrogation of Mr. Hamilton, impacted aid and Hill-Burton and some others.

But the point I would like to stress, Senator, what we are undertaking to do if we follow this budget is allocate large chunks of money under these four general rubrics and then in effect say, "You, the local communities and the States, undertake to do what you want with this money under these general headings." This is not a way to economize. This is not a way to assure that things are being done more efficiently. In many ways it is the greatest extravagance to ask for large allocations of funds without any indication of how that money is to be used and without any alternatives being proposed.

We can submit, if you would like, sir, a statement in which we will set up item by item exactly which ones are involved, exactly which ones we think ought to be discontinued.

Senator PROXMIRE. That would be appreciated.

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

AN ALTERNATIVE BUDGET FOR FISCAL YEAR 1974

SUMMARY

In accordance with a request made by the Joint Economic Committee to Sol M. Linowitz, Chairman of the National Urban Coalition, the Coalition staff undertook to evaluate the administration budget for fiscal year 1974, and to recommend changes in spending priorities.

We limited our objectives. Except where policy issues or longer-range spending priorities are involved, we focus on outlays for fiscal year 1974—the amount of money the Federal government will spend next year—rather than budget authority (appropriations) or obligational authority (funds committed but not spent by the administration).

We do not address every program in the budget or even every governmental function.

We do not deal systematically with fiscal year 1973 impoundments and rescissions proposed or made by the administration; many of these are still unresolved.

We have not taken account of possible tax reform.

We propose no overall increase in Federal spending in fiscal year 1974. Our alternative budget reorders priorities within the spending ceiling of $268.7 billion proposed by the President.

Because we are mainly concerned with outlays for the next fiscal year, we do not address in great detail several programs—national health insurance, for example—which we endorse but doubt will be enacted in time to result in any substantial spending in FY 1974.

This is a minimum Alternative Budget, in our view. Further evaluation and reflection would undoubtedly suggest other program areas in which increased or reduced spending could be recommended.

Rationale for reordered priorities

In deciding how to reorder the spending priorities rocommended by the Administration for FY 1974, we were guided by several principles and observations.

First, as the National Urban Coalition has declared before, the United States ought to pursue six goals as a nation:

To achieve full employment with a high level of economic growth and reasonable price stability.

To provide all citizens with an equal opportunity to participate in American society and in the shaping of governmental decisions affecting their lives.

To guarantee that no American will go without the basic necessities: food, clothing, shelter, health care, education, a healthy environment, personal safety and an adequate income.

To rectify the imbalance in revenues between the Federal government and state and local governments.

To assure adequate national security against military threats from abroad.

To meet our obligations to assist in the economic development of the world's less-developed nations.

We believe, second, that the Federal government bears a greater responsibility than any other institution in our society to ensure that the basic needs of disadvantaged citizens are met.

Third, we share the belief of the Administration that some Federal programs are so narrowly drawn and exist in such profusion that they could logically be consolidated, resulting in more efficient use of Federal dollars at the level. But consolidation of programs does not require relinquishing Federal commitments to specific goals. Where grant consolidation seems logical, we generally prefer to move to block grants, under which Federal objectives and purposes are specified with considerable precision, but which allow local governments more latitude that they now possess, in many cases, to decide how these objectives will be carried out.

Fourth, we believe that considerable new social research and experimentation ought to be conducted and supported by the Federal government. Many of the principles on which existing social and economic assistance programs are based have been called into question in recent years. We need to know far more about how a number of social and economic assistance programs actually affect their intended beneficiaries, and to test a variety of new proposals for economic and social aid.

Fifth, and a closely related point, we do not believe that the inadequacies of essential social and economic assistance programs justify abrupt reductions in spending, or termination of programs mandated by law. Neither the real needs of American citizens nor the need for reform and redirection of social and economic assistance are served when expectations and orderly plans are disrupted suddenly.

The alternative budget: A summary

Table 1 compares Administration Budget outlays for FY 1973 and FY 1974 with the outlays recommended by the National Urban Coalition.

In overall terms, we propose shifting $5.1 billion from defense and $1 billion from General Revenue Sharing to eight Federal domestic functions.

In summary, these are our recommendations:

National Defense.—Cut military manpower by 300,000 men over the next fifteen months, for a savings of $1.6 billion. Reduce associated operations and maintenance costs by $600 million. Simultaneously, substantially reverse "grade creep" by moving 50 percent of the way toward restoration of the grade distribution of FY 1964, the last "peacetime" year before the manpower buildup for the war in Southeast Asia, for a savings of $600 million. Terminate or stretch out development or procurement of nine strategic and tactical systems, for a savings of $2.3 billion. In sum, reduce defense outlays by $5.1 billion in FY 1974.

Agriculture and Rural Development, Natural Resources and Environment.—Increase commitments for water and sewer capital grants in FY 1974, which will result in increased outlays in FY 1975. Sustain the loan subsidy program for rural housing at the FY 1974 level (at no additional outlay cost on the assumption that loan repayments and mortgage sales will equal funds lent).

Commerce and Transportation.—As the Administration Budget proposes, open

the highway trust fund for mass transit needs, and spend additional direct outlays for mass transit development. No increase in outlays recommended.

Community Development.—Reverse the decision to terminate commitments for community development programs. By FY 1975, consolidate six physical development programs into an urban development block grant program that preserves Federal purposes. Continue Model Cities as a separate Federal aid program. Initiate experiments with Metropolitan Community Development Corporations. Continue funding comprehensive planning grants directly to metropolitan councils of government. Increase outlays from $2.2 billion to $2.7 billion in FY 1974.

Office of Economic Opportunity.—Keep OEO intact as a Federal agency and increase its funding to $800 million in FY 1974.

Housing.—Reverse the decision to terminate commitments for the four Federal housing subsidy programs. Consider development of a housing block grant program. Initiate additional experiments with alternative ways of subsidizing housing requirements for low- and moderate-income households. Add $300 million to outlays for FY 1974.

Education.—Maintain Title I of the Elementary and Secondary Education Act and vocational education programs intact, and increase Title I funding to $2.5 billion. Increase funding for emergency education assistance to $500 million. Keep the library subsidy program as a separate categorical aid program. Double expenditures for bilingual education and increase early childhood education expenditures by 50 percent. Continue the strong support proposed by the Administration for Basic Educational Opportunity Grants but fund supplemental student aid. Add $1.2 billion to outlays for education in FY 1974.

Manpower and Employment.—Proceed with the essentially sound Administration proposal for consolidation of manpower training programs, but increase the funding for those programs. Reverse the decision to terminate the public service employment program authorized by the Emergency Employment Act. Add $1.2 billion to manpower and employment outlays in FY 1974.

Health.—Substantially increase the funding for health education and training—especially for paramedical training. Restore $75 million for Medicaid and $616 million for Medicare that the Administration proposes to save. Continue the community mental health program and restore funds for it that would be cut. Continue commitments and funding for the construction of health facilities, including Hill-Burton, but redirect the latter program to the upgrading and construction of health facilities in disadvantaged communities. Add $1.1 billion to health outlays for FY 1974.

Income Security.—Beginning late in FY 1974, initiate a program of welfare reform—specifically the Ribicoff-Administration compromise plan of last year—that would guarantee a Federal floor of $2,600 for a family of four. In FY 1975, raise the floor to $3,000 and provide wage supplements for the working poor. Provide full funding at the level of $2.5 billion for grants to states for social services for recipients of public assistance. Add a total of $1.1 billion to outlays for income security in FY 1974.

Veterans Benefits.—Reverse the proposal to cut over $200 million from veterans' pensions in FY 1974.

Law Enforcement and Justice.—Substantially reform the Law Enforcement Assistance Administration by requiring far more emphasis on personnel rather than hardware, on civil rights, on community assistance to law enforcement planning, and on other reforms of the criminal justice system. No increase in outlays is recommended.

Civil Rights and Equal Opportunity.—With very sharply increased outlays proposed for next year, no increase in funds is recommended. What is necessary is a sharp escalation in the commitment of the Federal government to enforcement of civil rights laws and provision of equal opportunity.

General Revenue Sharing.—Because of the present huge state revenue surpluses, reduce outlays for General Revenue Sharing for one year by $1 billion and apply this amount to the urgent public needs identified elsewhere in the Alternative Budget. Modify General Revenue Sharing to exclude payments for low priority needs, and shift the savings from this reform to more urgent needs.

TABLE 1.—ADMINISTRATION AND ALTERNATIVE BUDGET OUTLAYS FOR ALL FEDERAL FUNCTIONS AND PROGRAMS

[In billions of dollars and fiscal years]

Program or function	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974	Difference between administration and NUC outlays, 1974
National defense	76.4	81.1	76.0	−5.1
International affairs and finance	3.3	3.8	3.8	
Space research and technology	3.1	3.1	3.1	
Agriculture and rural development	6.1	5.6	[1] 5.6	
Natural resources and environment	.9	3.7	3.7	
Commerce and transportation	12.5	11.6	11.6	
Community development	2.1	2.2	2.7	.5
OEO	.7	.3	.8	.5
Housing	1.1	2.3	2.6	.3
Education	6.6	6.9	8.1	1.2
Manpower	3.9	3.3	4.5	1.2
Health	18.9	22.5	23.6	1.1
Income security	75.9	82.0	83.1	1.1
Veterans benefits and services	11.8	11.7	11.9	.2
Interest	22.8	24.7	24.7	
Law enforcement	1.6	1.9	1.9	
Other general Government functions	4.0	4.1	4.1	
General revenue sharing	6.8	6.0	5.0	−1.0
Allowances for contingencies	.5	1.8	1.8	
Duplications [2]	−.9	−.8	−.8	
Undistributed intragovernmental transactions	−8.4	−9.1	−9.1	
Total	249.8	268.7	268.7	

[1] We recommend a $1,000,000,000 increase in outlays for subsidized rural home loans, which would be offset by loan repayments and mortgage sales of an equal amount.
[2] Certain outlays we included under health duplicate expenditures also included under a number of other budget categories.

Note: Numbers may not add to totals due to rounding.

NATIONAL DEFENSE

In spite of an end to the war in Southeast Asia, progress toward improved relations with the Soviet Union and China, and continuing reductions in the requirements for military manpower, defense outlays estimated by the Administration will climb from $76.4 billion in FY 1973 to $81.1 billion in FY 1974. We believe that substantial reductions in these outlays could be made next year.

Military manpower

Considerable savings could be derived from a reduction in military manpower of 300,000 men by the end of FY 1974, which would bring force levels down to about two million men, the level recommended by *Counterbudget* as the appropriate force level to be achieved by the end of FY 1973 and maintained through FY 1976. Other defense analysts have recently made the same recommendation. Assuming the reduction was carried out at a constant rate from April 1, 1973 through June 30, 1974, assuming, for the moment, no redistribution of the present rank configuration, and making allowance for increased retirement pay outlays, outlay savings in FY 1974 are estimated at $1.6 billion.

Additional outlay savings in operation and maintenance costs associated with this manpower reduction are estimated at $600 million.

The present distribution of military manpower by rank is substantially skewed toward higher enlisted and officer grades, by comparison, for example, with the distribution of grades in FY 1964, the last year before the sharp increase in manpower for the war in Vietnam. The principal reason is that, as American involvement in the war has wound down, lower-ranking enlisted men and officers have left the service in disproportionate numbers, while higher-rankng career personnel have remained in. Now that peace has been restored, we believe this tendency toward "grade creep" should be reversed. If, by the end of FY 1974, grade distribution was restored to the grade pattern of FY 1964—to that of the last "peacetime" year—at the same time that total manpower was being reduced by 300,000, an additional outlay savings estimated at over $2 billion could be realized.

Actually achieving such a redistribution over the next fifteen months would probably prove difficult, however, and the cost of separation pay and additional retirement pay would reduce savings substantially. We propose that, by the end of FY 1974, half of the process of restoring the FY 1964 grade distribution be achieved, at an estimated outlay savings of $600 million.

Other defense savings: Research, development and procurement

Without detailed information on the full cycle of past and proposed outlays for research, development and procurement of weapon systems and other military hardware, and without similarly detailed information on the amount and duration of obligations incurred by DOD with contractors, it is impossible to be precise about the outlay effect—especially the short-term outlay effect—of a decision to terminate or stretch out development or procurement of a specific item of military hardware.

We were able to obtain from DOD only part of the information needed for precise calculations—outlay estimates for FY 1973 and FY 1974 for selected, but not all, weapon systems. Our outlay savings estimates at the end of this part take these figures into account and grant generous leeway for costs associated with our recommended reductions and extensions.

Trident Submarine and Missile.—Because the present Polaris-Poseidon fleet is virtually invulnerable, has a life-span that will make it useful well into the 1990's, and no new anti-submarine warfare system is on the horizon, we recommend terminating development of the follow-on Trident submarine. Research and development should continue, however, on the longer-range (4,500-mile) Trident missile, so that it can be retrofitted into the Polaris submarines, in order to give these submarines a substantially increased operational range. DOD projects the ultimate cost of a 10-ship Trident system at $13.5 billion, and it estimates FY 1973 outlays at $451 million and FY 1974 outlays at $817 million.

B-1 Bomber.—Development of the B-1 is being defended on the grounds that the nation will eventually have to replace the present bomber force, including the newer B-52 G/H class planes, that the B-1 will fly faster than the B-52, and that the construction of the plane will add significantly to the nation's nuclear strike capacity. None of these arguments justify building the plane, especially in light of the $11 billion ultimate cost projected by DOD. Modernization is extending the life of the basic B-52 G/H force for another fifteen years and giving these planes a highly sophisticated defense-penetration and standoff missile capability. B-1 development should be canceled. Several years hence, consideration should be given to initiating research on a bomber system to replace the B-52 G/H force in the late 1980's.

DOD estimates B-1 outlays at $375 million in FY 1973 and $442 million in FY 1974.

ABM Procurement and Development.—In view of the SALT accord, and because of the very substantial additional outlays estimated by DOD for Safeguard in FY 1973 and FY 1974, many defense analysts see no justification for completing the single Safeguard site the U.S. is building, at Grand Forks, N.D. We recommend that the deployment of Safeguard be terminated.

Advanced development and hardware procurement of Site Defense, intended to be a more sophisticated system than Safeguard, is inconsistent with the SALT accord, and should be terminated.

Research should proceed, however, on the design of a more sophisticated ABM system, on which DOD plans to spend $111 million next year, to guard against a Soviet breakthrough in offensive missile development—though the possibility of that development is admittedly slight at present.

DOD estimates outlays for Safeguard and Site Defense at $1,080 million in FY 1973 and at $726 million in FY 1974.

Minuteman Upgrading.—The original justification for MIRV's was the need to overcome a massive ABM system the Soviet Union was planning to build. The SALT accord gives ICBM's virtually free ride to target. No reason therefore exists to continue the conversion of Minuteman I to Minuteman II, now over 70 percent complete. The MIRVing program should be halted.

DOD estimates Minuteman I and III outlays at $611 million in FY 1973 and $771 million in FY 1974.

AWACS.—A sophisticated surveillance, command, control and communications system carried in a military version of a commercial aircraft, AWACS was developed to detect and direct the defense against Soviet bombers. In view of other defense priorities, in view of the fact that the SALT accord ratifies the

decision by the U.S. and the Soviet Union not to provide protection against each others' missiles, and in view of the fact that the Soviet bomber threat has remained constant numerically and has certainly declined in overall importance relative to Soviet missiles, there seems no justification for a more advanced warning system. In regard to the argument that AWACS could perform a tactical role, the system is too sophisticated, complex and vulnerable to be used efficiently for this purpose. AWACS should be terminated.

DOD estimates AWACS outlays at $179 million for FY 1973 and $198 million for FY 1974.

Nuclear Carrier.—In spite of improved defensive capabilities now being developed, the fourth nuclear aircraft carrier being requested by DOD seems ill advised, for three reasons. First, except in intervention situations involving no threat of nuclear or powerful conventional attack, carriers are relatively vulnerable systems. A direct or close nuclear or conventional hit would immobilize a carrier and its associated aircraft and support ships. Even a serious threat of attack would require evasive action by carriers that would deny takeoff or landing to their aircraft. Second, in view of the projected billion dollars that the CVN–70 now being requested will cost—exclusive of costs for support ships and aircraft—and in view of the alternative and cheaper option of employing land-based aircraft for the purposes for which the carrier is designed, additions to the nuclear carrier force seem unwarranted. Third, carriers are designed for conventional intervention situations, not for strategic purposes. In light of the Nixon Doctrine, the need for carrier forces should decline, not increase.

DOD projects CVN–70 outlays at $9 million in FY 1973 and $25 million in FY 1974. Budget authority requests of $299 million in FY 1973 and $657 million in FY 1974 clearly indicate that these comparatively modest current outlays represent only the early steps down a very expensive path.

S–3A Antisubmarine Warfare Plane.—The S–3A, a carrier-based antisubmarine warfare jet, is a more sophisticated plane for its purpose than the present force of ASW planes. But the same objections that can be made to carriers, on the grounds of both cost and vulnerability, can be made to the S–3A. Moreover, several defense analysts point out that the land-based ASW force, using the relatively new P–3C propjet aircraft and consisting of 24 squadrons of 9 planes each, can cover an estimated 80 percent of the oceans, making the S–3A a largely redundant system. About 48 S–3A's have now been procured, out of 199 which the Navy wants to purchase. We recommend that further procurement be halted.

DOD estimates S–3A outlays at $402 million in FY 1973 and $472 million in FY 1974.

SSN–688 Nuclear Attack Submarine.—In view of the size and versatility of the present submarine attack fleet, which now consists of 58 nuclear-powered and 24 diesel-powered submarines, in view of the high and increasing cost of the new SSN–688 class submarines—which are twice as expensive as the older Sturgeon class boats, and in view of the probability that the new round of arms talks will take up the issue of limits on undersea strategic systems—further procurement of the SSN–688's should be terminated.

DOD estimates SSN–688 outlays at $360 million in FY 1973 and $710 million in FY 1974.

F–14A.—The F–14A aircraft is carrier-based and designed for fleet air defense against a massive Soviet bomber attack—a very remote contingency, in the view of many defense analysts. For that reason, in view of the high current cost of $16.8 million per aircraft, and, again, in light of the inherent vulnerability of carrier systems, procurement of the plane should be terminated. Procurement of the F–14A's missile, the Phoenix, each of which costs several hundred thousand dollars, should also end.

Although DOD has provided no outlay figures on the F–14A or the Phoenix, we estimate continued outlays of $300 million in FY 1973 and in FY 1974 for the plane and its missile.

Outlays for all systems discussed above for the remainder of FY 1973 would total nearly $1 billion, assuming an equal distribution of spending throughout this fiscal year, and would total $4.5 billion in FY 1974. Assuming action was initiated immediately to implement the recommendations made above, we estimate that outlay savings would amount to $2.3 billion, or about 42 percent of the overall outlay figures for the next fifteen months. Some $3.2 billion would thus be reserved to take account of the difficulty and cost of terminating and stretching out contracts.

Table 2 compares Administration and Alternative defense outlays.

TABLE 2.—ADMINISTRATION AND ALTERNATIVE DEFENSE OUTLAYS

[In billions of dollars and fiscal years]

Program or function	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Manpower	41.8	43.9	41.7
Operating costs (other than payroll)	11.2	11.5	10.9
Investment	21.8	23.6	21.3
Other [1]	1.6	2.1	2.1
Total	76.4	81.1	76.0

[1] Includes military assistance, atomic energy, defense-related activities, and deductions for offsetting receipts.

AGRICULTURE AND RURAL DEVELOPMENT, NATURAL RESOURCES AND ENVIRONMENT

Although budget priorities will not permit an increase in outlays in these areas in this Alternative Budget—with the exception of the rural housing subsidy program—we believe that the substantial underfunding or cuts in several program areas in the Administration Budget should be corrected by FY 1975.

Sewage treatment capital grants

A good example of underfunding can be found in the sewage plant construction grant program. While the Administration Budget shows outlays increasing from $727 million in FY 1973 to $1,600 million in FY 1974, both figures are very substantially below budget authority. We recommend that commitments for sewage treatment plants be substantially increased next year, which would result in very much higher outlays for FY 1975.

Rural housing loans

We oppose the freeze on commitments for the subsidized housing loan program administered by the Department of Agriculture. This decision is as little justified, in our view, as the similar freeze on the urban housing subsidy programs. We recommend that outlays for the rural housing program be continued at about the level estimated for FY 1973—around $2 billion annually—instead of declining by 50 percent to the estimated FY 1974 level of about $1.1 billion. Assuming that loan repayments and sales of mortgages will match disbursements—as the Adminstration Budget inldicates should be the case—we show no increase in outlays for the program.

As Table 3 shows, outlays in these program areas are the same in the Administration and Alternative Budget.

TABLE 3.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR AGRICULTURE AND RURAL DEVELOPMENT AND NATURAL RESOURCES AND ENVIRONMENT

[In millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Agriculture and rural development	6,064	5,572	5,572
Natural resources and environment [1]	876	3,663	3,663

[1] Outlays in this budget category are very substantially offset by income from rents and royalties on Outer Continental Shelf lands and other governmental receipts; such receipts total $5,308,000,000 in fiscal year 1973 and $3,212,000,000 fiscal year 1974.

URBAN TRANSPORTATION

The Administration Budget suggests that legislation the Administration proposes to submit to change transportation priorities would closely resemble the progressive bill that recently passed the Senate with Administration support. The Budget asserts that:

"The present system of categorical highway grants restricts outlays according to the source of funding, and thus may dictate unsuitable local priorities from the Federal level. The proposed legislation will eliminate this funding rigidity, so that cities and states can make capital investments in highways, buses, or

rail rapid transit without regard to whether the Federal source is the Highway Trust Fund or general receipts."

We endorse this objective but would go further, to recommend that funds freed from the highway trust fund be made available for operating as well as capital costs of mass transit.

We also concur in the 30 percent increase in direct outlays for mass transit capital grants between FY 1973 and FY 1974, as proposed by the Administration Budget.

Given other budget priorities, we recommend no change in transportation outlays from the figures proposed by the Administration Budget, as Table 4 indicates.

TABLE 4.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR GROUND TRANSPORTATION

[In millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Mass transit	380	494	494
Highway improvements [1]	4,846	4,677	4,677
Other	337	366	366
Total	5,563	5,537	5,537

[1] Includes both Federal funds and trust funds.

COMMUNITY DEVELOPMENT

As Table 5 indicates, the Administration has terminated commitments for three community development programs and plans to terminate another four by June 30 of this year.[1] As in the case of the housing subsidy programs, outlays for community development projected for FY 1974 would pay only for commitments made prior to the termination dates.

TABLE 5.—ADMINISTRATION OUTLAYS, FISCAL YEARS 1972–74; BUDGET AUTHORITY, FISCAL YEAR 1974; AND STATUS OF 7 COMMUNITY DEVELOPMENT PROGRAMS

[In millions of dollars and fiscal years]

Program	Administration outlays 1972	Administration outlays 1973	Administration outlays 1974	Budget authority, 1974 [1]	Status of program
Urban renewal	1,189	1,000	1,050	138	Commitments to end June 30, 1973.
Model Cities	500	583	600	0	Do.
Rehabilitation loans	39	38	0	0	Do.
Neighborhood facilities grants	23	26	35	0	Do.
Water and sewer grants	134	130	123	0	Commitments terminated Jan. 5, 1973.
Public facility loans	22	20	28	3	Do.
Open space grants	52	57	70	0	Do.
HUD salaries and expenses for community development programs.	23	25	23	23	Continues.
Total	1,982	1,879	1,929	164	

[1] Budget authority requested by administration for 1974.

Source: Administration budget, fiscal year 1974.

In place of the six physical development programs, the Administration proposes to submit legislation to create Urban Community Development Revenue Sharing, to take effect July 1, 1974. While Model Cities would be folded into the new fund, it would not remain a Federally-mandated program.

Aside from the substance of Urban Community Development Revenue Sharing, which we discuss below, the immediate and crucial problem posed by the Administration's actions is the certainty of a drastic reduction in physical development

[1] We have dealt in a separate section with the Office of Economic Opportunity to emphasize our conviction that the poverty program should remain intact.

programs all across the nation, starting at least by the beginning of FY 1975, and possibly earlier. In other words, owing to the long lead time physical development requires between commitments and the start of actual demolition or construction, the suspension of *commitments* until the end of June 1974 will cause a delayed and equivalent suspension of Federal and local expenditures and local development activity.

Both in terms of momentum for physical development, and in terms of income and wages in the construction industry, the hiatus promises to be devastating throughout the nation. One practical example illustrates this point: Local governments logically require that water and sewer lines be built, or at least financed, before they issue permits to contractors to start construction on houses and other buildings which will use those lines. If funds for new water and sewer grants continue to be unavailable, thousands of cities and towns will have to delay starts on a major share of planned private and public building construction for this reason alone.

We therefore strongly recommend that the Administration reverse its decision to terminate community development programs, and that ample new budget authority be provided for each program in FY 1974. That budget authority could be transferred to a consolidated community development program if such a program is ready for implementation in FY 1975. We propose outlays for the six physical community development programs of $1.500 million in FY 1964, $171 million above outlays recommended by the Administration.

Consolidation of community development programs

The question of whether existing community development programs should continue as categorical aid programs is quite separate from the question of funding them so long as they are mandated by law.

With the exception of Model Cities, which we believe ought to remain a separate. Federally-funded program, there is considerable merit in the idea that existing physical development programs should be consolidated and local officials given more discretion than they now have to decide on local priorities and to administer development. To that extent we agree with the Administration.

More specifically, however, starting in FY 1975, we favor a block-grant approach to community development which—much like the bill that passed the Senate last year—supplants the six existing physical development programs and incorporates Federal guidelines and standards providing that a major share of funds be distributed and expended in areas of greatest need.

A block-grant distribution formula should reserve a majority of funds—perhaps 80 percent—for local governments in Standard Metropolitan Statistical Areas. Within that reservation, heavy weight should be given in actual allocations both to an index of economic and social needs—such as the incidence of poverty or unemployment—and to an index of physical need—such as the incidence of substandard housing.

Second, a block-grant fund should require that localities spend a disproportionately high share of their outlays for the benefit of geographic areas in which poor citizens live.

Third, while a reservation of funds should be made for every locality which qualifies, no local government should receive funds until it specifies, in broad terms—not in great detail, as present programs require—how the funds would be expended, and shows that its programs will meet Federal objectives, including improvement of blighted areas, the provision of low and moderate-income housing, and the provision of essential social and community services that must accompany physical development. As a condition for continued grants after the first year, an annual evaluation should be required to determine whether localities are meeting their own goals and conforming to Federal standards. A small matching contribution would be required of localities—on a 90/10 basis, for example—in order to demonstrate local commitment.

Model cities

As it was conceived, Model Cities intended to concentrate and integrate resources for social and physical development in areas of greatest need in central cities, and to give the residents of those areas a far greater share of control over programs designed for their benefit. We believe those purposes remain sound. Moreover, unless the program continues to be mandated and funded at the Federal level, it seems likely it would eventually vanish altogther in competition with physical development programs for local funds. We therefore, recommend ex-

tending Model Cities, and propose outlays of $800 million to fund it in FY 1974, some $200 million more than the Administration would provide.

Experimental metropolitan community development corporations

We recommend that a limited experiment with urban community development corporations be started in FY 1974 to test how well local governments in selected metropolitan areas respond to opportunities to plan and implement community development cooperatively, and to test the idea that Federal funds might be used more systematically to attract many times their value in private investment for planned metropolitan development.

After enactment of appropriate legislation, the experimental program might be conducted in this way: As administering agency, HUD would choose several metropolitan areas whose local governments agree to form a metropolitan-wide development corporation. The corporation would possess the power to plan, finance and build a wide range of improvements, including water and sewer lines, housing for low- and moderate-income households, public buildings, parks, and transit facilities. HUD would make commitments for minimum annual Federal grants for a minimum term of years—perhaps 30 or 40. Development corporations would be empowered to spend or lend Federal contributions and to issue special-purpose indebtedness backed by Federal guarantees. HUD would monitor each participating corporation and issue annual reports on the progress of each experiment.

We recommend outlays of $50 million in FY 1974 to initiate tests with Metropolitan Community Development Corporations.

Section 701 planning grants

Section 701 of the Housing Act of 1954, as amended, authorizes grants which were principally intended to foster coordinated planning for community development. It has been the main source of support for councils of local governments in metropolitan areas, and has stimulated joint resolution of problems and issues that spill over local jurisdictional boundaries, including, for example, air and water pollution, and park and recreational needs.

Metropolitan areas now receive 701 funds directly from the Federal government. States receive funds for themselves and for smaller communities. The Administration Budget proposes, starting in FY 1974, that "all planning and management grants will be made to States, allowing Governors to make suballocations to local governments and other eligible recipients in accordance with State priorities." We oppose this recommendation, because we believe it could well result in sharp reduction and termination of planning funds for metropolitanwide councils of government.

We recommend outlays of $125 million in FY 1974 for the program.

Table 6 compares our budget recommendations for community development with those of the Administration.

TABLE 6.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR COMMUNITY DEVELOPMENT

[In millions of dollars and fiscal years]

Program	Administration estimates		National Urban Coalition recommendations, 1974
	1973	1974	
6 physical community development programs	1,296	1,329	1,500
Model cities	583	600	800
Experimental metropolitan community development corporations			50
Other community development [1]	250	300	[2] 323
Total	2,129	2,229	2,673

[1] Excludes OEO.
[2] Includes $23,000,000 additional for sec. 701 comprehensive planning assistance grants.

OFFICE OF ECONOMIC OPPORTUNITY

The Administration intends to dismantle the Office of Economic Opportunity by abolishing the Community Action Program and scattering all other functions of the agency to new homes in the Federal bureaucracy. Just how the Administration would proceed is summarized in Table 7, presented in the Administration Budget. (Note that dollar figures are obligational authority, not outlays.)

TABLE 7.—OBLIGATIONAL AUTHORITY AND PROPOSED DISPOSITION OF OEO PROGRAMS, FISCAL YEAR 1974

[In millions of dollars]

Program by activities	1972 actual	1973 estimate	Responsible agency, 1974
Research, development, and evaluation	45.0	66.7	Various agencies.
Community action	351.0	285.3	Local option.
Health and nutrition	157.2	165.2	HEW.
Community economic development	26.8	30.7	OMBE.
Migrants and seasonal farmworkers	36.5	36.3	DOL.
Legal services	67.7	73.8	Independent corporation.
General support	18.2	18.5	GSA.
Total obligations, net	702.4	676.5	
Transfers to other accounts	38.3	.2	
Total	740.7	676.7	

Source: Administration budget, fiscal year 1974.

The Administration has already begun to implement its plans, in the expectation that Congress will not override them. Employees of OEO field offices were recently given notice of termination of their employment. Many local agencies funded by OEO are operating on month-to-month grant extensions. Federal agencies which would run the programs to be spun off from OEO are making plans to absorb them.

The National Urban Coalition has consistently and strongly supported OEO. We hope that the process of dismantlement has not proceeded so far that it cannot be reversed. OEO is the only Federal agency whose primary mission is to "strengthen, supplement and coordinate efforts in the furtherance" of a policy to "eliminate the paradox of poverty in the midst of plenty." Its continued existence is crucial.

At the local level, OEO helps poor people to share in the planning and decision-making processes of their communities. They serve on the boards of neighborhood councils, community action agencies and social agencies. They now constitute one of the largest voluntary-action efforts in the country. Their participation has helped make public and private social service agencies more relevant to the needs of poor people, and therefore more efficient and economical. In helping to determine the use and allocation of significant sums of money, they and their community action agencies have exercised an impressive degree of sound judgment and responsibility. This unique and successful effort in citizen participation is the heart of the OEO anti-poverty program. For these reasons, we particularly object to the Administration's plans to end direct Federal support for the Community Action Program. We recommend outlays of $400 million in FY 1974 for the Community Action Program alone.

OEO has been an advocate of the poor. No other organization has done more to champion the importance of the non-professional in our society. OEO has generated leadership opportunities for minority representatives and poor people unmatched by any other agency or institution.

As the Administration has pointed out, some of the activities of OEO—research, health and nutrition programs and programs for migrants, for example—duplicate programs conducted by other agencies of the Federal government. When OEO was founded, the rationale for such duplication was that the agency should try to develop innovative ways of bringing services to poor people and thereby demonstrate how to overcome the bureaucratic inertia and insensitivity that characterize many established Federal programs. It was also thought that by giving OEO control over a diverse range of programs, the agency could develop ways of integrating those programs at the local level, to demonstrate ways of overcoming the typical discontinuity among programs serving the poor that has resulted when independent Federal agencies operate at the local level.

We believe that these goals remain sound. Through its research and demonstration activities, OEO has in fact initiated and supported innovative projects that are becoming an accepted part of public and private social and economic policy. That process should certainly continue. With the exception of the legal services program, which we believe could responsibly be transformed into an independent corporation if the basic aims of the program are not weakened, we therefore recommend that the present functions of OEO be kept under the aegis of that agency.

As Table 8 indicates, we recommend that new budget authority be requested for an intact OEO for FY 1974, and that outlays for the agency next year total $900 million, rather than the $328 million the Administration proposes for the OEO programs it would spin off.

TABLE 8.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR OEO PROGRAMS

[Millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
All OEO programs	694	328	830

HOUSING

The Federal government sponsors four programs to assist low and moderate-income households: rent supplement, home-ownership assistance, rental housing assistance and low-rent public housing.

In terms of accumulated budget authority and outlays, the Administration Budget indicates that substantial increases in housing assistance will occur in FY 1974, as shown in Table 9.

TABLE 9.—ADMINISTRATION BUDGET AUTHORITY AND OUTLAYS FOR HOUSING ASSISTANCE PROGRAMS, FISCAL YEARS 1972-74

[In millions of dollars]

Item	1972	1973	1974
Budget authority	1, 372	1, 800	2, 100
Outlays	1, 120	1, 663	2, 000

Source: Administration budget, fiscal year 1974.

By themselves, however, these numbers are misleading, because, on January 5, 1973, the Administration terminated new commitments for all four programs for 18 months. Outlays for the rest of this year and for next year will pay only for commitments made prior to January 5.

The greatest problem posed by the termination is that the level of new housing assistance will begin to decline, probably quite precipitously, at least by the beginning of FY 1975, and possibly earlier, unless the decision to terminate is reversed or a new housing assistance program immediately replaces the terminated programs. Throughout the nation, plans for expanded housing assistance made by mayors, city councils, community organizations and builders—and not least the poor families for whom housing assistance programs were designed—have had to be abruptly ended. The effect of the termination on the housing construction industry, and thus on local economic growth and employment, will be to depress both.

The Administration's decision to terminate the subsidy programs is based on four objections; according to the Administration Budget, the programs have:

(a) Provided a fortunate few with new housing through subsidies of $700 to $3,000 annually, while other families in the same income range pay more for unsubsidized housing that is not new;

(b) Provided windfall profits and tax shelters to intermediaries in the housing and financial sectors;

(c) Created strong pressures for builders, developers, suppliers and laborers to inflate construction and land costs, causing subsidized housing to cost more than comparable unsubsidized housing; and

(d) Placed families in homes which they cannot afford to maintain, thus straining the family budget.

It is quite true, to take the first objection, that limitations on available resources have produced a serious anomaly, under which only a small proportion of all households whose income would qualify them for benefits actually participate in the subsidy programs. It seems to us that the answer to this

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inequity is not to terminate the subsidy programs, but to restructure them so that households with the greatest need—those with the largest families and lowest income—are served first, and to allocate increasing resources to housing assistance so that a growing proportion of households in need receive benefits. In granting preference to households with the greatest need, care should be taken to ensure that the important goal of economic integration is not lost.

Two responses can be made to the Administration's second objection—that the subsidy programs provide "windfall profits and tax shelters to intermediaries." First, if the Administration means that some intermediaries have derived illegal or unwarranted profits from the programs, that seems to us to argue for far better administrative controls, and, if necessary, legal action against violators. Second, tax preferences of several kinds are available to virtually the entire real estate and construction industry in the United States, not just to those who build or own subsidized housing. Those preferences were reviewed and changed by Congress and the Administration as recently as 1969, one year after passage of the 1968 Housing Act, which established the two newest housing subsidy programs. If the Administration opposes this system of tax benefits, then we believe it should submit corrective legislation.

The third objection—that the subsidy programs have inflated the cost of subsidized housing above the cost of unsubsidized housing—argues for better management and control by HUD. Moreover, this objection leaves unexplained why housing subsidy programs, which benefit citizens whom inflation hurts most, have been selected for elimination from a number of other government-subsidized programs whose costs have risen rapidly—notably, for example, any number of weapon systems being purchased by the Department of Defense.

The fourth objection—that some households cannot afford to maintain subsidized housing—seems to ignore the fact that a principal feature of the subsidy programs is precisely that households pay a low *proportion* of their income for housing. Any evidence that the proportion is too high argues for reducing the family contribution, not for ending the programs, in our view.

We by no means believe that the housing subsidy programs are perfect. Indeed, they have defects that the Administration Budget does not mention. One is that they have done little to provide opportunities for the movement of poor and minority citizens out of central cities and into suburbs. Another is that, in administering the subsidy programs, HUD could go much further than it has to ensure that both the design and location of subsidized housing better meet the real needs of beneficiaries, and to insist that social and other services required by residents of subsidized housing be provided for when subsidized housing is built.

We recommend that the freeze on commitments for low- and moderate-income housing be lifted immediately, and that new commitments continue to be made at a level which will at least sustain the growth in outlays for the subsidy programs that has developed over the past several years. While intensive efforts should be made to reform the housing subsidy programs, they should continue to be funded. Our cities cannot afford a sharp decline in the rate at which housing is provided for poor citizens, much less a termination of the subsidy programs. Assuming that expenditures keep pace with the pattern of outlays between FY's 1972 and 1973, expenditures for FY 1974 should reach about $2.2 billion, some 10 percent above the level of $2 billion proposed by the Administration.

We also recommend that consideration be given to the development of a housing block grant program, which, if implemented, would supplement the existing housing subsidy programs through grants made to local governments, would be fully compatible with the community development block grant system recommended elsewhere in the Alternative Budget, and would incorporate explicit Federal objectives that preserve the aims of the present subsidy programs.

In order to provide a base of experience which could guide the design of a housing block grant program, we propose budget authority of $250 million and outlays of $50 million in FY 1974 for a variety of experiments with housing subsidies—in addition to experimental programs being conducted by HUD and OEO. These funds could be used for:

Testing of proposals under which local elected officials play a larger role than they do at present in setting local housing priorities;

Extensive further testing of alternative systems of direct housing grants and capital grants with which poor households could find their own housing on the open market;

Funding of intensive counseling services to assist tenants in adapting to existing subsidized housing, and in finding better housing;

Subsidies to suburban jurisdictions to compensate for any higher demand for services that result from the introduction of subsidized housing.

Table 10 compares Administration and alternative recommended outlays for housing in FY 1974.

TABLE 10.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR HOUSING

[Millions of dollars and fiscal years]

Program	Administration estimates		National Urban Coalition recommendations, 1974
	1973	1974	
Low and moderate income housing subsidy programs	1,663	2,000	2,200
Experimental housing grants			50
Other housing programs [1]	−531	341	341
Total	1,132	2,341	2,591

[1] Includes offsetting receipts from secondary mortgage operations and other special housing assistance functions amounting to $774,000,000 in fiscal year 1973 and $340,000,000 in fiscal year 1974.

EDUCATION

The Administration Budget indicates that an increase in outlays for education of around 4 percent will occur between FY 1973 and FY 1974. The figures are $6,064 million for 1973 and $6,280 million for 1974.

Elementary and secondary education

The principal feature of the Administration Budget is a proposal for an Education Special Revenue Sharing program that would combine some 30 categorical aid programs offering assistance to elementary and secondary schools and cost $1,693 million in FY 1974. The Administration sent its Education Special Revenue Sharing bill to Congress last week, accompanied by a brief summary which indicates that:

Appropriated funds are to be used for 5 purposes: education of the disadvantaged; education of the handicapped; vocational education; assistance for schools enrolling children who live on Federal property; and supporting materials and services. Any of the funds may be used for construction.

Most of the proposed outlays for Education Special Revenue Sharing would be derived from money now expended under the Elementary and Secondary Education Act (ESEA). While the message accompanying the shared-fund education bill indicates that Federal purposes embodied in ESEA would be generally reiterated under the new program, it is not clear whether the quite specific compensatory education aims of Title I of ESEA would in fact be satisfactorily maintained under Education Special Revenue Sharing. The summary quoted above states that:

With respect to amounts allotted for the disadvantaged, each State and each local educational agency would be "held harmless" for fiscal year 1974 at 100 percent of the amount allotted to it for fiscal year 1973 under Title I of the Elementary and Secondary Education Act.

Funds for Title I in FY 1973 are less than budget authority, because of impoundment, and keeping FY 1974 funds at that lesser FY 1973 level takes no account of inflation. Moreover, no indication is given by the summary that "hold harmless" money would continue after next year.

We believe that Title I of ESEA already constitutes a well-designed block-grant program that should not be replaced, especially in the absence of convincing evidence that Education Special Revenue Sharing would strengthen the objectives and increase the funding for Title I.

We are similarly concerned that if vocational education funds were folded into Education Special Revenue Sharing, as the Administration proposes, the funds now earmarked for disadvantaged students in the vocational education program would no longer be so earmarked, and, therefore, could be spent for other purposes.

Instead of folding Title I of ESEA into a shared fund, we recommend that that program remain intact and that outlays for it be increased from the estimated FY 1973 level of $1,500 million to $2,500 million in FY 1974. Further, we strongly recommend that the present formula for distribution of ESEA Title I

funds, which provides for a double count of students from AFDC families, should be retained as is, except for requiring the use of 1970 census data in place of 1960 census data.

We also believe that the administration of Title I programs should be improved. The Office of Education has been lax in its enforcement of the requirement that Title I funds be expended for the benefit of disadvantaged children. New efforts should be made to enforce that Federal objective.

Aside from Title I and vocational education funds, it may well be possible to combine a number of small categorical aid programs without giving up significant Federal purposes.

Emergency school assistance

Designed to aid desegregating schools through grants made to selected local school districts, the emergency school assistance program is funded far below the level of Congressional authorization. We propose outlays for the program of $400 million in FY 1974 instead of the $202 million indicated by the Administration Budget. We recommend further that a higher proportion of the Emergency School Assistance grants be awarded to community-based organizations, and that care be taken to ensure the participation of parents in planning and implementing the desegregation programs.

Library grants

We disagree with the Administration proposal to abolish categorical aid to school and public libraries. In our view, the likelihood is small that libraries will have enough political clout at the local level to compete successfully for funds to replace lost Federal contributions. The library aid program should be maintained as a distinct category in the Federal budget, at an additional outlay of $49 million in FY 1974.

Impact aid

The Administration Budget proposes to reduce outlays for aid to school districts that include children whose parents work on Federal installations—the so-called impact aid funds. This reduction—from $468 million in FY 1973 to $131 million in FY 1974—is long overdue. We believe other criteria for distribution of Federal funds make far more sense than the proportion of children whose parents happen to work for the Federal government but do not live on Federal property and who thus pay local property taxes.

Bilingual education

The Administration is not requesting higher budget authority for bilingual education programs, which means that, because of inflation, outlays in FY 1974 will be lower than they were in FY 1973. Bilingual education programs are authorized both under Title VII of the Elementary and Secondary Education Act and the Emergency School Aid Act, and have been valuable for Spanish-speaking children, especially by supporting bilingual teaching in classrooms and emphasizing reading materials that focus on their cultural identity and heritage. We recommend doubling outlays from around $45 million to be spent in FY 1973 to $90 million in FY 1974.

Preschool education

The Administration Budget proposes to increase spending for child development, at least 90 percent of which is expended for Head Start, from $385 million in FY 1973 to $420 million in FY 1974, although one-third of the increase is a transfer from OEO research funds. We would go considerably further, however, and increase child development funds by 50 percent over the FY 1973 level, which would allow the program in FY 1974 to serve a total of 480,000 children, with expenditures of $630 million. Although budget limitations probably preclude any further increase next year, we believe that benefits of intensive preschool education programs are high, and that in FY 1975 and beyond, expenditures for an expanded preschool program ought to increase. We recommend also that sponsorship of a high proportion of early childhood education programs continue to be awarded to community-based organizations, that care be taken to ensure the participation of parents in planning and running local programs, and that a majority of funds continue to be spent on disadvantaged children.

Higher education

The Education Amendments of 1972 created a new student assistance program incorporating the highly desirable principle that student aid should be

uniformly distributed to all qualifying students, and that qualification be uniformly based on need, as indicated by family income. The Administration's endorsement of Basic Educational Opportunity Grants, demonstrated by its proposal for $622 million in FY 1974 outlays, is most commendable. We recommend, however, an additional $200 million in FY 1974 outlays for supplementary grants, intended to help students requiring additional aid, and $50 million to fund the Federal share of the newly-authorized Federal-State Student Assistance Program.

Career education

The Administration Budget proposes to reduce funds for occupational and vocational education from $300 million in FY 1973 to $168 million in FY 1974. We recommend that funds be continued at the FY 1973 level next year, while career education and vocational education programs are being evaluated. The results of evaluation may well point the way toward reforms in career education programs that should be adopted in future years.

National Institute of Education

We endorse the Administration's proposal to fund the National Institute of Education at a level of $118 million in FY 1974, more than doubling the $43 million to be expended in FY 1973.[2] The Administration commendably wants to encourage intensive, multidisciplinary research "to try to find out more about what works and does not work in the educational process," in the hope of providing "a much better knowledge base for developing future education programs and for evaluating the effectiveness of existing program." We recommend, however, that the NIE should concentrate a much larger share of its funds on identifying the most effective means of implementing equal educational opportunity.

Administration recommendations and our alternative proposals for outlays in education are compared in Table 11.

TABLE 11.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR EDUCATION

[In millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Education revenue sharing		[1] 1,693	
Title I, ESEA	1,500	411	2,500
Emergency school assistance	59	202	400
Preschool aid	385	420	630
Basic opportunity grants		622	622
Supplementary opportunity grants			200
Federal-State student grants			50
Career education	300	168	300
National Institute of Education	43	118	118
All other	4,349	3,232	[2] 3,281
Total [3]	6,636	6,866	8,101

[1] Excludes $244,000,000 for school lunch program accounted for under income security in the administration budget.
[2] Includes $49,000,000 additional for aid to libraries and $45,000,000 additional for bilingual programs.
[3] Includes $572,000,000 in fiscal year 1973 and $586,000,000 in fiscal year 1974 for general science outlays.

MANPOWER AND EMPLOYMENT

The Administration Budget proposes to cut funding for manpower and employment programs by $621 million, a reduction of 16 percent from estimated FY 1973 outlays of around $3.9 billion. Substantial reductions would occur in spending for the two most important manpower programs, both administered by the Department of Labor. Expenditures for what the Administration calls Manpower Revenue Sharing, consisting of manpower programs authorized by the Manpower Development and Training Act and Title I of the Economic Opportunity Act, would decline by more than 17 percent. Outlays for the Emergency Employment Assistance program—public service jobs authorized by the Emergency Employ-

[2] Some portion of this total would be derived from the transfer of certain OEO funds to the Institute. In our section on the poverty program, we recommend keeping those research funds under the aegis of an intact OEO. We would also keep outlays for the Institute at the level of $118 million.

ment Act—would be cut by 47 percent. Moreover, the Administration proposes to let the Emergency Employment Assistance program lapse entirely; it requests no new budget authority for the program in FY 1974.

Manpower revenue sharing

Studies of the Federal manpower training programs have documented several kinds of deficiencies. In part because of inadequate analysis of the prospective market for given skills, many local programs have provided training for jobs that are in little or no demand. Manpower programs have shown particularly little success in training people for higher-skill jobs in expanding service industries, for example. All too often, different Federally funded agencies have been found to be duplicating training opportunities in a given field, with no agency aware of the existence of the others. Many training programs have offered inadequate job counseling, referral and placement for trainees, or none at all.

These deficiencies are attributable in part to the multiplicity of grants at the Federal level, and to the absence of local institutions which possess the power and the ability, for a given job market area, to project employment needs, to plan the coordinated use of Federal manpower funds, and to administer, or at least oversee, both training and placement programs.

The Administration Budget suggests that the Administration is aware of these deficiencies of the manpower training programs, and is moving in a direction which could help to correct them. This is what the Budget has to say:

The effectiveness of individual programs depends on the degree to which they meet the needs of the people they enroll and the employers who hire them. As part of the overall Administration effort to bring program planning and decision-making responsibility closer to the local level where perception of enrollee and employer need is clearest, several steps have been taken in recent years to decentralize the management of Federal programs. Greater authority was delegated to the regional manpower administrators, uniform regional boundaries were established to improve interdepartmental coordination of related programs, and regional offices were reorganized from a categorical program basis to a geographical area basis to provide a better appreciation of individual State and community manpower problems.

At the State and local level the interagency Cooperative Area Manpower Planning System (CAMPS) has been strongly emphasized as a vehicle for coordination of planning efforts by various manpower agencies. In addition, staffing grants were awarded to mayors and governors to develop their manpower planning and program assessment capability.

Major steps are now underway to build upon this framework so that during 1973 and 1974 a transition to manpower revenue sharing can be achieved as smoothly as possible. CAMPS committees have been restructured as advisory councils, appointed by State and local elected officials and responsible to them. The councils will advise the governors and mayors on manpower needs and programs and assist in the development of comprehensive manpower plans for their areas.

Seventy-five percent of manpower revenue sharing funds, according to the Administration Budget, would be available for local allocation, and 25 percent would be "retained at the Federal level for programs requiring national supervision, and for research, demonstration, evaluation, labor market information, and technical assistance to support the decentralized program activities." We think these objectives and the allocations proposed are not unreasonable.

In implementing the Manpower Revenue Sharing program, the Administration has evidently proceeded gradually and in consultation with local officials, and, moreover, seems to be interested, as we are, in preserving the original Federal purposes of the manpower programs.

No guarantee exists, of course, that the shift to greater local control of the manpower programs will quickly improve their deficiencies—especially their mixed record of providing training that leads to employment. Evaluation may indicate that many localities simply do not possess enough expertise either in assessing local employment needs or in administering training programs. In that case, the Federal government should probably devote a larger share of Manpower Revenue Sharing funds to technical assistance in order to improve the quality of local market analysis, program planning, and administration.

The effectiveness of manpower training programs could be improved further, in our view, if direct and formal links were established at the state and local level between Manpower Revenue Sharing and the permanent, Federally-

funded public service employment program we recommend below. With substantial control over the use of both training funds and public service employment programs in their hands, local officials could improve the value of manpower training by ensuring that part of the training funds are used to provide skills to trainees who subsequently take public service jobs. We recommend that a substantial share of Manpower Revenue Sharing funds therefore be earmarked for this purpose.

The Administration's attempt to correct the deficiencies of the manpower training programs would be undermined by the reductions it proposes in spending for Manpower Revenue Sharing in Fiscal Year 1974. State and local officials can hardly be expected to carry out their new responsibilities in the manpower field with far less money than has been available in the past several years. We recommend that manpower revenue sharing outlays for FY 1974 be set at about the FY 1972 level, which will require expenditures of $500 million more than the outlays of $1,265 million projected by the Administration for next year.

We also recommend that outlays for computerized job placement be raised to $50 million for FY 1974, instead of declining from $36 million in FY 1973 to $25 million in FY 1974, as the Administration proposes.

Research and evaluation

At a time when control over manpower programs is being shifted to state and local agencies, the need for research and evaluation funds will increase, not decline. We recommend outlays of $35 million for manpower research and evaluation in FY 1974, not $20 million.

Emergency employment assistance

Far more devastating than the reduction in funds for Manpower Revenue Sharing is the Administration's proposal to allow the Emergency Employment Act to lapse on June 30 of this year, and to spend only $580 million in remaining budget authority for the program in FY 1974. By the end of FY 1973 Emergency Employment Assistance will have provided 280,000 people with public service jobs—many as aides and paraprofessionals in fields as diverse as health, law enforcement and education—to the benefit both of the local governments which employed them and to the individuals themselves. Of men and women who have held jobs under EEA, 90 percent were unemployed prior to enactment of the program, and 10 percent were underemployed. A significant number have been Vietnam veterans.

We recommend that the Emergency Employment Act be extended, and that outlays for FY 1974 be increased from $580 million to $1,300 million. We note also that in the section on Income Maintenance, we have recommended that a separate $1.2 billion be expended for additional public service jobs which would be developed and administered as part of the welfare reform package we propose for FY 1974. This total of $2.5 billion in public service employment funds could put as many as 350,000 people to work next year at productive and useful jobs and reduce unemployment by a significant several tenths of a percentage point, thus accelerating the slow movement of the economy back to full employment.

Table 12 compares outlays proposed by the Administration with those we recommend for manpower and employment.

TABLE 12.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR MANPOWER AND EMPLOYMENT PROGRAMS

[In millions of dollars and fiscal years]

Program	Administration estimates		National urban coalition recommendations, 1)7
	1973	1974	
Manpower revenue sharing	1,533	1,265	1,765
Emergency employment assistance	1,100	580	1,300
Research and evaluation	32	20	35
Computerized job placement	36	25	50
All other	1,178	1,368	1,368
Total	3,879	3,258	4,518

HEALTH

The National Urban Coalition has long supported a comprehensive program of national health insurance funded by Federal tax dollars to provide universal and comprehensive coverage of the health needs of all American citizens. However, we recommend no outlays for national health insurance in FY 1974 because it is unlikely that the program could be implemented before FY 1975, even if it were enacted today.

In the meantime, there are several ways in which the health outlay priorities recommended by the Administration Budget for FY 1974 could be reordered to correct some of the deficiencies which make decent halth care difficult for Americans—especially poor and minority Americans—to obtain.

Health training and education

The Administration proposes reductions of 6 percent in outlays for health manpower education and training between FY 1973 and FY 1974. The change in the distribution of outlays is especially objectionable. While aid to education of physicians and dentists would increase by 19 percent, aid for the training of paramedical personnel would decline by 10 percent, for example. It is partly through a sharp increase in paramedical personnel that the nation can hope to channel essential medical services to poor and minority people at a more rapid pace. We recommend that outlays for paramedical personnel be increased by 50 percent from $132 million in FY 1973 to $200 million in FY 1974, and that outlays for all other training which the Administration would reduce—for research personnel, nurses, mental health professionals, and other health personnel—instead be increased by a 4 percent inflation factor from FY 1973 to FY 1974.

Medicaid

The Administration Budget says that "Legislation will be proposed to require Medicaid reimbursement for services provided in free-standing clinics and to terminate Federal payments for dental services provided to adults. States may, however, continue to provide dental services." This is a regressive step, which we oppose. The Administration suggests that savings would amount to $75 million, an amount we have restored to the FY 1974 budget.

Medicare

An equally regressive proposal in the Administration Budget would force the elderly to pay an additional $616 million for hospitalization covered by Medicare by increasing the share of hospital charges borne by Medicare patients. We emphatically recommend that this proposal not be adopted, and that the outlay savings of $616 million be restored to the FY 1974 Budget.

Mental health programs

The Administration proposes to save some $63 million in FY 1974 by initiating an eight-year phaseout of Federal financing for neighborhood mental health programs, which have introduced mental health care in poor and minority communities where no mental health services of any kind were previously available. We recommend a reversal of the decision to end the program, and restoration of $63 million for the program in the FY 1974 Budget.

Health facilities

The Administration's proposal to eliminate the Hill-Burton program—which has funded construction of community health care facilities since 1947—ignores the fact that a great many urban hospitals need to be remodeled or rebuilt, and that construction funds are badly needed for health facilities other than hospitals. Like other aspects of health care, health facilities are unevenly distributed, with high-income communities having far greater access to them than do low-income communities. We believe that Hill-Burton should be continued, but that funds provided by it should be devoted to upgrading urban hospitals and to construction of flexible, multi-purpose community health-care facilities in low-income areas, both urban and rural.

We are equally concerned with the decision by the Administration to suspend new commitments for constructing and funding operational costs of neighborhood health centers, 67 of which have been or are now being built under authority of either the Public Health Service or the OEO. Neighborhood health centers have proved their value in some of the poorest communities in the nation, where they provide, in many cases, the only health care available. We urge that

commitments continue to be made for construction and funding of neighborhood health centers.

We recommend that overall outlays for Federally supported health facility construction be set at $450 million, which would add $69 million to the FY 1974 budget, and that new budget authority both for Hill-Burton and for neighborhood health facilities be provided in the FY 1974 budget.

Table 13 compares proposed Administration outlays for health with outlays recommended by the National Urban Coalition.

TABLE 13.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR HEALTH

[In millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Paramedical training	132	119	200
Other medical training [1]	1,247	1,174	1,359
Medicaid	4,301	5,247	5,322
Medicare	9,573	12,612	13,228
Federally supported health facilities construction [1]	417	381	450
All other	3,218	2,979	[2] 3,042
Total	18,888	22,512	23,601

[1] Includes outlays also accounted for under other budget categories. Duplications are subtracted in table 1.
[2] Includes $63,000,000 for neighborhood mental health programs.

INCOME SECURITY

The Administration has announced that it will not resubmit the Family Assistance Plan or other legislation to replace the present wefare system. We believe that decision is unfortunate. The National Urban Coalition has strongly backed the need for basic reform of the chaotic, unworkable and demeaning system of public assistance.

Our conception of fundamental reform of the welfare system presumes that the government will vigorously pursue economic and social policies that reduce the need for public assistance to the lowest possible level by moving to implement a government goal of a decent job at a decent wage for all Americans.

For those who cannot find employment, for those who work but remain in poverty, and for those who are in ill health, or whose family responsibilities dictate that they not work, a wholly new, adequate and humane system of income maintenance must be instituted. When fully implemented, such a system would:

Provide coverage for *all* needy households, including those with and without children;

Ensure, through a system of direct cash grants, that household income does not fall below a minimum standard which is set well above the poverty-income level as defined by the Census Bureau;

Incorporate a system of wage supplements that eliminates poverty for the working poor and encourages recipients of public assistance to find and keep jobs.

An ideal program of this kind would be expensive. The authors of *Counter-budget* calculated that a program which would provide a basic cash allowance of $5,898 (in FY 1976) to a family of four and incorporate a work-incentive formula that would reduce public assistance payments by 50 cents for each dollar of earned income, would cost more than $50 billion in FY 1976.

We strongly endorse a proposal of this magnitude as a goal of Federal policy, but we recognize that other priorities will not permit it to be carried out in FY 1974.

We do recommend, however, that steps toward the goal of full reform be initiated in FY 1974. To that end we have included in our budget the major elements of the so-called Ribicoff-Administration compromise welfare reform proposal developed last year jointly by representatives of the Administration and Senator Abraham Ribicoff of Connecticut. That proposal includes:

Coverage for families, and for others who cannot work, including children, mothers of children under 6, caretakers of children whose parents or guardians work or for whom suitable day care is unavailable, families headed by males for whom work is unavailable, and elderly, ill or incapacitated persons.

A basic Federal payment of $2,600 for a family of four, entirely financed by the Federal government, with the proviso that states whose payment levels exceed, or have exceeded, $2,600 would be required to make supplemental payments up to the highest level of assistance they have ever paid.

A pilot program to test the cost and impact of income supplements to be paid to those who work but whose income remains low.

Additional funds for child care, job training, and public service employment, in order to afford additional opportunities for employment to recipients of public assistance.

Institution of procedures to ensure fairness, including the right to counsel, written opinions in welfare adjudication, the elimination of punitive and cumbersome reporting and checking procedures, abolition of state residency requirements and the determination of eligibility based on current need.

Following is part of a table inserted in the *Congressional Record* (September 28, 1973) by Senator Ribicoff, which compares Federal oultays under the present system of public assistance with projected outlays under the Ribicoff-Administration proposal:

TABLE 14.—ESTIMATED 1ST-YEAR OUTLAYS FOR PUBLIC ASSISTANCE AND ASSOCIATED PROGRAMS UNDER CURRENT LAW AND UNDER THE RIBICOFF PROPOSAL

[In billions of dollars]

	Current law	Ribicoff-administration agreement
Payments to families	5.3	7.2
Payments for food stamps	2.9	.1
Hold-harmless; fiscal relief		.8
Subtotal, payments	8.2	8.1
Child care	.6	.9
Training	.3	.5
Public jobs		1.2
New employment service		.1
Administration	.6	1.1
Subtotal, related and support activities	1.5	3.8
Impact on other programs		-.1
Grand total	9.7	11.8

The difference in costs between the Ribicoff-Administration compromise proposal and current law amounts to $2.1 billion for the first year of operations.

We believe the compromise proposal would be a modest step toward welfare reform. For purposes of the Alternative Budget we assume that if the plan was adopted now, it could take effect at the beginning of the fourth quarter of FY 1974. Thus we estimate that the cost of carrying out the proposal would amount to $525 million more than the cost of continuing the present system of public assistance in FY 1974.[3]

In FY 1975, we recommend raising the basic Federal support payment to $3,000 for a family of four, extending coverage to additional categories of needy households, including single people and childless couples, and instituting wage supplements, with a 50 percent offset rate, for the working poor.

Grants for social services

We recommend that outlays to states for social services that benefit public assistance recipients and other low-income people be set at the full authorization level of $2.5 billion, instead of being cut back to $1,891 million, as the Administration proposes. Moreover, we recommend rescinding regulations issued by HEW which restrict eligibility for social service programs.

Table 15 compares our proposed outlays for income maintenance in FY 1974 with those of the Administration.

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[3] We include outlays for child care, job training, public service jobs, a new employment service and for administration as part of the welfare category in our Alternative Budget because both Ribicoff and the Administration conceived of these expenditures as part of an integrated welfare package. At appropriate points elsewhere, these outlays are asknowledged but, of course, not duplicated.

TABLE 15.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR INCOME SECURITY

[In millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Welfare reform			525
Grants to States for social services	2,445	1,891	2,500
Other income security programs	73,444	80,085	80,085
Total	75,889	81,976	83,110

VETERANS BENEFITS AND SERVICES

We strongly recommend restoration of $223 million the Administration Budget proposes to save in FY 1974 by "bringing [veterans'] pensions into closer alignment with need."

Table 16 compares Administration and Alternative outlays for veterans benefits and services.

TABLE 16.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR VETERANS BENEFITS AND SERVICES

[In millions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
Veterans benefits and services	11,795	11,732	11,955

LAW ENFORCEMENT

Title I of the Omnibus Crime and Safe Streets Act of 1968 established a new Federal agency, the Law Enforcement Assistance Administration. LEAA makes grants to state and local governments for the purpose of improving systems of criminal justice. LEAA outlays were $699 million in FY 1972, and are projected at $855 million in FY 1973 and $891 million in FY 1974.

LEAA funds were not intended for general support or fiscal relief. They were supposed to be used to foster reform of and innovation by state and local law enforcement agencies. A recent analysis of LEAA, *Law and Disorder III*, prepared by the Lawyers' Committee for Civil Rights under Law, found that the LEAA has largely failed to implement these goals, that "its grants are reinforcing the existing discriminatory patterns of the criminal justice system, rather than seeking to eliminate them."

The authors of *Law and Disorder III* summarize their major findings in this way:

"The over-all result is that the federal reform program has become a fiscal relief program. In almost four years of operation and after the distribution of roughly $1.5 billion in funds, the LEAA program has not initiated a basic reform of the nation's criminal justice system. Instead, LEAA has taken the system as given and invested its funds in making the criminal justice agencies more efficient, primarily through expenditures that meet existing material needs. This focus has tended to reinforce the present deficiencies of the criminal justice agencies, making fundamental reform more difficult.

Review of the state expenditures shows that, like the federal discretionary grant program, the funds are going for such outstanding needs (or newly stimulated wants) as new communications equipment, information and intelligence systems, helicopters, night-vision equipment, new training facilities, crime labs and even night sticks, helmets and street lighting. Many such items may in fact be needed, but they are the bread-and-butter expenditures that the states are supposed to fund themselves—not the kinds of innovative projects that Title I was intended to fund. Some of the new technology and tactics represent reforms, in the sense that they are new or untried, but they are not in most cases directed to basic modifications of police (or other agency) operations; they are purchased singly and not as part of an over-all modernization or upgrading effort, and they

do little to change the basic operation of the grantee agency. The new technology without new forms of street patrol and police organization promises little or no basic change."

The Administration Budget proposes new legislation to combine nearly all LEAA programs and 90 percent of LEAA funds into a Law Enforcement Special Revenue Sharing program, which, according to the language of the Budget,

* * * will distribute funds by formula among the States with an assured 'pass through' to local governments, eliminating unnecessarily restrictive Federal limitations. It will also provide greater flexibility in meeting variations in State and local needs, and permit quicker, more responsive approaches to crime reduction and prevention.

The Administration has not sent a bill to Congress to accomplish these purposes, but this description of the Administration's intentions suggests that Law Enforcement Special Revenue Sharing could well exacerbate the defects of the present LEAA program, by giving states and localities an even freer hand than they now have to spend Federal law enforcement grants in any way they wish.

We recommend, instead, that LEAA remain intact, and that an intensive effort be made to reform the way in which the agency operates, and the way in which states and local governments expend the LEAA funds they receive.

Specifically, we recommend that when the LEAA program is renewed, the new legislation provide:

That LEAA be authorized to commit funds for at least five years to law enforcement agencies that agree to hire new personnel, or upgrade existing personnel, in order to improve public safety for residents of high-crime neighborhoods. Such a provision could help reduce the understandable tendency of police agencies to spend LEAA funds on hardware rather than personnel, out of the fear the money committed to manpower this year may dry up next year.

That LEAA require state and local plans for use of funds to specify how participating law enforcement agencies will (a) guarantee equal opportunity in employment; (b) assure that a far greater portion of funds is expended for improved public safety for minority, low-income and working-class citizens; and (c) end discriminatory aspects of local systems of criminal justice. In order to assure that Federal civil rights laws are not violated by recipient agencies, sufficient funds should be expended to allow LEAA to hire at least one Federal enforcement officer for every state.

That poor and minority citizens be represented in significant numbers on state planning boards, whose function is to recommend the allocation of most LEAA funds to local law enforcement agencies.

That a significant share of LEAA funds—perhaps $50 million—be earmarked for experimental approaches to community participation in law enforcement. Community Action and Model Cities agencies, for example, could receive funds to promote community education on crime reduction, to mobilize public opinion in support of neighborhood safety programs, and to advise local law enforcement agencies on ways to reduce crime in poor neighborhoods.

That at least 50 percent of each city's funds for operating programs be spent for programs of national priority, including youth programs, narcotics enforcement and treatment programs, court reform, corrections reform and human relations training for police officers.

That local law enforcement agencies be required to develop special impact programs which not only ensure that *more* personnel are committed to high crime areas, but that those personnel are given intensive training to improve their effectiveness in dealing with crime in poor and minority communities.

That discretionary grants—funds granted by the LEAA directly to specific law enforcement agencies instead of being channeled through the states—be focused more explicitly on experimental programs that promise to reduce crime through (a) better deployment of law enforcement personnel; (b) improvement of the professional skills of personnel; and (c) diversion programs that keep pretty offenders out of the main criminal justice system and that route offenders with special problems to more appropriate agencies, thus leaving the criminal justice system free to deal with more serious offenses.

As Table 17 shows, we are concerned enough about the defects of the LEAA program in its present form that we cannot recommend higher outlays than those proposed by the Administration for FY 1974.

TABLE 17.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR LAW ENFORCEMENT AND JUSTICE

[In millions of dollars and fiscal years]

Program	Administration estimates		National Urban Coalition recommendations, 1974
	1973	1974	
Law enforcement assistance administration	855	891	891
All other	775	986	986
Total	1,630	1,877	1,877

CIVIL RIGHTS AND EQUAL OPPORTUNITY

The Special Analysis volume of the Administration Budget indicates that outlays for civil rights and equal opportunity programs throughout the government have increased by 23 percent from FY 1972 to FY 1973, and will increase again in the next fiscal year by 24 percent, with total outlays in FY 1974 at $3.2 billion. The Equal Employment Opportunity Commission, to take one example, will receive $30 million this year and $42 million next year. We endorse this considerably higher level of expenditures.

Unfortunately, as a recent report by the U.S. Commission on Civil Rights makes clear, these increased expenditures bear little relation to the low level of commitment and effectiveness of the Federal government in enforcing civil rights laws and improving equal opportunity. In *The Federal Civil Rights Enforcement Effort—A Reassessment*,[4] the Commission found that

"* * * the inertia of agencies in the area of civil rights has persisted. In no agency did we find enforcement being accorded the priority and high-level commitment that is essential if civil rights programs are to become fully effective. Significant agency actions frequently are accompanied by extensive delays—in the issuance of regulations, in the implementation of regulations, and, greatest of all, in the use of sanctions when discrimination is found. Innovative steps occur here and there but they are uncoordinated with those of other agencies.

The Commission concludes that its latest study

* * * has reinforced the findings of the three preceding reports that the Government's civil rights program is not adequate or even close to it.

It is conceivable that additional funds for civil rights and equal opportunity programs are required by one or more agencies of the Federal government. But we could hardly recommend additional overall outlays in the light of this comprehensive and discouraging assessment of the government's role over the past four years. What is needed is not more money, but a sharply escalated commitment on the part of the Federal government to securing both the rights and opportunities that this nation must guarantee to all of its citizens.

GENERAL REVENUE SHARING

No detailed evaluation has been conducted of General Revenue Sharing, which was enacted in October 1972. But we believe several factors argue for modifying the program, at least provisionally, before funds are passed out in FY 1974.

First, many state governments now enjoy a very substantial revenue surplus. In a number of states, excess income amounts to several hundred million dollars; the surplus in California alone, for example, totals nearly a billion dollars.

Second, because of inexorably rising costs, comparatively stable or declining tax bases, and especially the effect of FY 1973 reductions in many Federal grant programs, many cities are in financial trouble.

Third, it is clear that many local government bodies—primarily those in suburban, small-town and rural regions of the country—are using funds from General Revenue Sharing for needs that seem marginal, at best, especially by comparison with the needs of cities.

[4] Published January, 1973.

We have two recommendations. First, before funds are distributed in FY 1974, the law should be revised to exclude very marginal and low-priority outlays, and to reduce the share of funds given to local governments whose needs for funds are small because they perform few, if any, significant governmental functions. Savings from these reforms should be added to the share of General Revenue Sharing funds allotted to cities.

Second, we recommend (a) that FY 1974 outlays be reduced by $1 billion, or 17 percent, (b) that this reduction be absorbed by the newly-affluent state governments, and (c) that the entire $1 billion be used to help pay for the high priority additional domestic outlays we recommend elsewhere in this Alternative Budget. We do not recommend a permanent reduction in funds allotted to states. Evaluation of projected income and expenditures of state governments next year may well indicate the reduction should be restored in FY 1975. We do not think it unreasonable, however, under *present* circumstances, to shift a billion dollars of FY 1974 General Revenue Sharing funds to the needs we identify elsewhere in this Alternative Budget, rather than add them to the already considerable surpluses in state government treasuries.

Table 18 compares proposed Administration outlays for General Revenue Sharing with outlays we propose.

TABLE 18.—ADMINISTRATION AND ALTERNATIVE OUTLAYS FOR GENERAL REVENUE SHARING

[In billions of dollars and fiscal years]

Program	Administration estimates 1973	Administration estimates 1974	National Urban Coalition recommendations, 1974
General revenue sharing	[1] 8.2	6	5

[1] Includes $2,600,000,000 in half-year entitlements for 1972.

Senator PROXMIRE. One of the most interesting proposals we have seen is a proposal by the General Accounting Office which could save $2 billion over the next 5 years by financing our housing by direct Government loans instead of by the indirect methods we now use. Of course, that would be a very welcome saving and, of course, there is no question that is mathematically correct.

Mr. Wirtz, as you say, the administration apparently feels if the issue of priorities can be confused with fiscal policy then the administration priorities will prevail, and that is my problem. I agree with that. If we let them confuse it with fiscal policy we are going to lose. We have to make it absolutely clear we are talking about priorities. You are an old hand, a bureaucratic infighter, you were Secretary of Labor for 6 years, and a very successful one. Do you have any, you are free now, you can give us advice, do you have any advice on what Congress can do to make our priorities prevail?

Suppose we could come in with a ceiling at the President's level, maybe even a little lower, and supposing the President then may still want to impound funds, we are under his budget or at his budget, and we cut defense, we cut highways, and we have cut in some of these other areas, we apply those to human programs, manpower programs, and the President refused to spend them; what can we do?

Mr. WIRTZ. I believe personally that the congressional appropriation process should include some provision which would permit Congress to provide its own self-imposed overall ceiling. That does seem to me essential, and will be part of my answer to your question. I think that makes sense.

Senator PROXMIRE. Very good.

Mr. WIRTZ. I also assume it is appropriate for the President to express his view as to what that ought to be, but the Congress should then make the decision. And with respect to the so-called impoundment question, it seems to me that if the Congress does make a deliberate decision as to what the overall total ought to be, then it would be very wrong to leave the situation so that one man can determine from day to day at his whim, if you will, during the year, what the priorities are to be. So my answer would be that Congress ought to——

Senator PROXMIRE. Suppose you were Secretary of Labor and Mr. Ash is the head of the Office of Management and Budget and that we provide funds for manpower training, and Mr. Ash says you can't spend them, what can we do in Congress to make it possible for you to be able to do that, spend that money, provide that resource?

Mr. WIRTZ. I am sure Mr. Ash would feel as strongly as I do that the question of what he and I would do in a single administration is hypothetical. [Laughter.]

I think the Congress should set an overall limit on itself in one way or another, and provide by law, that there shall be no cutting back except in terms of administrative necessity or something of that kind, and then throw down the gauntlet on that. I think the position of throwing down the gauntlet, absent the setting of an overall ceiling, is perhaps a weak one.

Senator PROXMIRE. When you say, "throw down the gauntlet," what can we do? President Kennedy impounded $10 billion for a new wing of B-52's in 1962. I thought he was right, I got four votes for his position in the Senate but the Congress thought he was wrong. He signed the bill and that made it law that $10 billion was available to spend but he impounded the money and I supported that impoundment and I can't be inconsistent now and argue that President Nixon is wrong if he feels very deeply about a measure. Was Kennedy wrong to impound that money? Was he wrong in not spending it for B-52's?

Mr. WIRTZ. I have forgotten the specifics of the issue. May I inquire whether that was a matter of an expression of an overall fiscal or monetary policy, or whether it had to do with the efficiency of the particular program?

Senator PROXMIRE. Efficiency of the overall program, not to do with the overall policy.

Mr. WIRTZ. It does seem to me to be a distinguishable case. I would assume any President worth his salt, which means any President, ought to be in a position to exercise sound, reasonable judgment about the efficiency element in the administration of a particular program. I couldn't get upset about a decision on that basis. I could get very much bothered though about a position which I understand to be the present position which is that "Given hell and high water as far as the social programs are concerned, as a matter of fiscal policy I am not going to spend that because I have got some other priorities." Those seem to me distinguishable cases.

May I add one other piece in answer to your question which was in terms of what Congress can do—and you gave me the privilege of private citizenship: It has not come through to most of us yet that the Congress is really intent on closing the tax loopholes and providing for tax reform. I agree with Sol Linowitz a hundred percent on that. Most of us don't hear a real voice from the Hill yet which says we are

going to close up those loopholes. Most of us are wondering whether there is really the determination in the Congress to close up the special privilege loopholes. I guess most of us feel that the Congress position, either constitutionally or morally, on the question of impoundment would be stronger if the Congress were at the same time really closing up the loopholes. I have gone too far to be discrete.

Senator PROXMIRE. Thank you.

Chairman PATMAN. After Senator Proxmire gets through with his questions is there any objection to recessing until the next meeting of the committee? I would like to have it understood that each member of the committee, between the Members of the House and Senate, will have an opportunity to extend their remarks at the end of this record before it is concluded, and also insert related matter.

I have two questions that I would like to insert in the record at this point and ask the members of the panel to comment on them when they correct their transcripts. Without objection, it is so ordered.

Mr. WIRTZ. Mr. Chairman, may I make a request for an opportunity along the same line to supplement my remarks on the basis of some further thought about your question with respect to the National Development Bank? Would it be appropriate to submit a statement to suggest what that might do?

Chairman PATMAN. Yes. Each member not only extend their remarks any way they want to but especially on the National Development Bank.

Mr. WIRTZ. Fine.

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

RESPONSE OF WILLARD WIRTZ TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. Mr. Wirtz, in my statement this morning I stressed the need for establishment of a National Development Bank to help fund the priority needs of the nation.

One of the chief functions of such an institution should be providing financing for the creation of new job opportunities and new job training opportunities both in the public sector in terms of public works and facilities and in the private sector in relation to new or expanded businesses and industries.

How do you think a National Development Bank should be designed in order to provide optimum employment and job training opportunities?

Answer. In general terms, and with a constraining realization of the limitations on my understanding of this broad area, I can only affirm the obvious importance of the National Development Bank proposal to use the capital market in new ways to meet the critical and growing demand for public services and facilities at the state and local level.

The proposal recognizes the need to deal effectively with the problems of insufficient funds to meet long-term public borrowing demands; of the disproportionate burden of state and local governments in periods of contracting credit availability; of tax inequities resulting from exclusive reliance on tax-exempt bonds; and of the growing costs of present borrowing methods. With total state and local debt approaching the $200 billion level, and with predictions that the annual borrowing demand will double by the end of the decade, the creation of a new source of financing should come high on the list in reordering Federal priorities.

You inquire particularly about the possibilities of designing the National Development Bank so as to provide "optimum employment and job training opportunities". I interpret the request as inviting more specific reaction than a general abbreviation on the obvious, yet also obviously important, fact that an increased degree of responsible credit availability, especially in "depressed urban and rural

areas," is bound to have a strengthening effect which will take the form, among others, of increased employment opportunity.

I accordingly raise the question of whether H.R. 3550, as it presently stands, goes as far as it perhaps could in suggesting how its extraordinarily perceptive recognition of some of the critical but often overlooked aspects of a *real* full employment policy is to be implemented in practice. Section 3(4), for example, is significant in its recognition of the "underemployment" problem, and its provision for anticipating crisis situations. Paragraphs (1) and (2) in the proviso to Section 14 is similarly distinguished by its recognition not only of the reasonableness of requiring the providing of training opportunities as a condition of the use of public credit but also of the point that this training should be for jobs with a future to them.

I look, though, without finding full satisfaction, for the provision in the body of H.R. 3550 which would assure the *implementation* of the concepts identified in Sections 1 and 3. Nor, I guess, am I fully assured by the realization that this *could* all come about properly in the exercise of responsibility identified in Sections 4 and 5 as being in the Board of Directors and their officers and employees.

Perhaps a specific example will permit making better whatever point there may be here.

Unemployment in the construction industry has been chronically higher than necessary because of the underutilization of construction workers. From 1960–1970 the average unemployment rate in construction was more than double the rate for all workers. A principal cause of this underutilization is "seasonal unemployment." This is commonly attributed almost entirely to weather conditions which used to afford adequate explanation for it but actually no longer do.

Stabilization of construction operations throughout the year would lessen the hardship of frequent spells of unemployment for construction workers and bring about more efficient use of other resources in that industry. The Congress has recognized this problem before, in the 1968 amendments to the Manpower Development and Training Act. Title IV produced a Federal study of the construction seasonality situation and led to President Johnson's directive to Federal agencies to take seasonal variation into account in the planning of Federal and Federally-assisted construction activities. But nothing much has happened.

I should think it would be worth at least considering whether there could be at least specific bases laid in the provisions of the Development Bank bill for encouraging year-round planning, including counter-seasonal contract awards and financial incentives for winter employment in the public construction.

This is only one example. I am simply suggesting, perhaps entirely presumptuously, that there could perhaps be further consideration of the *implementive* aspects of some of the points which are included * * * and so significantly * * * in the statements of purposes and objectives in H.R. 3550.

I understand that some revisions of this Bill are under consideration. We would be glad, as The Manpower Institute, to be of any possible assistance in this connection.

During the hearing, I was also asked to consider "* * * having the National Development Bank (take) care of cases like Penn Central, Lockheed and others * * *."

There are important differences between these two cases, but I assume the question is meant to deal more broadly with the possibility of general legislative authority to make or guarantee loans to major private business enterprises in financial difficulty.

I think that this type of situation should probably be considered entirely apart from that of public loans or guarantees to small businesses generally, or for the support of minority business enterprise, or for the purpose of developing, retaining, or attracting businesses in economically distressed communities. It is perhaps an overly personal view that at least as far as the Penn Central situation is concerned it should, at least at the moment, be considered in terms of the "conditions of viability" the trustees in bankruptcy have identified—rather than in terms of additional Government financing (except in connection with the costs of passenger service).

Question 2. The Administration has emphasized the fact that unemployment has been reduced from 6 to 5 percent during the past year or so and that it expects that joblessness will be further reduced to 4.5 percent by the end of the year. There's a strong implication in such statements that if and when this is accomplished the nation will have solved its employment problems.

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In your view, what are the real dimensions of current unemployment in the nation when not only those without a job, but those who are underemployed and those who are not statistically listed in unemployment reports are considered?

Isn't it really a deception to describe unemployment in the terms that are currently used in the Bureau of Labor Statistics monthly reports? Wouldn't the Congress move more quickly and rapidly to effectively meet these problems if the true unemployment picture was presented to us?

Answer. Your questions raise several different points, all in my judgment vitally important. Neither the public nor the Congress is today getting a clear picture of (i) the *whole* unemployment situation, (ii) what it takes to meet this situation, or (iii) the potential there is for materially improving this picture.

This is a mixed matter, as your questions recognize, of the measurements themselves and of the policies which are being developed in terms (at least ostensibly) of these reported unemployment figures.

It is actually these policy developments which give the form of the old measurements new significance, and as I view it greatly increase the necessity of developing new forms of measurement. The apparent decision to call 4½ percent (or even 4 percent) unemployment (as it is presently measured) "full employment" is in my judgment wrong to the point of being irresponsible. It comes down to a decision to achieve stability (that is, prevent inflation) by leaving four to five million people out of work at all times. Part of the fallacy of this is that it doesn't work. The rest of it is that it puts the cost of the anti-inflationary effort on those who are least able to carry it. This is indecent.

Your questions are directed more, however, at the measurements themselves. They are, in their present form, from my experience with them, careful and entirely honest reflections of what they purport to cover. I have infinite respect for the Bureau of Labor Statistics people and procedures. They do exceedingly effectively and conscientiously what they purport to do; and it is principally the change in the times and in the technology and in the range of government policies which makes these traditional measurements inadequate, in my appraisal of them, for present and future purposes.

Three kinds of changes seem to me imperative:

The first of these, directly responsive to part of your question, is that there should be a measurement which includes the "underemployment" to which you refer and those forms of "not working" which are currently left out. We started in the Department of Labor in 1966 to develop a "subemployment" measurement—to include these additional elements. This effort was carried forward to some extent after the 1969 change in Administration. It has recently been abandoned—I think very unwisely.

I agree—and think the Bureau of Labor Statistics would agree—with your point that "unemployment" as it is measured does not convey the whole story of the failure of our economy to provide decent jobs for all people willing and able to work.

This may be illustrated by taking the BLS figures for the last quarter of 1972, at a time when the official estimate of the number of unemployed—people who were not working and were looking for work—was 4,600,000.

(a) People who are not working and *not currently looking for work* are not counted as unemployed. Most of these are housewives, students, retired or disabled people, but there were among them 700,000 people who said that they really wanted a job now, but were not looking for work because they thought it would be useless to look—there were no jobs they could get. These "discouraged workers" ought to be included in the Congress' consideration of what needs to be done on the employment front.

(b) Among the people who have jobs are some who are underemployed in the sense that they want full-time work but can only get part-time work. There were 2,200,000 in this predicament in the last quarter of 1972.

(c) If we are concerned about *decent* jobs for all willing and able to work we have to look at the kinds of jobs in which people are employed. We all know individuals who have to endure the frustration of working in jobs below the level of skill for which they have been trained—engineers or scientists driving taxicabs, for example—but we have no statistics on how many such people there are. Another touchstone is whether the job pays enough to support a family, and here we have a measure. In 1970, 1,200,000 families had incomes of less than $4,000 (a figure below the poverty level for a family of four) *even* though the family head worked full-time the year round. In addition, 300,000 single individuals

(not in families) earned less than $2,000, the corresponding poverty level, by year-round full-time work. The figures for 1972 were probably not much different; (the overall employment situation in 1970 was better than at the end of 1972).

Adding these three groups to the "unemployed" as estimated, brings the number of people who have an employment problem that the Congress ought to be concerned about up to 9 million—equivalent to 10 percent of the labor force.

This is a minimal estimate of the extent of the problem. It leaves out many people working below their highest skills. It leaves out people earning little above poverty-level incomes by full-year work. It leaves out people who are not even found by the census takers. We ought to get better information about these groups. Yet even without going into these points, the presently reported unemployment figure shows only half of the problem we *know* we have.

Second, the present monthly BLS reports include, but they are given little notice, breakdowns which reflect the various *quite different kinds* of joblessness—at least so far as their causes are concerned—which are all called "unemployment". And because we have one word for it—and make the mistake (as I view it) of announcing one over-all average for it (currently about 5%)—the misconception develops that there is one answer to it. This is wrong.

One illustration here will suffice. Adult and teen-age "unemployment" are in my understanding of them substantially different situations—particularly when it comes to what to do about them. The "unemployment rate" announced as being curently about 5% comes from averaging an adult unemployment rate of about 4% and what I would call a Youth Dislocation rate of about 16%. Thirty percent of our "unemployment" total is in the 16-to-19 years age group. It *demands* answers of its own. These youngsters are less significantly "out of work" than they are "out of school" (three-fifths of them)—without the training or education machines can't do better or cheaper. We ought to announce each month as totally separate items—and tell the press that any lumping of them is wrong, that we have been making a mistake about this—an Adult Unemployment total and rate (covering those 20 years of age or older), and a Youth Dislocation total and rate (covering the 16-to-19 year age). Then it would become clearer that we have a problem here—in this "youth dislocation" situation—unparalleled in any comparable country and demanding immediate attention. But just "more jobs" isn't the answer—in itself—to this one.

Third and finally, the necessary steps should be taken to provide regional and local unemployment figures, as well as those for particular narrower areas in which unemployment (however it may be described) is concentrated. A full awareness of the political problems this invites doesn't diminish the realization that without such a break-out, there can be not efficient administration of a manpower training program.

We do what we measure, and the inadequacy of our present "unemployment" measurements represents the single most easily remedied deficiency in the current effect to make full employment—in its true sense—part of our national purpose.

Chairman PATMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Wirtz, what I find lacking and maybe I am unfair to you, is lack of sufficient emphasis on the importance of overall demand for labor as the crux of a successful manpower training program. In other words, it would seem to me that a manpower training program in an atmosphere of high unemployment is unlikely to succeed or succeed very well, whereas if you have a real demand for labor, increasing demand, it is much more likely to succeed and, as a matter of fact, we would get a whale of a lot of private manpower training because employers will hire people to put them to work.

Mr. WIRTZ. The point is completely well taken. I know that none of these manpower programs will work except when there is a real demand for jobs, and I suppose it is just natural after 10 years of fighting what has seemed to me the economists' overemphasis on macroeconomics, that I fail to give enough attention to that. I know that none of this works, none of the training will pay off, unless the economy is working well, and there is a strong demand. I appreciate the suggestion and agree completely that I have in my statement

understated the importance of the demand for jobs which will come from a strengthened economy.

Senator PROXMIRE. You provide some facinating analysis of the dehumanizing aspect of some of our work. We have seen it most dramatically demonstrated at Lordstown, Ohio, where the Vega plant is where there have been strikes based not on working conditions or wages but the work is so monotonous and dull and life is so uninteresting for young people who have substantial education.

You suggest a series of changes that are very helpful but could you put a price tag, give us some notion of what this would cost, the extent to which this might increase prices if we did it. You propose, as I understand, sabbaticals for workers. You propose these when firms innovate with new equipment and machinery, the law should require retraining of workers. Wouldn't that increase cost and prices?

Mr. WIRTZ. No. sir, I would take care of the technological retraining program, whatever you want to call it, by taking half of the cost of it out of the unemployment insurance, and the other half of it out of the savings which the companies get from investing in the new equipment.

Now in Germany they are taking it all out of the unemployment insurance, and it does seem a sensible use to be made of the unemployment insurance fund.

Senator PROXMIRE. They can do it there because their unemployment is so much lower, can't they?

Mr. WIRTZ. Their unemployment is lower. There are some differences in the measurements; but there is no point in going into that. Sure, there is less of it there than there is here.

Senator PROXMIRE. So that again this is a problem that could be far more easily solved if we get unemployment down sharply.

Mr. WIRTZ. There is no reason to duck your question. I would pay for it by taking half of that cost for that technological training program out of unemployment insurance and half of it out of the savings under the——

Senator PROXMIRE. Along that line, would you favor an amendment that I have introduced to the Wage-Price Control Act that would provide as a statutory goal the achievement of 4-percent unemployment by April 30, 1974, the end of the Wage-Price Control Act. We have a goal of 2½ percent inflation by the end of the year, and it seems to me these things should go in tandem.

Mr. WIRTZ. Senator, I think that 4 percent is too high.

Senator PROXMIRE. We ought to have something. The administration says 4½ is as low as they will get and they say 4 percent is much too low. I am trying to get something realistic, and I am talking about a year, I am not talking about what it ought to be. I think as I said it ought to be 2 percent but I am talking about what we can get in a little over a year without inflation.

Mr. WIRTZ. Well, you are speaking about whether it is advisable to accept it as 4 percent. I gather that the current administration figure is 4.5 percent. I guess I do not understand how we would go about just legislating a 4-percent goal. It seems to me we would have to include specific programs.

Senator PROXMIRE. Now specifically, because your expertise is so clear in the manpower training area, what do you think about pro-

grams that tend to fracture the manpower training program nationally by relying on revenue sharing?

Don't you create a situation in which local governments which can't have the same kind of overall view of what our national employment needs are would be responsible for manpower training in a way that might not suit our national needs?

What I am saying is if we had a national manpower training program centralized it would be more efficient and more appropriate than to have one that relies on revenue sharing and relies on local jurisdictions.

Mr. WIRTZ. I have never supported revenue sharing in the manpower field, and feel that the interests of the community as a whole, the national community and the local communities, can be better served by working out sensible administrative arrangements rather than by revenue sharing as such. I add just one point on that: As an illustration, revenue sharing of the manpower program means turning it over to State governments in which there may be five different agencies working in this particular area at the State level. I doubt whether that is going to work.

Mr. HAMILTON. If I could add to that, Senator, from our point of view we don't support special revenue sharing for manpower either, for many of the same reasons, but the most critical point is if you are making a 36-percent cut in what the Federal Government is doing in the manpower area you can label it any way you want it, it is a disaster, and that far overshadows the question of how you organize or dispense it.

Mr. WIRTZ. I agree completely.

Senator PROXMIRE. The final question relates to the Penn Central. Do you agree with Penn Central trustees' decision to ask for $600 to $800 million in loans from the U.S. Government? I opposed that, the administration opposes it. You know more about it than, certainly, than I do, most of us do. I hate like the dickens to go that way, to see us propping up a private corporation when we are starving areas that are so obviously in the public sector and need the funds.

How about it, should we provide this loan?

Mr. WIRTZ. Senator, I speak with a certain hesitancy, and make it clear that I do so only on the basis of public documents. But I think your description of that February report covers only part of it. What ought to be done by the Federal Government, the Congress, and the administration, is to let Penn Central cut back these lines which are not economic, and to let it use only the labor it has a need for, and to stop making it in effect subsidize the passenger business. That $600 million is referred to only as the alternative if these other steps aren't taken.

I wouldn't have been in favor, frankly, of even appearing to be just asking for more money. It would seem to me better to make it clearer that what is being said is, "let us do these things that are essential to do."

The point sticks in my mind in terms of the old, old story about the drunken hotel guest who kept calling the desk starting about 7 o'clock in the morning, wanting to know what time the bar would be open. The clerk kept hanging up on him, and he kept calling back, in his drunken voice insisting that he wanted to know what time the bar would be open. The clerk finally said, "You will have to wait until

10 o'clock to get into the bar." And he said, "I don't want to wait to get in. I want to get out." [Laughter.]

Well, it is about the same way with Penn Central. They are not asking primarily to get into the Federal Government for $600 million. They are asking for what it would take to let them get out of hock to the past, if you will. And so my answer is that if it were just a question of yes or no on whether Penn Central ought to get $600 million—the answer ought to be "No." But it would be no only——

Senator PROXMIRE. What you are saying, then, if we don't require them to maintain these uneconomic services or these jobs that are worthless they won't need that money.

Mr. WIRTZ. I would insist for the time being that the right answer is that these other conditions ought to be changed. Now when you come——

Senator PROXMIRE. Then you are changing your position. I understood you to say let us alone in this area and no money would be needed. Now you are changing, let us alone and then we will talk about it.

Mr. WIRTZ. I don't mean to at all. I thought you were talking about another possibility, which is that you might not come through with those conditions. I don't mean you, I mean we the public. I would simply insist for the time being that that is the one right answer. Now, if that answer isn't forthcoming, then we will have to face the question of whether the alternative is just to close up.

Senator PROXMIRE. Then you would not need the funds, you would not ask for the funds if, we would not require this uneconomic——

Mr. WIRTZ. If there is support on those three points, I am clear in my own mind that there should be no additional money. I didn't mean to fuzz up that point. I am not suggesting that the three points be met and that the question of more money be taken up after that. So far as I know—or knew—if those three points are adequately taken care of there shouldn't be any more.

Senator PROXMIRE. Mr. Chairman, I want to thank this panel very, very much. I think it has been most helpful in making a record and I think it is going to greatly strengthen the kind of report that we can file in response to the President's Economic Report.

Chairman PATMAN. I share your views. Certainly this panel has been a wonderful panel, and may I suggest, Mr. Wirtz, when you discuss the National Development Bank, please consider the pros and cons of having the National Development Bank take care of cases like Penn Central, Lockheed, and others. Will you do that, please?

Will you please accept the thanks of the committee for your wonderful testimony, each one of you. It has been wonderful and it has been valuable, constructive testimony.

Mr. WIRTZ. Thank you.

Chairman PATMAN. It will be very helpful to us in making our report. Thank you, sir.

The commitee will stand in recess.

[Whereupon, at 12:05 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday. February 20, 1973.]

THE 1973 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 20, 1973

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

The committee met, pursuant to recess, at 10:05 a.m., in room 318, Russell Senate Office Building, Hon. Wright Patman (chairman of the committee) presiding.

Present: Representatives Patman, Reuss, Moorhead, Widnall, Conable, Brown, and Blackburn; and Senators Proxmire, Sparkman, Fulbright, Bentsen, and Javits.

Also present: John R. Karlik and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; L. Douglas Lee, research assistant; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF CHAIRMAN PATMAN

Chairman PATMAN. The committee will please come to order.

The Joint Economic Committee today begins its final week of hearings on the President's annual economic message. Today's hearing will be one of the most important of the series by virtue of the fact that the witness is Arthur Burns, Chairman of the Federal Reserve Board. The Board, under the leadership of Mr. Burns, formulates and implements monetary policies which, along with fiscal policy established by the administration, determines the conditions of the Nation's economy. In effect, the stature of the Federal Reserve Board ranks with that of the President in shaping our economy.

Welcome to the hearing, Mr. Burns. We are glad to have you, sir.

Mr. BURNS. Thank you.

Chairman PATMAN. We appreciate and need your information.

But before you begin your statement, I wish to make a few brief remarks about the conditions of the economy and the role played by you and the Federal Reserve Board.

On January 31, President Nixon, in the letter of transmittal that accompanied his economic report, said:

> The general prediction is that 1973 will be another very good year for the American economy. I believe that it can be a great year.

A part of the background against which that remark was made consists of what the President had called "the most significant monetary agreement in the history of the world," reached in December

1971, which resulted, among other things, in the devaluation of the dollar.

Since the President delivered his economic report with its glowing prediction for this year, the Nation has been embroiled in another international monetary crisis. The "most significant monetary agreement in the history of the world" was replaced with another agreement resulting in another devaluation of the dollar—reductions totaling nearly 20 percent in little more than a year. A few more of these international monetary agreements and the U.S. dollar will be approaching the status of banana republic currency. But then the administration would have us believe that devaluation is a good thing. If it is then countries that have devalued their currency the most must be looked on as the economic leaders of the world and those that revalued their currency upward are failing to achieve prosperity and are economically weak.

So far it has turned out to be a great year for currency speculators, a large number of whom are apparently U.S. multinational banks and nonfinancial corporations who joined the betting against the U.S. dollar and shared in the windfall profits resulting from the exchange of our currency into German marks and Japanese yen. The profits stemming from transactions in marks alone amount to $600 million.

In this connection, Federal Reserve Board member Andrew Brimmer has disclosed in a recent study that more than half of the Nation's 20 largest banks have 20 percent or more of their deposits in foreign branches. Two of the 20 have 46 percent of their total deposits in overseas branches, 5 have at least one-third of their deposits in foreign branches.

Through their foreign branches these banks can amass substantial amounts of a given currency for speculative purposes and easily convert these funds in contradiction of section 25 of paragraph 2 of the Federal Reserve Act, which states that U.S. banks are permitted to establish foreign branches "for the furtherance of foreign commerce of the United States."

Perhaps before you finish testifying, Mr. Burns, I hope you can inform the committee how massive currency speculation contributes to the furtherance of foreign commerce of the United States. I am sure the committee would also like to know whether the Federal Reserve Board has mustered enough concern in view of present circumstances to scrutinize the activities of these foreign branches to find out to what degree they are or are not fulfilling their statutory obligation. I am told that as of now neither the Federal Reserve nor the Comptroller of the Currency has any information along these lines.

The need for such information is urgent because foreign branches are an integral part of the overall operations of their parent U.S. banks. Any foreign branch can call on its U.S. headquarters to supply it with financial resources. In an emergency situation the parent U.S. bank can even borrow from the Federal Reserve for this purpose. In this situation, loans made by foreign branches are guaranteed by U.S. credit resources and ultimately by the Federal Reserve as the lender of last resort.

Equally important is the astounding growth of foreign branching by U.S. banks. In 1960, 8 U.S. banks had 131 foreign branches with

assets of $3.5 billion. By 1971, 91 U.S. banks had 577 foreign branches with assets totaling $67 billion.

Moreover, U.S. banks have been allowed to form consortiums among their overseas branches—something that is not allowed in domestic banking. Such consortiums are also allied with foreign banks which have branches in the United States, sometimes in the same cities where the parent U.S. banks are headquartered. Thus, the effectiveness of restrictions against this practice by domestic banks alone is threatened.

These financial consortiums now command resources which dwarf the sum of foreign reserves held by all governments. If left unchecked they will destroy the concept of governmental sovereignty in the financial markets.

I hope, Mr. Burns, that the Federal Reserve's silence on this situation will be replaced by action. This committee stands ready to cooperate in any way it can to help establish whatever disclosure requirements are needed and to provide additional safeguards and restrictions for the purpose of effective control.

The international currency crisis has been directly linked to lack of confidence in phase III of the administration's economic stabilization program, despite Mr. Burn's recent statements to the Senate Banking Committee concerning the success of the program. Basically, there was and continue to be little confidence that the administration supports its own standards regarding economic controls. In point of fact, the currency crisis developed at the very time the administration was making emphatic statements about clobbering violators with clubs. Those clubs have remained stashed away in a White House closest, even though the prime rate, business loan rates, yields on short-term Federal securities and mortgage interest rates have all been allowed to climb appreciably in the last 10 months, even though the Wholesale Price Index rose at an annual rate of 13.2 percent in January and 19.2 percent in December, even though rents have skyrocketed with the announcement of phase III.

The only phase III effort to hold down prices that the public is aware of consists of the jawboning effort launched by Mr. Burns as the Chairman of the economic stabilization program's Committee on Interest and Dividends to roll back a one-fourth point increase in the prime rate declared by four New York and Philadelphia banks. The rollback was achieved amid reports that these and other banks intend to hold the prime rate at 6 percent in what amounts to a meaningless gesture while charging higher than prime rate interest to prime customers. This has already been evidenced by higher interest rates being charged to stock brokers, a class of borrowers that historically have enjoyed prime rates.

Moreover, Mr. Burns has made it perfectly clear in his testimony before the Senate Banking Committee that he does not plan on extending his moral suasion or jawboning efforts to hold down interest in other loan categories. Using a line of reasoning, the logic of which so far escapes me, Mr. Burns has stated that he is willing to exert pressure on the prime rate because it is an institutional or administered rate, whereas interest rates that apply to other loan categories are governed by market conditions. To impose a ceiling on these rates, he has said, would cause inflation. In other words, rising prices can be used to fight inflation—in this case the rising cost of money. Under these ground

rules, the task of the Committee on Interest and Dividends has been confined to making sure the corporations retain a portion of the dividends they would otherwise pay out to stockholders and to watch over the all but meaningless prime rate. Perhaps you can clarify your thinking on this point, Mr. Burns.

I also hope you will comment on the astounding statements made by Robert Mayo, president of the Federal Reserve Bank of Chicago, who told the Wisconsin Bankers Association earlier this month that the administration's economic policymakers believe they have to protect banking against its own inclination to raise the cost of money and thus set the stage for legislation requiring control of interest rates. He noted that "the interest in this Congress is for the protection of consumers." And he told his banker audience to "play it cool for the next couple of months" in order to win the battle against governmental control of interest rates. I was not aware, Mr. Burns, that you, as an economic policymaker, were waging a battle against control of interest rates and consumer protection, but then Mr. Mayo may know you better than I do. In any case, I am sure the banking community is relieved to know they have nothing to fear from the administration.

It is apparent that the administration's attitude on interest rates parallels the Federal Reserve Board's attitude about the effect of its monetary policies on priority areas of the economy. You have often said, Mr. Burns, that it is the duty of the Federal Reserve to exert monetary policy in an overall sense. Little, if any, effort should be made to protect or support priority credit needs, such as housing, State and local government financing, and loans for small business and industry. But the effect of the Federal Reserve's restrictive monetary economy. The effect is to reserve whatever credit is available for the largest corporations and wealthiest individuals who can afford the cost of exorbitant interest rates. True priority areas are shoved to the back burners of the Nation's economy. It is a priority system in reverse.

Suggestions made by the Federal Reserve to protect housing against tight money-high interest rate conditions would not alter this picture significantly. Proposals dealing with variable interest rate mortgages, lengthening the maturity of deposits in mortgage lending thrift institutions and use of investment tax credits would not really change the acute shortage of adequate residential mortgage funds at reasonable rates during periods of restrictive monetary policy—to say nothing about other priority areas of the economy.

A recent study conducted for the Joint Economic Committee by the General Accounting Office disclosed that savings of $2.5 billion to $5 billion could be achieved between now and 1978 through a direct Federal lending program to provide low and moderate income families with residential mortgage loans. The savings could be achieved by virtue of the fact that the Federal Government can borrow loan funds at rates appreciably less than those charged by private sector lenders and subsidized by the Federal Government. It is my understanding, Mr. Burns, that despite these savings you would still prefer to have low and moderate income families rely on private sector lenders—even during periods when residential loan funds have been drastically cur-

tailed and whatever credit is available carriers intolerable interest rates which these borrowers cannot possibly afford.

I hope you will explain that position to the committee so that we may all see how it provides the Nation with a better way of fighting inflation and achieving the national housing goals.

Last week several committee witnesses issued sharp warnings that they expected heavy credit demands this year coupled with an increasingly restrictive monetary policy on the part of the Federal Reserve will lead the Nation into another crippling credit crunch. If they are right—and I sincerely hope that they are not—housing, State and local governments and small business and industry will once more be starving for loan funds at reasonable rates of interest. The Nation will experience its third tight money-high interest rate crisis in less than 10 years. The prospect of another credit crunch and the repeated history of tight money-high interest rate conditions should serve to convince the last doubter that Congress must fashion a method by which priority areas of the economy can be protected from these cyclical onslaughts—especially since they now seem to be an economic habit.

A large part of the solution to this problem can be provided through creation of a national development bank designed to provide adequate funds at reasonable rates of interest for all priority areas of the economy which cannot obtain such loan funds from conventional credit sources. In essence, a national development bank would be a federally funded direct loan program for low- and moderate-income family housing, for State and local governments and for small business and industry. One of its primary benefits would be extension of credit to economically depressed areas and areas which are threatened with economic depression by restrictive monetary policies. Funding for a national development bank could be provided through required purchase of bank obligations by the Treasury and through the sale of fully guaranteed obligations in the open market.

One of the most important aspects of a national development bank would consist of a capacity to guarantee the obligations of State and local governments, school districts, and of small business and industry as well as to provide direct loans. With the full faith and credit of the Nation standing behind them, the debt instruments of State and local governments would have the highest credit rating in the market. This is something which many of these borrowers cannot even approach under current market conditions because such relatively small borrowers are penalized by bond raters, not because of their inability to repay loans, but because they are simply unknown.

Simple economic justice demands the creation of a national development bank so that needed credit can be provided by priority areas. In effect, the operation of such a bank would tend to reverse the misguided priorities established by restrictive Federal Reserve monetary policy. As I indicated earlier, the Federal Reserve makes a great point of saying that it refuses to select priorities in implementation of monetary policy, but the sorry facts of the matter are that large corporations end up getting most of whatever credit is available and the rest of the economy is made to shoulder the burden of high interest and diminished credit. The priorities of this system are unmistakable and completely unjustified.

I wish to make it clear that the existence of a national development bank is simply recognition of, and a substitute for, the absence of stable, even-handed fiscal and monetary policies that are equitable for the people of the Nation who are most in need of credit at reasonable rates. If present patterns were reversed, there would be no need for this kind of public peoples' banks.

And the pattern can be reversed. It can be reversed in large part by making the Federal Reserve responsive to the policies of Congress and the administration. By this I mean the Federal Reserve Board should be reorganized so that each President would have the opportunity to appoint a majority of its members during his first term in office. No other agency of Government is controlled by persons whose terms of office runs 14 years, more than twice as long as any President is allowed to serve.

By the same token, the system by which the Federal Reserve is financed should be ended. There is absolutely no reasonable basis for allowing the Federal Reserve System to control an enormous portfoilo of Federal debt obligations and live off the income of such instruments. These two features, the tenure of office and a source of funds which it alone controls, make the Federal Reserve System completely independent of those who are elected to serve the people of this Nation—the Congress and the President.

But the situation is even worse than this. At present the Federal Reserve holds $71 billion in Treasury bonds in its portfolio—bonds which have been completely paid, but which continue to draw more than $4 billion a year in interest. In effect, this means that the national debt is far higher than it should be. Now, I recognize that the Federal Reserve needs debt instruments with which to conduct open market operations and thus implement monetary policy, but certainly not $71 billion in paid up bonds. The Federal Reserve itself has emphatically indicated and, in fact, presented testimony to congressional committees, that it needs no more than $10 billion in bonds with which to conduct open market operations.

The course of action which should be followed is unmistakable. All but $10 billion of the Federal Reserve's $71 billion portfolio should be canceled. Moreover, no interest should be paid by the Treasury to the Federal Reserve on such obligations and instead the Federal Reserve operations should be financed through congressional appropriations.

In this way, the national debt can be reduced $61 billion, interest payments of $4 billion annually can be ended, and monetary decisions can be made responsive to the policies of Congress and the President by virtue of the fact that the President shall appoint a controlling number of Federal Reserve Board members, with the advice and consent of the Senate and Federal Reserve financing shall be provided by Congress.

Once and for all we will have put an end to what is nothing less than a monetary monarchy within what is otherwise a democratic government.

Again, welcome to the hearing, Mr. Burns.

I would like to insert in the record at this point excerpts from a statement that was prepared by Mr. Andrew F. Brimmer, member, Board of Governors, Federal Reserve System, about the foreign bank

accounts, and other matters relating to it and without objection, it will be inserted at this point.

[The excerpts from Mr. Brimmer's statement follow:]

TABLE 3.—ASSETS AND DEPOSITS OF SELECTED LARGE BANKS IN THE UNITED STATES, JUNE 30, 1976

[Millions of dollars]

Name of bank	Total domestic assets	Deposits: Total deposits	At domestic offices	At foreign offices	Foreign as percent of total
Multinational banks (20):					
1. Bank of America, San Francisco	26,086	32,393	21,667	10,726	33.1
2. Chase Manhattan, New York	19,919	22,823	14,985	7,838	34.3
3. First National City, New York	17,847	25,035	13,471	11,564	46.2
4. Manufacturers Hanover, New York	10,972	11,964	9,024	2,941	24.6
5. Chemical Bank, New York	10,971	10,787	8,520	2,267	21.0
Subtotal	85,795	103,002	67,667	35,336	
Share of multinational total (percent)	(49.28)	(53.16)	(49.82)	(60.99)	
Share of grant total (percent)	(22.74)	NA	(22.51)	NA	
6. Morgan Guaranty, New York	9,724	10,717	6,646	4,071	38.0
7. Security Pacific, Los Angeles	9,162	9,132	7,721	1,411	15.5
8. Bankers Trust, New York	8,151	9,521	6,550	2,971	31.2
9. Continental Illinois, Chicago	7,932	8,176	5,978	2,199	26.9
10. First National Bank, Chicago	7,405	7,400	5,195	2,206	29.8
Subtotal	42,375	44,946	32,090	12,858	
Share of multinational total (percent)	(24.34)	(23.19)	(23.62)	(22.19)	
Share of grand total	(11.22)	NA	(10.68)	NA	
11. Wells Fargo, San Francisco	7,016	6,711	5,589	1,122	16.7
12. Crocker Citizens, San Francisco	6,096	5,862	4,911	951	16.2
13. United California, Los Angeles	5,761	5,085	4,468	615	12.1
14. National Bank of Detroit	5,110	4,802	4,222	580	12.1
15. Mellon National Bank, Pittsburgh	4,736	4,963	3,548	1,415	28.5
Subtotal	28,718	27,421	22,738	4,683	
Share of multinational total (percent)	(16.49)	(14.15)	(16.74)	(8.08)	
Share of grand total	(7.61	NA	(7.56)	NA	
16. Irving Trust, New York	4,043	4,164	3,165	999	24.0
17. First National Bank, Boston	3,765	3,974	2,646	1,328	33.4
18. First Penn., Bala Cynwyd, Pa	3,501	2,946	2,566	380	12.9
19. Marine Midland, New York	3,136	4,962	2,610	2,352	47.4
20. Cleveland Trust, Cleveland	2,774	2,361	2,358	3	
Subtotal	17,214	18,407	13,345	5,062	
Share of multinational total (percent)	(9.89)	(9.50)	(9.82)	(8.74)	
Share of grand total	(4.56)	NA	(4.44)	NA	
Multinational total	174,107	193,776	135,840	57,939	
Share of grand total (percent)	(46.11)	NA	(45.19)	NA	
Regional banks (60)	92,116	NA	71,180	NA	
Share of grand total (percent)	(24.40)	NA	(23.68)	NA	
Local banks	111,360	NA	93,563	NA	
Share of grand total (percent)	(29.49)	NA	(31.13)	NA	
Grand total	377,583	NA	300,583	NA	
Memorandum:					
All insured commercial banks (number: 13,669)	661,838		549,985		
Weekly reporting banks (as percent of all insured banks)	(57.1)		(54.6)		
Multinational banks	(26.4)		(24.6)		
Regional banks	(13.9)		(12.8)		
Local banks	(16.8)		(17.2)		

NA Not applicable.

Note: Head office claims on foreigners and assets of foreign branches are not shown for individual banks to prevent disclosure of confidential data. However, these data are shown for the multinational banks grouped by size into 4 classes of 5 banks.

Sources: Federal Reserve Board. Total assets: Call Report June 30, 1972. Deposits: Consolidated Call Report, June 30, 1972. Head office claims on foreigners, Voluntary Foreign Credit Restraint reports. Assets of branches, monthly reports to Federal Reserve Board.

The report to the Senate Finance Committee on "Implications of Multinational Firms for World Trade and Investment and for U.S. Trade and Labor" estimates that short-term assets of the principal institutions active in international money markets totaled $268 billion in 1971.

This figure is equal to nearly 60 percent of the U.S. money stock at the end of 1971, $465 billion, defined as currency, demand deposits, and time deposits at commercial banks (excluding large CDs).

It is more than three times as large as the total international reserves of all the "industrial countries" as defined by the IMF at the end of 1971—$88.5 billion.

It is well over twice as large as total world reserves—$122 billion.

The implications, then, of these privately held short-term assets for international and domestic monetary policies are enormous.

Of the $268 billion of short-term assets in the international money markets in 1971, $190 billion—or 71 percent—were controlled by U.S. institutions—U.S. banks and their branches and U.S. non-banks and their affiliates. The portion controlled by U.S. banks and their foreign branches (and excluding their affiliates) was $74.4 billion or 28 percent of the total. On the liability side, the figure was slightly higher. Of an estimated total of $201 billion in short-term liabilities controlled by the principal private institutions active in international money markets in 1971, $77.5 billion or 38½ percent were controlled by U.S. banks and their foreign branches. Thus, the share of private short-term assets in these markets controlled by U.S. banks is equal to 84 percent of the reserves of the industrial nations, or 61 percent of total world reserves.

The significance and implications of the role of U.S. banks in these markets is obvious and I hope that before you leave today, Dr. Burns, you will comment on the problem it poses for Federal Reserve policy and the monetary policies of other nations as well.

Chairman PATMAN. All right, now, shall we proceed under the 10-minute rule, is that satisfactory? We ought to have him deliver his statement and then we will have the 10-minute rule. Mr. Burns, we will hear your statement first.

STATEMENT OF HON. ARTHUR F. BURNS, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

It is a pleasure to meet once again with the Joint Economic Committee to present the views of the Board of Governors on the condition of the national economy.

The past year has witnessed a remarkable expansion of economic activity. The physical output of goods and services rose 7.6 percent over the past four quarters, and production in the industrial sector advanced even faster. The number of persons employed in civilian jobs has of late averaged about 2½ million above year-earlier levels. Last month, the rate of unemployment fell to 5 percent, or nearly a full percentage point below the level of a year ago.

Economic expansion during the past year was also well balanced, and employment therefore recovered in practically all major sectors of the economy. Consumers have been spending freely on a wide array of goods and services. This housing industry has defied earlier predictions of an impending decline. Business expenditures for capital equipment have risen substantially. And inventory investment, a laggard in this recovery, has also joined the economic advance of late.

As we see the state of business, the current expansion has considerable momentum. Consumer buying and business investment in fixed capital are both likely to continue their upward course. Business firms, moreover, will need to add substantially to their inventories in coming months to accommodate a rising pace of sales. A good increase in physical output during 1973 thus appears in prospect. As produc-

tion increases, the demand for labor will grow, and we may look forward with some confidence to further declines in unemployment during 1973.

While we have been experiencing robust expansion in the domestic economy, our foreign trade has proved singularly disappointing. True, exports rose substantially last year, but the dollar value of our imports increased even more. The vigor of our economic expansion was a major cause of the rise in imports. Other factors were also at work, including the explosive increase in energy requirements which caused our oil imports to grow.

Our overall international economic accounts have continued to be seriously out of balance. The Smithsonian agreement of December 1971 was recognized by all concerned as a temporary arrangement, but it was also felt that it would give the nations of the world sufficient time to rebuild the monetary system on a permanent basis. As events have turned out, less was achieved through the Smithsonian agreement than we or other nations expected from it. Serious conversations on international monetary reform have been underway for several months, but they have gone forward much too slowly. Meanwhile, another monetary crisis developed in recent weeks. The reasons for its precise timing may be debated, but there can be no doubt about the underlying cause; namely, the huge continuing deficit in the balance of payments of the United States, which has had its counterpart in the persistent surpluses of other countries.

The progress we need in our international accounts is enormous, and the way to a lasting solution does not depend on us alone. The devaluation of the dollar announced last week, together with the realinement of exchange rates accepted by other countries, should prove helpful over the longer run. Prompt action is now needed to revise the par value of the dollar and to adopt new legislation to promote expansion of international trade and to help restore equilibrium in our international transactions.

In the months immediately ahead, opposite influences will play on our foreign trade. The currency realinement will have a perverse influence until demand patterns become readjusted to the new structure of exchange rates. On the other hand, the expansion of economic activity abroad will tend to bolster our exports in coming months. Also, our underlying competitive position in world markets should improve as a result of recent trends in costs and prices in the United States and abroad.

In most industrialized nations, inflation last year was proceeding at a pace substantially faster than in the United States. Our own inflationary problem, though worrisome, has thus far been under better control. In the first half of 1971, prior to the imposition of wage and price controls, the rate of inflation was about 5 percent, judging by comprehensive price measures for goods and services produced in the private sector. The inflation rate slowed to 3½ percent in the first half of 1972, and to about 3 percent in the latter half of last year.

This moderation in the pace of inflation has resulted from reduced pressure of rising costs on prices. Unit labor costs in the private nonfarm sector rose last year by only 1.6 percent, compared with 3.4 percent in 1971 and 6.6 percent in 1970. The improvement stemmed mainly

from larger increments to productivity, but a somewhat slower advance in wages was also a factor.

The progress we have thus far made in moderating inflation is, however, insufficient. There is no room for complacency when the average level of prices is still rising quite rapidly, when it appears likely that productivity improvements will fall short of last year's fast pace, when wage rate increases—if we may judge from the closing months of last year—are becoming larger again, when imported goods are going to cost more as a result of the recent devaluation of the dollar, and when American families are facing sharply higher grocery bills.

The unhappy recent rise in food prices is especially disturbing. This should not, however, blind us to the remarkable accomplishment of the past year and a half—a period when price advances became smaller while real output and employment were growing very briskly. This is an unusual pattern of behavior in an advanced phase of a business-cycle expansion.

Let me turn next to the role that monetary policy has played in recent developments.

A year ago, as the committee will remember, unemployment was still nearly 6 percent of the labor force, and industrial production had not yet regained prerecession levels. With an effective wage and price policy in place, the central task of monetary policy was to promote expansion in economic activity on a sufficient scale to reduce the gap between actual rates of production and our full employment potential.

There can be no doubt that ample availability of credit contributed materially to the expansion of economic activity over the past year. For example, the impressive rise in consumer purchases of new autos and other durable goods could hardly have occurred without a pronounced increase in consumer installment credit. Again, the exceptional growth of residential mortgage loans contributed powerfully to sustaining new housing construction at record levels. I am also convinced that the stability of long-term interest rates strengthened investor confidence and facilitated the expansion of business capital investment; the weakness of this sector, it may be recalled, had seriously restricted economic recovery during 1971.

Early in 1972, monetary policy sought to make up for the shortfall in the growth of money balances in late 1971. The rate of monetary expansion was, therefore, high in the first quarter of 1972. As the year progressed, evidence accumulated that economic expansion was quickening and that increasing demands for credit were putting upward pressure on short-term market interest rates. This gave rise to some concern about the market for longer term securities. It nevertheless was clear that efforts to prevent a rise of short-term market rates would result in excessively rapid expansion of the monetary aggregates.

Federal Reserve policy therefore tolerated the rise in short-term market interest rates that began last March and has continued since then. By the end of 1972, yields on Treasury bills, commercial paper, Federal funds, and on other short-term market instruments had increased about 2 percentage points from their lows, and some further upward adjustment has occurred since the beginning of this year.

Past experience indicates that a rise in short-term market interest rates is usually followed by slower growth of the monetary aggregates. This was an objective of monetary policy during 1972, and the rate of

increase in the narrowly defined money supply—that is, demand deposits plus currency in public circulation—did in fact moderate during the late summer and early fall of 1972. Late in the year, however, additions to money balances spurted to a pace well above what the Federal Open Market Committee desired.

The precise causes of the unusual increase in money supply last December are still somewhat elusive. One known factor is that the revenue-sharing checks received by States and localities temporarily raised the cash balances of these governmental units. It may also be that a change during November in Federal Reserve regulations governing bank remittances for cash letters contributed to the spurt. In any event, the December bulge in money growth proved to be short lived. This January, the narrowly defined money supply showed no further increase.

Increases in the money stock are very uneven over time, and rates of increase must be measured over more than a few months to determine the thrust of monetary policy. Thus, the narrowly defined money supply grew by 7.4 percent from the fourth quarter of 1971 to the fourth quarter of 1972. This was actually a little less than the increase in real output of goods and services, and far less than 11 percent rise in the dollar value of output. If the money supply had grown at a significantly lower rate, we would probably have experienced smaller gains in real output and employment last year, and unemployment would be at a higher level now.

In view of the lag in the workings of monetary policy, the Federal Reserve did, however, deem it desirable to move gradually toward a less expansive monetary policy during 1972. In the first quarter, the reserves for supporting bank deposit expansion came entirely from open market operations. But as the year moved on, a sharp reduction occurred in the additions to nonborrowed reserves—from a 12 percent annual rate in the first half of the year to 2 percent in the second. Member banks reacted to this more reluctant provision of reserves as they customarily do—that is, by borrowing more at the discount window. There are, however, limits to such a process. Bankers know that they cannot rely on these borrowings in more than limited amounts or for more than limited time periods.

Developments have thus been underway for some time that should result in somewhat slower growth of the monetary aggregates. The Federal Reserve has also taken other restraining actions. Late in November, the Board raised margin requirements to forestall excessive use of credit in the stock market, and we thereby also indicated our concern about potential inflationary developments. And in January, the discount rate was raised to bring it into better alignment with market rates of interest. This move served notice to the banking system and to the public at large that supplies of money and credit were being brought under a tauter rein.

The current economic expansion has entered a more sensitive phase, in which new problems may be encountered. A substantial further increase of real output is needed to provide employment opportunities for a growing labor force, and to make possible further progress in reducing unemployment. However, with labor and capital resources being utilized more fully, the expanding demand for goods and services could begin to pull prices upward and thereby reinforce prevailing

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cost-push pressures. In the absence of monetary and fiscal restraint, excess aggregate demand might easily reemerge and touch off a new round of inflation.

This must not be permitted to happen. The hard-won gains our Nation has made in the struggle against inflation must not be frittered away. To do so would say the confidence of our people in the integrity of Government. We must also be mindful of the fact that inflation is now being resisted abroad by more stringent monetary policies, and also by incomes policies in some countries. If the potential benefits of the new exchange rate realinement are to be realized, the rate of inflation in the United States must be reduced further. For monetary policy, these considerations indicate a need to practice greater moderation during 1973 in the provision of new supplies of money and credit.

The Federal Reserve will remain mindful, nevertheless, of its responsibility to support further gains in real output and employment. Success in that endeavor will mean continued expansion in business activity, and thus rising credit demands. Market interest rates may, therefore, rise further, as they typically do in the expanding phase of the business cycle. But it is my hope and expectation that sharp increases in long-term rates can be avoided.

I can assure this committee of two things. First, the Federal Reserve recognizes that in order to keep the monetary and credit aggregates under good control, it will be necessary to avoid efforts to hold open market interest rates at artificially low levels. Second, the Federal Reserve does not intend to permit severe stringencies to develop in the credit markets, or to try to correct for every error in public or private policies.

The proper role of monetary policy in the achievement of our national economic objectives is a comparatively modest one. Monetary policy can help to establish a financial climate in which prosperity and stable prices are attainable. But it cannot guarantee the desired outcome; the task is much too large.

The course of fiscal policy certainly has a vital bearing on reaching our national economic objectives. It now appears that Federal budget outlays in fiscal 1973 will be held to $250 billion—or some $6 billion below what the staff of the Joint Committee on Reduction of Federal Expenditures estimated just a few months ago. This would be a welcome achievement. Furthermore, the proposed budget for fiscal 1974 calls for a balance between revenues and expenditures at full employment.

However, the administration's budget for fiscal 1974 can hardly be called austere. After all, total outlays are scheduled to rise an additional $19 billion or 8 percent. The national interest would be well served in present circumstances if the Congress saw fit to stay at or below the expenditure limits proposed by the President. It is also highly important, as the members of this committee well know, that congressional procedures be reformed so that Federal spending can be brought under better control.

Early evidence of better control over Federal expenditures would go a long way toward assuring the public that excess aggregate demand will not reemerge in 1973 and later years. But there are times when overheating of the economy originates in the private sector. At such times, flexible fiscal tools can help to curb private spending.

Some months ago, the Federal Reserve Board urged the Congress to consider a variable investment tax credit as a means of improving the conduct of economic stabilization policy. The essence of the proposal is that the President be given authority to initiate changes in the investment tax credit. At the same time, Congress would retain its traditional control over taxes and act as a full partner in making the needed adjustments. For example, the President might be permitted to change the tax credit within a specified range—say, between zero and 10 or 15 percent, subject to modification or disapproval within 60 days by Congress.

This proposal, the Board believes, would facilitate making the timely adjustments required for a more effective stabilization policy. Prompt action by the Congress on a flexible investment tax credit would make it possible to use this instrument, if it were needed, to curb the growth of business capital expenditures later on in this expansion.

Improved policies of managing aggregate demand, important though they be, will not of themselves suffice to assure prosperity without inflation. Structural reforms are also needed. Not a few of our corporations and trade unions now have the power to exact rewards that exceed what could be achieved under conditions of active competition. As a result, substantial upward pressure on costs and prices may emerge long before excess aggregate demand has become a problem.

There is no easy path to meaningful structural reform. Genuine progress would require that we undertake to curb abuses of economic power by both business firms and trade unions, besides reappraising a host of laws and governmental regulations that interfere with the competitive process.

Let me turn, before closing, to the role that private policies must play to insure that inflationary developments do not frustrate governmental efforts to promote prosperity without inflation.

Since August 1971 our Nation has been engaged in a new effort to influence wage and price decisions through direct controls. In its present phase, greater reliance is placed on self-discipline in abiding by rules of appropriate behavior. Phase 3, however, is hardly a voluntary program. Several areas of the economy remain under mandatory control. Furthermore, the President has indicated his firm intention to take whatever action may be necessary to achieve compliance with the objectives of the program. He has ample authority to do so under the Economic Stabilization Act.

Yet, in the final analysis, the workability of any form of controls in an economy as large and complex as ours depends on public acceptance of the need for controls and on cooperation of the participants in the program. Phase 2 was successful in moderating wage rates and prices because of the widespread support it received from the American public, including business firms and the trade unions. Phase 3 will enjoy a reasonable measure of success if that spirit of cooperation continues, and if labor and management join together to increase productivity and to hold down increases in wage rates and prices.

Our Nation's financial institutions must also make their contribution if the stabilization program is to succeed. It will be in their own interest, as well as in the national interest, to manage their lending policies more cautiously in the months ahead. Any rapid rise in com-

mitments for future lending, for example, would increase the exposure of individual financial institutions to a liquidity squeeze, and at the same time contribute to an inflationary round of spending by businesses and other borrowers. Wise bankers will shun the temptation that arises during a period of business expansion to step up their lending activities. If excessive extensions of credit are averted through exercise of prudence by lenders and borrowers, the need for strong monetary restraints will not arise.

In recent weeks, I have felt a sense of concern developing across the Nation about the ability of the United States to deal with the problems that prosperity creates. This concern is understandable. We live in troubled times, and memories are still fresh of the damage produced by inflation during the later years of the 1960's. But there is no need to be afraid of prosperity. Our national economic policies are now set on a course that promises to bring us closer to the goal of a prosperous economy with stable prices. If we persevere, as we must, that objective can be realized.

Thank you.

Chairman PATMAN. Mr. Burns, I prefer not to ask questions but I would like to file written questions for the record if you will answer them for me when you correct your transcript.

Mr. BURNS. I will be very glad to do that.

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

RESPONSE OF HON. ARTHUR F. BURNS TO WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. I assume, Mr. Burns, that you are familiar with remarks made earlier this month by Robert Mayo, President of the Federal Reserve Bank of Chicago, when he spoke to Wisconsin bankers.

Mr. Mayo said that the Administration's economic policy makers want banks to play it cool on interest rates until after Congress has extended the Economic Stabilization Act, otherwise the Administration might lose what was described as the battle against mandatory control of interest rates.

Was Mr. Mayo reflecting the views of the Administration's economic policymakers when he said these things? If not, what do you suppose put such an idea in his head?

Do you think that any banker listening to Mr. Mayo would think he has anything to fear from the Administration if interest rates continue to rise?

Answer. Mr. Mayo has informed me that in his answer to a question raised by bankers critical of the efforts of the Committee on Interest and Dividends to forestall increases in the prime rate, he reminded them that the timing of such proposed increases seemed to him to be a premature reflection of short-term interest rate increases in the market and that caution on the part of the bankers would be in their own self-interest, as well as in the national interest, since they presumably would prefer voluntary to mandatory controls. Mr. Mayo was speaking only for himself, but I see no inconsistency between his views and my own on the necessity of self-discipline in abiding by rules of appropriate behavior.

Question 2. As you know, Mr. Burns, the General Accounting Office has conducted a study for the Joint Economic Committee indicating that $2.5 billion to $5 billion could be saved by the Federal Government between now and 1978 if Federal loans were made on a direct basis to low and moderate income families qualifying for federally assisted residential mortgage loans. The basis for this conclusion is the fact that the Federal Government can borrow money at rates which are cheaper than the cost of subsidizing housing loans made by private lenders at market rates.

Such an approach would not add any additional pressure to financial market since the loans would be made anyway by the private sector but at much greater cost. Furthermore, mortgage lenders have indicated they would not object to

such an approach to the housing needs of low and moderate income families so long as lenders can serve these loans.

What do you think of that, Mr. Burns?

Answer. This proposal suggests a direction for public policy that I believe the Congress would be ill advised to pursue. Mortgage lending functions—traditionally the province of private financial intermediaries—would be further centralized in the Federal Government, and expansion of Federal direct lending within this area would almost certainly lead to demands for similar treatment by other sectors. Furthermore, an increase in direct mortgage lending by the Federal Government would add correspondingly to budgetary expenditures over the near term and thereby complicate the management of our fiscal affairs.

The savings in cost that this proposal appears to offer could, in my opinion, prove largely illusory. The calculated saving is based on the interest yield of 6.5 percent on long-term Treasury bonds issued August 15, 1972. This calculation does not take into account the probable increase in interest rates on Treasury notes or bonds that would result if any significant quantity of additional long-term Treasury securities were issued to provide needed loanable funds. Furthermore, allowance would have to be made for the additional costs that would accrue to the Federal Government of administering a direct loan program as compared with the present approach.

Question 3. Mr. Burns, is there any reason why the Federal Reserve should hold more than $10 billion in Treasury bonds in its portfolio inasmuch as Federal authorities have stated that at the most no more than that amount would be needed for open market transactions?

Answer. A portfolio of $10 billion or so would provide the Federal Reserve with enough marketable securities to conduct open market operations.

But the Treasury obligations in the System's portfolio perform another important function, as collateral for Federal Reserve notes in circulation. Shifting the bulk of the portfolio to noninterest-bearing securities could undermine public confidence in our currency, because the Reserve Banks then would no longer hold marketable assets equal in value to their liabilities on Federal Reserve notes.

Against the grave risk of undermining confidence in our currency, there would be no offsetting benefit to the Treasury. Even though the Treasury obligations held by the Federal Reserve are marketable because they yield a return, the great bulk of the System's earnings are paid to the Treasury as interest on Federal Reserve notes. Thus, the net effect insofar as Treasury outlays are concerned is the same as if all but $10 billion or so of the Reserve Bank's portfolio were noninterest bearing.

Question 4. Is there any valid reason why the Federal Reserve System, since it is an agency of the Government, should not be subject to a complete audit by the General Accounting Office?

Answer. The accounts of the Board are audited each year by a topflight outside firm of certified public accountants. Their audit report is reproduced in the Board's annual report, and copies of the report are furnished to the Chairman of the House Committee on Banking and Currency and the Chairman of the Senate Committee on Banking, Housing and Urban Affairs. No restrictions are placed on the auditors in the conduct of their duties.

Each Federal Reserve Bank and branch is examined at least once each year by the Board's staff of field examiners, who are directed to determine the financial condition of the Bank and compliance by its management with applicable provisions of law and regulation. The examination includes a comprehensive review of the Bank's expenditures to determine if they are properly controlled and of a nature appropriate for a Reserve Bank. An outside commercial accounting firm is engaged to accompany the Board's examiners on their examination of one Reserve Bank each year, to provide an outside evaluation of the adequacy and effectiveness of the examination procedures.

In addition to the annual examination by the Board's examiners, the operations of each Reserve Bank are audited by the Bank's internal auditing staff on a year-round basis under the direction of a resident general auditor. He is responsible to the Bank's board of directors through its chairman and its audit committee, and is thus independent of the Bank's operating management. Each year, the Board's examiners review thoroughly the audit programs at all the Reserve Banks to see that the coverage is adequate and the procedures effective.

Congress has thus designated the Board of Governors as its GAO for purposes of reviewing the operations of the Reserve Banks. The Board reports directly to Congress, and stands ready to provide any information Congress seeks about

expenditures by the System. If still another arm of Congress were directed to audit the Reserve Banks, the result would be overlapping responsibility, with consequent impairment of efficiency.

Moreover, a degree of confidentiality is essential in conducting many of the System's functions, including examination of State member banks, purchases and sales of securities in the open market in furtherance of monetary policy, and operations conducted on behalf of foreign central banks. Granting GAO access to all System records would pose problems in maintaining necessary confidentiality.

Finally, it should be emphasized that in reviewing agency operations, GAO goes far beyond a simple financial audit. Besides verifying accounts and determining that expenditures are properly controlled and authorized, GAO makes judgments about whether programs authorized by Congress are fulfilling the purposes Congress envisioned, or whether they are no longer needed. In the sensitive area of monetary policy, Congress has vested decision-making responsibility in the Federal Reserve System, and has established safeguards to ensure that the System will exercise independent, professional judgment. Injection of policy critiques by GAO would be inconsistent with this long-established policy of Congress.

Question 5. Why should not each President have the opportunity to appoint a majority of the Federal Reserve Board, including the Chairman, during his first term of office?

Does not the inability of the President to appoint a majority of Federal Reserve Board members during his first term place the agency beyond his authority—beyond his economic policies?

Answer. The Congress deliberately established relatively long terms for Board members as one of several means for assuring the independence of the Federal Reserve System. The reasons for granting such independence were well stated by the Subcommittee on General Credit Control and Debt Management in 1952.

"The independence of the Federal Reserve System is based, not on legal right, but on expediency. Congress, desiring that the claims of restrictive monetary policy should be strongly stated on appropriate occasions, has chosen to endow the System with a considerable degree of independence, both from itself and from the Chief Executive. This independence is in no way related to the unsettled question of whether the Board of Governors is or is not a part of the Executive Branch of the Government. It is naturally limited by the overriding requirement that all of the economic policies of the Government—monetary policy and fiscal policy among them—be coordinated with each other in such a way as to make a meaningful whole. The independence of the Federal Reserve System is desirable, not as an end in itself, but as a means of contributing to the formulation of the best over-all economic policy. In our judgment, the present degree of independence of the System is about the best suited for this purpose under present conditions."

It should be noted that while the Federal Reserve is not subject to policy direction by the Executive, the channels of communication between the Federal Reserve and the President, the Treasury, the Council of Economic Advisers, and other departments and agencies are open and in constant use. Thus the Board and the Administration, in meeting their separate responsibilities, make decisions on the basis of shared information, and a full exchange of views.

Through the years, Presidents have respected the unique status of the Federal Reserve, no doubt because the existing arrangements have worked well for the country.

Question 6. Mr. Burns, why shouldn't the Federal Reserve operations be financed entirely by Congressional appropriations?

Answer. The existing accounting arrangements, under which the Federal Reserve System's expenses are met out of its earings, properly reflect the fact that the System is an independent entity, separate and apart from the Treasury. More importantly, if the System were required to pay all of its earnings into the Treasury and meet its expenses out of appropriated funds, it would lose a substantial degree of its independence.

Moreover, our payments mechanism relies heavily on operations conducted by the Reserve Banks, and interruptions in flows of checks, currency, or coin could seriously curtail economic activity. Financing System operations with appropriated funds without running such a risk would mean that the System would have to defend budget requests large enough to meet maximum possible needs, because the level of these operations varies widely and at times unpredictably.

The Federal Reserve derives its income mainly from the interest it earns on the portfolio of U.S. Government securities it has acquired in carrying out its monetary policy responsibilities. During 1972, the gross current earnings of the Banks amounted to about $3.8 billion. Expenses totaled a little over $400 million, leaving net current earnings of about $3.4 billion. With a $50 million net deduction from profit and loss account (principally due to a $52 million loss on foreign exchange transactions), net earnings before payments to the U.S. Treasury were a little over $3.3 billion. Statutory dividends to member banks amounted to $46 million, additions to surplus accounts were $51 million, and the remaining income, slightly more than $3.2 billion, was paid into the Treasury.

Thus, as a practical matter, the net outcome to the Treasury and the American taxpayer is virtually the same under the present arrangements as it would be under the authorization-appropriations process. The funds required to meet the expenses incurred by the Federal Reserve in carrying out its responsibilities would have to be provided in any event.

Although the Government's income and expenses would be little affected by substituting the authorization-appropriations process, there would be a significant loss to the American public because of the resulting impairment of the independent status of the Federal Reserve.

The tradition of independence of the central bank has wide support not only in Congress but among students of monetary matters. The House Banking and Currency Committe sent out questionnaires in 1968 to 125 economists "representing all schools of thought on the fundamental question of how to manage the Nation's money and credit", in Chairman Patman's words. Among the questions was one asking whether the Federal Reserve should operate with appropriated funds. Those responding in the negative outnumbered those who favored the idea by about two to one.

Secretary of the Treasury Henry H. Fowler, in responding to the same questionnaire, offered the following comments:

"It would not be desirable to make the Federal Reserve subject to the regular congressional appropriations process. There is every evidence that the Federal Reserve is managed prudently and efficiently; thus there is no clear need for the proposal. Adoption of the proposal would almost certainly lead to a major reduction in the existing degree of Federal Reserve independence within the Government and in its insulation from day-to-day political pressures. It would also tend to introduce uncessary operational rigidities that might diminish the System's ability to respond very promptly and flexibly to various domestic and international contingencies.

"While the role of the Federal Reserve within the Government is in many ways unique, it should be noted that the Congress has also exempted the other major bank supervisory authorities—that is, the FDIC and the Comptroller of the Currency—from the regular appropriations process."

Question 7. Despite restrictions applying to domestic U.S. banks, do you think it is all right for foreign branches of U.S. banks to enter into consortiums among themselves and with foreign banks? By the same token, do you think it is all right for these same foreign bank branches to enter into consortiums with U.S. banks, particularly in instances where the foreign branches are located in the same city or area as the U.S. bank?

Answer. The term consortium banking can refer either to a group of banks participating in a given loan transaction or to a separately incorporated banking institution that is owned by more than one bank. The first arrangement is common in both domestic and international banking, as banks often syndicate loans to diversify their portfolios against risk and to avoid legal limits on loans to individual borrowers. Foreign branches of U.S. banks may participate in syndicates of large foreign loans with foreign banks, just as a number of U.S. banks may participate in large loans to their major U.S. customers.

The second type of consortium activity, a banking institution incorporated abroad owned collectively by banks from several conutries, is a relatively recent development in international finance. Some of the large U.S. banks are shareholders in banking institutions of this type that do not maintain offices or places of business in the United States.

To date, there is no evidence of significant anticompetitive consequences from the participation by U.S. banks in foreign banking consortia of either type. In practice, competitive strains have emerged among the shareholders in the foreign banking consortia; individual shareholding banks sometimes prefer to retain the most desirable business in their own portfolios and to channel the

less desirable business to the consortium banks. Therefore, for the most part, these consortium banks have not grown very rapidly.

Question 8. Mr. Burns, section 25 of paragraph 2 of the Federal Reserve Act permits U.S. banks to establish foreign branches "for the furtherance of foreign commerce of the United States."

To what degree have foreign branches of U.S. banks participated in the exchange of U.S. currency for German marks and Japanese yen just prior to the devaluation of the dollar?

Do you view currency speculation on the part of U.S. foreign bank branches under the circumstances that prevailed just prior to devaluation consistent with section 25 of paragraph 2 of the Federal Reserve Act?

Answer. The Federal Reserve has requested information from U.S. banks on the extent of unusual foreign exchange market activity by these banks and their foreign branches, both for their own accounts and for accounts of customers, and will analyze that information when it is received.

Unusual exchange market activity by customers of the foreign branches might reflect speculation, but it also might reflect hedging operations as customers sought to cover their previously unhedged foreign currency positions. There is no ready way for either the U.S. banks or the Federal Reserve to distinguish such hedging operations—which would customarily occur in periods of exchange market uncertainty—from speculative purchases of foreign currencies in anticipation of exchange rate changes. Moreover, the same activity may be regarded as speculation by one party and as hedging by another. Thus it is not possible to ensure that the provision of international banking services by foreign branches will never facilitate speculation.

Question 9. As I said in my statement, the aggregate resources that can be marshaled by consortiums of U.S. foreign bank branches far outweighs the sum of foreign resources held by governments.

How can governments confidently attempt to exert sovereignty with any confidence in this situation?

Answer. The problem of international capital flows is a major topic in the current discussions of reform of the international monetary system. I expect that those discussions will focus on possible methods of dealing with destabilizing capital flows. Success in this area would be substantially furthered by the achievement of reasonable equilibrium in international payments.

International capital flows are a matter of concern to governments because of their effects both on the balance of payments and on domestic monetary conditions. For the United States, flows have not created problems for Federal Reserve monetary policies. The role of U.S. banks in these flows is limited by the voluntary credit restraint program and also by the Regulation M reserve requirement on banks' borrowings from foreign branches.

The flows that have occurred have in good part reflected both the transfers of liquid assets by major international corporations and the use of bank credit by these corporations. In the recent period, it is likely that most of the bank credit was denominated in U.S. dollars. Our data show that some of it came from U.S. banks; some doubtless came from foreign branches of U.S. banks, and some also from foreign banks that have substantial banking operations in the Eurodollar market.

Question 10. Mr. Burns, your statements to the Senate Banking Committee during hearings on the Economic Stabilization Act make it clear that with the exception of the prime rate, you intend to let interest rates applying to other loan categories seek their own level without interference from the Committee on Interest and Dividends.

Moreover, it was reported at the time you were jaw-boning four New York and Philadelphia banks to roll back a ¼ percent increase in the prime rate that there would be no punitive action should they refuse to return to the prevailing six percent rate. It was also widely reported that banks intended to hold the six percent prime rate up a facade and apply higher than prime rates to loans made to prime customers.

In addition, Mr. Burns, you have said that rising interest rates counter inflation. In other words, rising prices are disinflationary.

Do you not think that for the sake of accuracy, the President should change the name of the Committee on Interest and Dividends to the Committee on Dividends alone?

Perhaps you can clarify your position on rising interest rates for the Committee.

Answer. Despite the recent sharp increase in some short-term market rates, the rates with which the Committee on Interest and Dividends is most concerned, such as those on mortgage and consumer loans, generally have remained relatively stable at levels below those prevailing in August 1971.

As I have said on previous occasions, Mr. Chairman, the prime rate and other institutional lending rates should be distinguished from the interest rates that are set in the open and highly competitive market for securities. Any attempt to control rates in the open market would seriously erode the ability of the Federal Reserve Board to conduct monetary policy and, to be effective, would require a vast Federal bureaucracy to take over the job of rationing credit now performed by the market. Neither of these developments would be in the national interest.

The Committee is concerned about the prime rate because it is highly visible and has acquired a symbolic significance. Some increases in the prime rate must be expected if market rates rise. However, the Committee has made it clear that, in the event of prime rate increases, special moderation will be observed with respect to small business and agricultural loans as well as home mortgage and consumer loans.

Chairman PATMAN. Senator Proxmire, vice chairman of the committee.

Senator PROXMIRE. Mr. Burns, the fact that you are a brilliant man, a very reassuring man to have at the head of our monetary system is clear by the turnout this morning. We have more members here than I think we have had in a hearing in a long, long time.

Nevertheless, I am most disturbed by what I think I do not perceive in your statement. You say that the rate of inflation must be reduced in the United States, and then you indicate that monetary policy has a very limited role to play in this. In fact, if the credit markets are sufficiently stringent you will have to step in and ease them, and then you end up by saying we should not be concerned about the problems of prosperity.

Well, frankly, there are three elements here that give me a great deal of concern. No. 1, we had the biggest wholesale price increases in December and January that we have had in 20 years. Those wholesale price increases, primarily in food but not entirely, are sure to be reflected in higher consumer prices, in my view, in the coming months. These coming months are going to mark very important negotiations by 4 million workers which will set the pattern for wages for the next 3 years, perhaps in many segments of industry. Under these circumstances, with the consumer price index rising as possibly a 5- or 6-percent annual rate, perhaps more during this period, it is going to be very, very hard to keep to the 5½-percent guideline, let alone getting it below that. I do not think it is realistic to expect we can do that very well.

No. 2, I think there has been a great underestimate of the inflationary impact of devaluation.

We all know we are going to have to pay more, as you pointed out in your statement, for what we import. In fuel there is no way of avoiding this, especially with respect to oil. American companies and other companies have agreed to pay $750 million more April 1, annually, for oil; that will be reflected in fuel prices here. There are other imports, of course, that also would go up.

We have the loss of competition from imports which is a second inflationary impact which is definite and clear. This is especially true in steel and in autos and elsewhere. But there is no question about that.

No. 3, we have the stimulus to our economy from increased exports

coming at the very time when the economy is zooming and this too, it seems to me, is going to result in additional inflationary pressures.

Now you put all these things together and, as I calculate, it is not extreme to say we might have a one-third increase in inflation, in other words, instead of a 3-percent, a 4-percent inflation, if you calculate all of these elements in a realistic way.

Are you taking these into consideration in the kind of reassuring statement you are giving us this morning?

Mr. BURNS. Well, needless to say, Senator, I am very keenly aware of what has happened in the realm of wholesale prices during the months of December and January. That was your first point.

Second, I am fully aware of the fact that devaluation is bound to have some influence on our price level in an upward direction.

Third, I recognize that devaluation is expected to lead to an increase in our exports. Thus, I am very keenly aware of the observations you made, and it is precisely because I am aware of these observations, and many others, some of which I have covered in my statement, that I think that the time has come to take the problem of inflation a good deal more seriously than we have.

For one thing, let me say that as far as I am concerned, we have had two devaluations now, and we must not have another. As far as I am concerned, the deficit in our balance of payments, which has persisted since 1950, is a cancerous growth affecting our own economy, and the entire international financial and political system. It is a cancerous growth that must be cut out. Therefore, a determined effort to bring the rate of inflation down this year is, I think, essential, and that involves the Congress, it involves the executive establishment, and it involves the Federal Reserve Board.

I have tried in my statement to convey that thought. I am glad to have this opportunity to reemphasize it, and in the course of these hearings, as questions come my way, I may find myself doing it time and again.

Senator PROXMIRE. My time is up, Mr. Chairman. I would like to follow it up when I get another chance.

Chairman PATMAN. Mr. Widnall.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Burns, we certainly welcome you here before the committee today. I believe the Members of the Congress have great confidence in your ability and your administration of the post that you hold, a very responsible post.

In your statement you mentioned the need for structural reforms and you alluded to our antitrust laws. Could you elaborate on the exact type of reforms you had in mind?

Mr. BURNS. As far as our antitrust laws are concerned, I believe two things are needed. First, we need even stricter enforcement of these laws than we have had; second, I believe that violations of our antitrust laws should require much heavier penalties than are possible under existing law. I think violation of antitrust laws should be considered in this country as a major crime. Adequate punishment should be meted out, first, by revising our legislation, and second, by improving administrative and judicial enforcement.

Representative WIDNALL. You have stated that productivity gains in the coming year will probably not be as great as they were last year,

which is reasonable since the greatest productivity gains come at the start of the upswing.

Could you comment on the efforts that are currently being made to improve our national productivity, and tell us whether you feel that the National Commission on Productivity has had or will have an impact on keeping output ahead of rising labor costs?

Mr. BURNS. I think efforts to date, to the extent that I am familiar with them, have been quite inadequate.

Representative WIDNALL. Quite inadequate, did you say?

Mr. BURNS. Yes. I am hopeful that the National Commission on Productivity will become far more active, far more constructive, far more imaginative, and certainly far more enterprising than it has been. I believe that the Congress appropriated a certain sum of money for local productivity councils and the like. I have not checked recently, but when I did several months ago very little had been accomplished under that congressional appropriation.

I have long believed that productivity councils working at the local level—community by community, establishment by establishment—can be very constructive. We tried them during World War II, and we achieved extraordinary success. I would like to see that effort carried out now on a comprehensive scale. There is enough good will in this country which, if mobilized, could produce significant results. It has not yet been mobilized.

Representative WIDNALL. I heartily agree with you, Mr. Burns, and there are a great many citizens who want to participate to provide a better America and a better economy, an overall economy doing much better than right now. These citizens have not been called upon to contribute; there is a wealth of talent available.

What growth in the money supply in calendar year 1973 do you foresee as being consistent with the aims of the new budget as presented to us by Secretary Shultz?

Mr. BURNS. The only think I can say on that subject is that the growth of the money supply must be at a lower level than we had during 1972. I cannot give you a quantitative figure.

Representative WIDNALL. What do you see as the prospects for the housing industry in this coming year, 1973?

Mr. BURNS. I think this will be an excellent year for housing. Actually, we had an extraordinary year during 1972.

If you count not only the private dwellings that were constructed, but also the public housing units and the mobile homes, about 3 million housing units were started during 1972.

I think this will be another good year. Our thrift institutions are amply supplied with funds. The inflow of funds continues to be rather large, not as large as it was a year ago, but it is still quite considerable. Certainly the Federal agencies, such as the Federal Home Loan Bank Board and Fanny May, are in a position, if needed, to give generous support to the housing industry. I think this will be a good housing year.

Representative WIDNALL. Thank you, Mr. Burns. My 10 minutes are up. I only regret, on behalf of the minority, that members of the minority side on this committee never have an opportunity to make speeches at the beginning of the meeting in order to display their own

ideas about saving the economy. We are trying to confine ourselves to the questions on the evidence at hand.

Chairman PATMAN. Senator Bentsen.

Senator BENTSEN. Mr. Burns, I think you made a most learned presentation, and I think the counsel you have given to the Nation is good.

I, too, share your concern about the imbalance of trade. We listen to the traditional economic theorists as to how we influence it by relative growth of nations, and by devaluing our own currency. While I agree not enough attention is being given our currency, I also think not enough attention is being paid to some of the nontariff barriers that are being imposed. We look at Japan today, probably the most expansionist nation in exporting its products of any nation in the world and yet one of the most protectionist and restrictive in protecting is own industries. We look at the European Common Market, that is entering into tariff agreements with some 50 other nations, preference agreements, and it seems to me to be a direct violation of the most-favored-nation clause.

If we devalue our currencies to try to make our exports cheaper, we will not really gain much if they keep these nontariff barriers in effect. Do you have any counsel concerning that as to what can be done?

Mr. BURNS. I think, Senator, that we have to be far more energetic than we are in presenting the facts on trade to other nations. We have to educate them and they need a great deal of education.

One of the appalling things to me, the course of my travels and conferences with foreign financial and trade officials, is how little many of them know about the U.S. trade position and about the U.S. balance-of-payments position. I have talked to Europeans in very high places who advised me that the United States continues to enjoy a large surplus on the merchandise account in our trade with Europe. They do not realize that the $2 to $3 billion surplus that we traditionally had with Europe has now vanished. We now have a deficit with Europe just as we have a deficit with every other major section of the world.

Senator BENTSEN. We are going to have to do a better job of selling our case and explaining our problem then, it seems to me.

Mr. BURNS. I think we do. Of course, it takes communication, which requires two; we have got to do our part. I never lose an opportunity to practice my professorial art, acquired over a period of almost a half century in teaching, whenever I meet with foreign representatives. I think we all have to do that, but I have also learned in the course of teaching that a teacher can go only so far. He needs good pupils as well.

Senator BENTSEN. Well, I think we are going to have to do some unilateral things too, finally, Mr. Burns.

Mr. BURNS. I was coming to that. I think we need legislation of a kind that I hope we may not have to use but which, if necessary, we will be willing to use, so that to a degree our words of instruction will be followed up by action. And, perhaps, action on our part will prove more effective.

Senator BENTSEN. Mr. Burns, I would like to ask you just one more question because of the limitation on my time, if I may interrupt, and that is the question concerning the variable investment tax credit. I

have an interest in that and would like to see something accomplished in that regard. I think one of the problems that we run into when we talk about giving the President discretion in that kind of a situation is that we are talking about giving up some of the powers of the Congress. I do not think that is politically realistic, particularly in this climate.

I would hope the art of economics has developed into enough of a science where we could find, an index or some indices that we could tie the investment tax credit to whereby we could take politics out of it and we could anticipate the economy to a degree and put it on or take it off or vary it without a political consideration.

Mr. BURNS. I wish I could give you some assurance on that but I cannot. I have searched and searched hard for a mechanism to perform this task objectively, but I have not found it.

I want to say this, Senator. The plan that was presented by the Federal Reserve Board to the Congress for a flexible investment tax credit is so designed that the Congress would be a full partner with the President. The Congress would not be turning over the power to the Prseident. The Congress would act jointly with the President, as it does in all revenue legislation, and as it does in all legislation. Since presenting this plan to the Congress I have worked out, with the assistance of members of my staff, some further modifications in the plan which are designed to augment the degree of participation by the Congress in administering or in carrying out changes in the variable investment tax credit.

Senator BENTSEN. I look forward to studying it. My time is up.

Chairman PATMAN. Mr. Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr Burns, thank you for making yourself available to this committee with your balanced and very much respected advice. At this point it must be a busy time for you.

I note your comment that we have had two exchange rate realinements and we must not have another, and I take it from that that you feel some sense of urgency about a more permanent arrangement, and that you feel we must deal with this in some more basic way than we have through the actions already taken.

It is in this context that I would like to ask two questions that Senator Javits would like to have asked in his name. He is in New York City today and cannot be here, but they are interesting questions.

The first one is what effect—I will give you both questions—did the announcement of phase III have on the position of the U.S. dollar overseas which led to this latest monetary crisis?

The second is, he notes, obviously the exchange rate realinements worked out 2 weeks ago are not a permanent arrangement. (*a*) What effect should this latest crisis have on the negotiations leading to long-term reform of the international monetary system, and (*b*) should an integral element of such reform include the changing of the functions of the IMF so the IMF could act as an international central bank?

Mr. BURNS. As far as your first question is concerned, I do think that the initial announcement of phase III was very widely misinterpreted. It was widely believed, both in this country and aboard, that the controls that were instituted under phase II were being

largely, if not completely, eliminated. But I think that impression was corrected after a very few days; therefore, I doubt if the announcement of phase III could have had very much effect on foreign opinion with regard to the position of the dollar.

Actually, I think that the very poor trade reports that we had for the months of November and December had a much larger effect, and I also think that the crisis was set off by the dual exchange system set up by Italy which stimulated an outflow of capital to Switzerland which, in turn, led to a floating of the Swiss franc.

But I cannot emphasize too much that the underlying basic cause of the most recent monetary crisis was the conviction on the part of the entire world, including our own business and financial people and business and financial people abroad, that the U.S. balance-of-payments deficit was continuing on an enormous scale. That is the basic cause. There is not the slightest doubt about that.

Now, as to your second question, crises do have a function. They have a function in the sense that they inspire all of us to do some fresh thinking, to take some new actions. In fact, my old professor of philosophy, John Dewey, had a love of crises for that reason. His theory was that we think only in times of necessity and at all other times we proceed by rote, simply practicing the habits that we had long ago acquired.

Now, I think that there is a new spirit in financial circles around the world to get on with the job of international monetary reform. But I must say this to you in all honesty: I have lived a long life, and in the course of living one watches people and learns something about them; they wake up after a crisis, and they are eager for reform. But when things quiet down for a while people are apt to return to their old habits. Therefore, I think that all of us, and this includes Members of the Congress as well as members of my profession, and others, should keep on urging at every opportunity speedier action on international monetary reform.

I made a trip to Europe early in January in large part to warn foreign financiers about what may be coming, and I was told on all sides that there was nothing to fear, that exchange markets were calm, that the United States had inflation under control, that improvement was coming, that problems of monetary reform are difficult, that we must debate them very carefully, and so forth and so on. I came away a somewhat discouraged man as a result of that trip, a little wiser but also a little sadder. I hope very much we now will get on with the job.

But if we are to get on with the job, every one of us, will have to keep urging that this job be performed. Congress should press the administration, the Federal Reserve Board and, above all others, foreign countries, because this time the United States has been leading and urging, while other countries unhappily have been lagging.

Representative CONABLE. My time is up, Mr. Chairman.

Chairman PATMAN. Senator Sparkman.

Senator SPARKMAN. Thank you, Mr. Chairman.

Mr. Burns, we tried a devaluation once before, and it did not succeed; did it? You do not measure it as having been successful; do you?

Mr. BURNS. I can say, Senator, that I expected more from the first devaluation, better results than we have had. But I would also say that time must pass before a devaluation can produce benefits. The initial

effects of a devaluation are never good. Two or 3 years must elapse before the full benefits of a devaluation can be realized. But we live in a world where people are impatient; not many realize that it takes time before a devaluation can work its partial, and I want to underline the word "partial," cure.

However, Senator, having said this, I certainly agree with you that the great improvement in our foreign trade which many people expected from the Smithsonian Agreement has not be realized.

Senator SPARKMAN. Well, I have been interested in noticing that many people have proposed many different things which would be added to the devaluation, for instance, an import surtax now. We had that before for a short time; did we not?

Mr. BURNS. We did; yes. That was from August 15 until December 17, 1971.

Senator SPARKMAN. Did that have any successful results?

Mr. BURNS. I believe it made a dent in our imports; yes. But I do not have the precise facts in mind to answer your question more fully.

Senator SPARKMAN. We did not keep it on very long.

Mr. BURNS. No; we did not.

Senator SPARKMAN. And then you discussed, I believe, the proposition of the President being allowed to raise and lower tariffs to meet certain conditions that arise, and you endorse that; do you not?

Mr. BURNS. I do.

Senator SPARKMAN. Would that also include allowing him to take certain steps to make up for or to see to it that our products got into a country?

Mr. BURNS. It would.

Senator SPARKMAN. Would you say that that probably is the principal thing we ought to do to support this devaluation?

Mr. BURNS. I think a trade bill which would give to the President the power not only to reduce tariffs but also to raise them, and in special circumstances to do so with regard to individual products or individual countries—I think broad power like that in present circumstances could be constructive, and I endorse it.

Senator SPARKMAN. Thank you, Mr. Chairman.

Chairman PATMAN. Mr. Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman, and thank you, Mr. Burns, for appearing. It is always a pleasure to have you before a committee with which I am associated.

Mr. Burns, I have listened to your statement and questions and answers, and I feel to some degree that maybe the Federal Reserve is in some way more sinned against than sinning; that is, you are being blamed for economic problems that are not of your doing. For example, we talk about the balance-of-payments deficit. Yet, as long as we maintain large numbers of troops abroad maintaining their pay and allowances and allowing their families to live with them, that means a steady outflow of American dollars for which no return is being received except in the sense of national defense considerations which cannot be neglected. Yet it does have an effect on the economy over which the Federal Reserve has no control.

I think about a very basic weakness that is developing in our economy, the energy crisis, and the fact that we are apparently dealing with somewhat of a monopolized source of supply in the Middle East.

The producing nations have come together, and while they have not exercised an embargo on us, they have cooperated to the degree that they have raised their prices very effectively. Here again this has a direct effect on the balance of trade and balance of payments. At the same time, we have all the reserves of the companies of this country—we have them in Alaska that we know about—but because of environmental concerns we are not allowed to extract those reserves and use them as a lever perhaps to compel the oil-producing countries to be more realistic in their pricing formula.

You mentioned, and I think correctly so, that so long as we have big business concerns and monopoly labor unions, the ability to raise prices beyond what the market would otherwise dictate is a fundamental problem in our economy, and this is something over which the Federal Reserve has no direct control.

Now, do you have any thoughts, should we begin to discuss these matters openly, such as trade union monopoly; should we begin to say perhaps we should trade off some of our environmental concerns and start extracting the oil from Alaska so we will have some economic leverage in dealing with some of the oil-producing nations?

Mr. BURNS. Well, let me thank you, first of all, for your kind words about the Federal Reserve. I think you are right. We are blamed for all kinds of things, but that, after all, is not a novel thing for a central banker. The central banker is right there; it is his responsibility to accept criticism, and, to the extent that he has good sense, he will never answer it.

You mentioned several difficulties. First, the drain on our balance of payments that is caused by our military commitments abroad: I know nothing about national security considerations, but I must say that it makes no sense to me to maintain troops in Europe on the scale that we do. I think that we could accomplish everything we seek to accomplish and need to accomplish with a fraction of the military forces that we have abroad.

Representative BLACKBURN. Let me inject a question at this point, Mr. Burns. Assuming that neither of us is an expert in the field of national defense considerations, if it is determined tht they are essential for defense purposes then at least our free nation partners in Western Europe should bear their share of the expense; would you not think?

Mr. BURNS. I could not agree more.

As for the enemy problem, in the kind of world we live in, we ought to be developing our own resources to a larger degree than we are doing. If you look at estimates of our prospective imports of oil, what they will do to our balance of payments, what they will do to the power that other countries will have to buy into American enterprises and the like, I think we have a real problem here. We have postponed dealing with it. I think this is one of our urgent national problems and we ought to be thinking about it and talking about it openly. As for excessive power on the part of some of our corporations and our trade unions, I think it is high time we talked about that in a candid way. We will have to step on some toes in the process. But I think the problem is too serious to be handled quietly and politely. I have great faith in this country and in its citizens if the problem is handled openly.

I do not believe in punitive measures, but I do believe in reform. But we must discuss the need for reform and reform measures openly.

Representative BLACKBURN. Thank you, Mr. Burns. My time has expired.

Chairman PATMAN. Mr. Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Burns, on the international balance-of-payments question which you were just discussing, you modestly disclaimed the title of expert on security, but is it not a fact that if we keep up with military balance-of-payments expenditures abroad, either directly or through military aid, constantly getting new bases in Greece or Bahrein or the Indian Ocean, are we not going to run into just the repeated series of devaluations that you have decried, and are we not going to end up in hock to European and Middle Eastern creditors on a very large scale and, in the end, is that not going to be quite bad for our security, and maybe worse than reducing 300,000 troops to 150,000 or whatever is projected?

Mr. BURNS. Well, there is no question about it but that the drain on our balance of payments from our military expenditures is something that we ought to try to correct. However, I do not think it is the decisive factor in our balance of payments. There are many other things that we need to do. As for devaluations, I cannot emphasize too much or too often that as far as I am concerned this is the last devaluation.

I think this must become our national policy. If we travel the devaluation route, what little discipline exists in the world with regard to currency parities will leave us. As it is, there has been a certain breakdown in international discipline. We had to devalue this time, there is not the slightest doubt in my mind; but other countries have been devaluing prematurely. This must not become a habit, and, as far as we are concerned, we ought to consider this a closed chapter. We have a problem but we should deal with it in other ways.

Representative REUSS. The problem, though, is it not, is that the dollar, if we go on as we have, becomes overvalued? Once that happens on a basis of fundamental disequilibrium, then devaluation is simply the lesser of several evils, so what you really mean, is it not, is that you are determined that the dollar will not become fundamentally overvalued?

Mr. BURNS. We must bring a halt to inflation. We must resolve to do that, and I think we must resolve to end our balance-of-payments deficits, let us say, within 2 years and do what is necessary to accomplish that.

Representative REUSS. You have quite properly called for faster motion in international monetary reform. The fact is that the group of 20 charged with this task has been proceeding at a very leisurely pace, meeting for a day or two every month or two. They are going to meet here in another month. Should this not pass away rather quickly? Should not the United States, in a courteous but firm way, indicate that it wants the group of 20 to say in rather constant session, until a draft reform is accomplished?

Mr. BURNS. Speaking for myself, I have said that time and again, privately. As far as the U.S. Government is concerned, perhaps the administration has not gone that far, but the administration also has been strongly urging faster action.

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Representative REUSS. One question on domestic policy. Do you not see something ironic in your testifying, as I think you have to. that you intend to make monetary policy tighter, create less new money than the 7.4 percent which you created last year? Frequently that was in defiance of the mandate of this committee, which said, "Do not create more than 6 percent," and I congratulate you on defying us. Is there not something ironic about tightening money in order to dampen down inflationary activity at a time when, through our tax system, we are giving some $6 billion a year in stimulus to business plant and investment, which is one of the most bottlenecking items in the economy? Would it not be better right now to remove some of these tax stimuli and would not doing that accomplish two purposes? One, retard the inflation in those sectors, and two, not impose such a rough across-the-board meat ax burden on the Fed, with its inevitable consequences of tight money on State and local governments, small business, housing, and so on?

Mr. BURNS. Well, I hope that we will escape tight money. I hope that we can get by this year without a significant increase in long-term interest rates and, therefore, avoid the adverse effects that you fear so far as local governments and housing are concerned. My guess is that we will.

At the same time, I do think that we should be prepared to reduce the stimulus to business investment. The right way to prepare ourselves to reduce that stimulus is for Congress to consider very seriously the Federal Reserve Board's proposal for a variable investment tax credit which would make it possible to cut back that credit from its present 7 percent to any lower figure down to zero.

Representative REUSS. You do not think the stimulus is too great right now?

Mr. BURNS. I would not do it right now, no. We still have a rather high rate of unemployment, and I do not think that business capital investment has yet gone out of bounds. But I would certainly want to be ready for it.

Representative REUSS. My time is up.

Chairman PATMAN. Mr. Brown.

Representative BROWN. Mr. Burns, if you had the opportunity to write the scenario of national economic policy for the next 18 months what would that scenario be with particular reference to congressional action?

Now, I want to start off with one specific question. You mentioned shutting down previous, I should not call it loose, perhaps, but expansive monetary policies, and I assume that the consequent increases in interest rates or at least maintenance of interest rates at the present level would be designed to encourage private investment in more efficient productive facilities in the United States, to increase productivity. Would that be the objective of your monetary policy, among other things?

Mr. BURNS. Well, the objective of our monetary policy is, in the first instance, to sustain high levels of production and employment and, in the second place, not to contribute to inflationary pressures. These are the basic objectives of monetary policy.

We at the Federal Reserve have no instruments with which we can do anything to stimulate productivity as such. We, as individual mem-

bers of the Federal Reserve or in an individual capacity, may have some views on that subject. But the Federal Reserve Board has no powers at all in this direction.

Representative BROWN. Perhaps we could move on to the specific suggestion with reference to congressional action.

Mr. BURNS. Well, if I may be so presumptuous as to speak on the subject—I will do so in response to your query—the first order of business should be to reform congressional procedures so that better control can be achieved over Federal expenditures. Congress now acts on governmental spending in a fragmented fashion. I think you have to set a goal. The goal that the Congress sets could be the President's recommendation or it could be some other figure which Members of the Congress decide upon, but then machinery should be devised to stay within that figure.

Representative BROWN. Now, with respect to fiscal policy, what would you commend to the Congress as its response to the President's budget?

Mr. BURNS. Well, my recommendation would be that you certainly not go above it, and if you can find ways of going below it, may God bless you in the process.

Representative BROWN. What about the suggestion that we ought to maintain high rates of spending but compensate for that by some form of tax increase based on a tax reform or readjustment of the current tax rates through various segments of our economy?

Mr. BURNS. As far as taxes are concerned, I think this is a very heavily taxed country. A very large fraction, over a third at present, of our national output is really taken up by Government in the form of taxes. I would not like to see taxes go up.

As far as reform measures are concerned, I doubt if it is realistic to expect any large increase in revenue through reform measures. I doubt that the country is in a mood to accept higher taxes. I doubt if the Congress is in a mood to accept higher taxes at the present time. But I do think that the country is in a mood to accept better control, stronger restraint, over Federal spending, and I detect such a mood in the Congress. In fact, I think it is stronger in the Congress now than it has been over the past generation.

Representative BROWN. I would just observe, Mr. Burns, I do not think it is quite as strong in the Congress yet as it is in the electorate but we may be able to do something about that in the next few months.

Let me ask whether or not—you mentioned the fact that we should remove our troops from abroad as a matter of controlling our balance-of-payments situation there to some extent.

Would reduce monetary supply have the impact of reducing investment in productive facilities abroad by American investors? In other words, would they turn to investments here for productive facilities in the domestic United States?

Mr. BURNS. Well, I do think that one of the effects of the devaluation will certainly be to make investment abroad less attractive. Foreign currencies will cost more, and the stimulus to foreign investment by American enterprises will be reduced.

Representative BROWN. My time is up.

Chairman PATMAN. Mr. Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman, and thank you, Mr. Burns.

In your statement you make a pretty strong statement to the banking institutions of this country. I think that was intentionally made; was it not?

Mr. BURNS. Yes; it was.

Representative MOORHEAD. Is it partly the hope that it would discourage increases in interest rates?

Mr. BURNS. Well, it was made primarily in the hope that bankers would be more prudent in extending lines of credit to their customers and proceed more cautiously in making commitments.

Representative MOORHEAD. I think the message was very clearly stated.

Mr. Burns, you said to Senator Bentsen, I believe, that we have had two devaluations and we should not have another. Is it your judgment that at the present time the dollar is roughly properly valued, not over or undervalued?

Mr. BURNS. I can only express an opinion about that, Mr. Moorhead. I do not know that I can fully answer that question; I doubt that anyone can answer that question categorically.

My judgment is that the realinements of currencies should prove viable. However, one cannot be sure of that, and the way I think we must proceed from this point on is that we will prevent a further devaluation by practicing stability at home. Now, this is something we can do. When it comes to realining currencies, other nations are involved along with us. When it comes to trading rearrangements, other countries are involved along with us. But practicing stability at home is something we can do by ourselves, and we ought to do it.

Representative MOORHEAD. But does not the proposal we have given the other nations for reform of the monetary system, does it not envisage continued realinements of currencies in the future under proper guidelines?

Mr. BURNS. It envisages corrective action by individual governments when their foreign exchange reserves rise or fall unduly. The technique of corrective action under the American plan is left to the country concerned. A change in the par value of the currency is merely one type of corrective action. We have not wanted to emphasize that unduly.

Representative MOORHEAD. Is there anything that the Congress can do to help expedite legislatively, to help expedite this international montary reform agreement?

Mr. BURNS. I do not think—no; I do not believe so. I do not believe that you can do anything along legislative lines. But I think that individual Congressmen, or the Congress as a body, can speak up on the issue and urge speedier action by the group of 20.

As Congressman Reuss observed, the deputies of the group of 20 have been proceeding in excessively leisurely fashion, and they have done so because the governments of the world have not been sufficiently concerned. I think you can prod other governments, but I do not see that you can do anything along legislative lines.

Representative MOORHEAD. Even giving the President the power to institute import surcharges?

Mr. BURNS. Oh, yes, you can help implement monetary reform through enactment of trade legislation. That is very important at the present time, because we cannot be entirely sure that devaluation alone can do the job. We must be sure that there will not be another devaluation.

Representative MOORHEAD. Mr. Burns, would you believe that it would be necessary to extend the Economic Stabilization Act?

Mr. BURNS. Yes, I think the Economic Stabilization Act should be extended by the Congress for a limited period. I think it is necessary.

Representative MOORHEAD. Thank you, Mr. Burns, my time has expired.

Chairman PATMAN. What is the desire of the committee? We have some time, we can proceed to 12:30. You asked to be recognized when your time came, Senator Proxmire.

Senator PROXMIRE. Mr. Burns, I am delighted to hear you make the emphatic statement you just made now on reducing troops in Europe. It is the first time I have heard you make that statement, maybe you made it before, but it is most welcome.

I almost fell out of my chair, however, when I heard you say we should aim to eliminate our balance-of-payments deficit within 2 years. Are you talking about the balance of payments, not the balance of trade?

Mr. BURNS. I am talking about the balance of payments.

Senator PROXMIRE. On a liquidity basis. It has been adverse since 1949 or so, late 1940's; is that not right?

Mr. BURNS. Well, that is why we must not have another 20 years.

Senator PROXMIRE. Would this not take a sharp and sudden reaction not only on our part but on the part of Japan and Germany and countries throughout the world? I agree with you this would be a fine goal if we could achieve it. I just wonder if it is achievable in 2 years. You said, as I understand it, that for the devaluation to have its effect on trade, takes 2 to 3 years. So, to follow this through and to get this enormous adverse balance of payments down within 2 years when it has other adverse elements in it seems to me to be a little ambitious.

Mr. BURNS. It is ambitious, possibility too ambitious. But I would like to tell a story about a visit I had with Ben-Gurion, then Prime Minister of Israel, in 1948. I asked him whether he was getting much help from his economists and he said, "No, I am not getting much help from them." And I asked him why. "These are very able people and they are eager to assist you; why do you not call on them? They can help you."

And Ben-Gurion replied, "Well, you know, Professor Burns, I used to call on economists, but when I did they would always tell me that my plans and ideas were impractical or impossible. But we in Israel had to do the impossible; therefore, I ignored the economists and we went ahead and did the impossible."

I think we have to set ambitious goals for ourselves.

Senator PROXMIRE. Well, I appreciate that and I thank you for it.

Now, I would like to get to the third element in what I was talking about in what seems to me to be a weak inflationary program that we have and that is the phase III.

You indicated considerable confidence in it and I would challenge that confidence. Consider that what we are doing in phase III is in

effect now to weaken controls. No. 1, the prenotification and advance approval is eliminated.

No. 2, the profit margin guidelines have been substantially liberalized so a number of industries can increase their prices more readily.

No. 3, the guidelines have become voluntary rather than mandatory to a considerable extent.

No. 4, the penalties for exceeding the guidelines have been eliminated; that is, price violators do not have to make refunds.

No. 5, the enforcement staff has been cut in half. You may be able to convince some people we still have an effective system but you have not been able to convince the investment community, they have been reacting with the obvious impression this has been weakened; foreign investors the same way; the academic economists the same way; the forecasters in the business community the same way; the private forecasters, the financial press, the same kind of way.

Now, in view of the fact that psychology is such an important element in inflation, do you not think it would be wise for the Congress to strengthen the phase III bill rather than simply extend it for a year?

Supposing we required advanced notification and did something about beefing up the enforcement staff, and provided that there be penalties, refunds, if the price increases were in violation; how about some kind of really effective reaction on the part of Congress?

Mr. BURNS. Well, Senator, we are dealing here with a question of judgment. First, as to the facts. You are quite right in saying that prenotification as far as wages are concerned. The Mediation Board has the record of labor contracts: they know precisely when contracts expire, that information is available. Therefore, I would say that prenotification, as far as wages are concerned, is virtually in effect just as it was. You have done away with some paperwork, but the information is there.

Senator PROXMIRE. Well, it may be in effect in that sense but the fact is that the negotiations can be settled and determined before the administration can act, before the Cost of Living Council can prohibit them, they can put them into effect without any approval.

Mr. BURNS. Right. Well, that is something else. You have in mind not only prenotification but prior approval.

Senator PROXMIRE. Right.

Mr. BURNS. Yes. That prior approval is no longer required under phase III. You are quite right.

Second, I was going to go on to say that prenotification as far as prices are concerned, is still required in the case of the food processing industry, the health service industries——

Senator PROXMIRE. Construction industry.

Mr. BURNS [continuing]. And in the case of the construction industry.

Third, and perhaps most important, the President can reinstitute prenotification, or he can go further than that and require prior approval under the Economic Stabilization Act without amendment. I am assured by all those concerned with phase III, including the President, that administration under phase III will be firm; there-

fore, as far as I am concerned, I think it would be premature to say that it is not going to work.

You have a somewhat more flexible policy, that is true, but there are advantages in the more flexible policy because, as these controls continue, all kinds of distortions and grievances and evasions multiply. But whether phase III is going to work or not, time will tell. I think it is a promising approach. If it works well, we are all fortunate. If it does not work well, then we must look to the Executive for changes in that program and, of course, if they are not forthcoming the problem will be in the lap of the Congress. But I think the Economic Stabilization Act is a good statute without amendment.

Senator PROXMIRE. My time is up.

Mr. BURNS. On the other hand, if Members of the Congress felt that prenotification is important, I would voice no objection to it.

Chairman PATMAN. Mr. Widnall.

Representative WIDNALL. Mr. Chairman, I have no questions. Unless Senator Sparkman has some questions, I would suggest the House is now in session and I feel we should adjourn.

Senator PROXMIRE. I hope we do not adjourn as long as we can keep the room. We often are in session, the Senate is in session too, but this is one of those rare opportunities to question Mr. Burns. I hope we do not adjourn now.

Chairman PATMAN. Personally, I am willing to turn the chair over to the vice chairman to continue if he would like to ask questions.

Senator SPARKMAN. I have no further questions.

Senator PROXMIRE [presiding]. I would like to ask you, Mr. Burns, about another area that I think is of the greatest importance and I would like to read from an editorial in this morning's New York Times. It says:

> * * * the world now needs a central bank to provide unlimited support for any nation whose currency is in trouble. The provision of that support should be coupled with a requirement that the nation take the steps necessary to restore its balance of payments to equilibrium.
>
> This is the basic requirement for improving confidence in the world monetary system. It is the lack of confidence in the value of money that produces sudden crises, big devaluations and run-ups in the price of gold.
>
> The time has come for the major industrial nations to start to create an international monetary reserve system that can sustain national currencies while requiring orderly change in exchange rates. Other nations are unwilling indefinitely to accept the dollar as an international monetary reserve unit. which the United States can issue without limit to cover its own debts. It would only exacerbate economic and political tensions between the United States and other countries if this nation were to try to compel others to go on living indefinitely under a dollar standard, operating without genuine international supervision and safeguards.

Has the time come for an international bank for us to attempt to do something of the kind on an international scale that the Federal Reserve Board has enabled us to do on a national basis? Prior to 1913, we had great international difficulties because of the lack of confidence and great instability of our own currency. Other nations have gone through this.

I think the New York Times suggestion this morning is quite constructive, it may be too soon for it, maybe it can never come. We have rarely had in my memory, certainly in recent years never, had an opportunity like the present where all of the major nations are

members of the United Nations, and are beginning to work together in a trade way, and we have had this crisis developing.

Can we begin to give this some thought?

Mr. BURNS. Well, one thing is absolutely clear to me; namely, that reform of the international monetary system calls for a rule of international law in the monetary area. This will inevitably mean a strengthening of an institution such as the International Monetary Fund. This, I think, is absolutely necessary.

As far as an international central bank is concerned, that is something that the U.S. Government as yet has not put forward. We at the Federal Reserve Board have been studying that proposal. At the moment all that I can say to you is that the suggestion by the New York Times well deserves consideration by thoughtful people, and we in the Federal Reserve are taking it seriously. Where we will come out I cannot say.

Senator PROXMIRE. One of the very constructive suggestions made by Chairman Wilbur Mills of the Ways and Means Committee, was the notion that we might try to do something on an emergency basis at least to soak up these enormous refunds that are going to be paid out in the next few months, almost an unprecedented amount, a gross amount of over $20 billion available, probably $10 billion taken down by consumers.

He suggested that you have some attractively priced savings bonds made available especially to those who get refunds back so they will be more likely to invest them, not spend them.

What do you think of that suggestion?

Mr. BURNS. Well, actually, this is a proposal that I also put before the Committee on Ways and Means last June. I thought very well of it at the time and I wish the Congress had so.

Now, I have the greatest respect for Wilbur Mills. He is a great authority in this field. I am a little fearful, however, that the suggestion comes rather late. The great bulk of refunds to taxpayers come in the month of March, April, and May. A significant number of refund checks have already been issued. If you reflect on the amount of time that would be required for this legislation, and then the amount of time that the Treasury will have to take to implement the legislation, it seems to me that the proposal is somewhat late.

However, that is only my opinion. I have already checked with some Treasury officials, but I also want to check this out with Wilbur Mills, because he very rarely, if ever, speaks on a subject of this sort without knowing the precise facts.

Senator PROXMIRE. Congress is likely to act rather rapidly on the devaluation, on the devaluation proposal by the administration. I say Congress will act rather rapidly, we expect to act within the Senate in a few weeks, and the House within a few weeks, possibly it could be attached to that.

Mr. BURNS. Well, perhaps it could be done in time to achieve the purposes. I was for it before and am still for it. But I do not want to tell you what I know about this problem now in comparison with what I knew last June. Last June the facts as I understood them at the time were as follows: In fiscal year 1972 tax refunds came to $14 billion. The estimate for fiscal 1973 was $24 billion, a huge increase of $10 billion, and that troubled me. That is why I testified as I did

before the Ways and Means Committee, arguing in behalf of a special refund bond. I thought it was only fair to taxpayers as well, because, after all, when you pay more in taxes than you owe the Government you are making, in effect, an interest-free loan to the Government. Therfore, a special bond carrying a preferential interest rate would be only fair to taxpayers and would also accomplish an economic purpose of mopping up some purchasing power.

However, the Treasury estimate of $24 billion has now been reduced to $22 billion, and the Federal Reserve Board's staff estimate is lower still, it is now $20 billion. Therefore, although the problem is still there, it does not appear to be as large a problem as it did back in June. But this is a very long explanation, Senator. The gist of my answer to you is that if this can still be done, I am for it.

Senator PROXMIRE. Now, one of the other suggestions made by Chairman Mills, I thought, was also interesting, although it went against my grain, and most of us would resist it on equity grounds, but it made a whale of a lot of sense in an emergency basis.

Obviously, we need to attract capital from abroad to counteract capital flowing to abroad. He suggested we have a moratorium on taxes on foreigners who invest in American securities, that this would be one quick and sudden way to make our securities more attractive and could attract foreign capital without the kind of stiff increase in interest rates which many people have felt is about the only other day we can attract foreign capital.

How would you feel about that suggestion?

Mr. BURNS. Well, I noticed that proposal of Wilbur Mills. I found it attractive. I only had two thoughts about that. First, what does that imply for our tax treaties with other countries, and I am not in a position to answer that question. Second——

Senator PROXMIRE. I should think in view of the fact that they would benefit that there would be no objection on their part if we permitted their nationals to invest without taxation. The other way there might be a question.

Mr. BURNS. I think that is true but I still would want to consider the equities in the matter.

But my second thought on reading Wilbur Mills' proposal was that I might want to go further than he. I think he was proposing a temporary suspension. I do not think a temporary suspension will do enough good. I would make the suspension of indefinite duration, because if we make it for a short period all that we would be attracting would be short-term capital when what we want and need is long-term investment.

Senator PROXMIRE. Well, the reason the temporary might be attractive on a realistic basis is can you really convince members of the public that if you are a foreigner you can invest in American corporations and pay no taxes at all, and if you are an American you have to pay a stiff tax on it.

Mr. BURNS. Well, we pay taxes. Our corporations would be paying the tax, and this is simply an additional tax that the invididual would pay. Obviously, Congress can legislate a proposal of this sort for 1 year or 2 or Congress could legislate a proposal of this sort without attaching a terminal date, to it. I would make it of indefinite duration.

Senator PROXMIRE. It is very interesting. I certainly will look into it further than I have and I think we ought to give it consideration.

There is also a great deal of talk about our repealing the restrictions on investments abroad so that it would be easier for American investors to invest abroad. Does this not run counter to our immediate need for reducing or holding down the exodus of dollars, the exodus of capital?

I would like to see all these restrictions go as all of us would. None of us favors them. In fact, we would like to see price controls go. The question is a question of timing.

Mr. BURNS. Well, the proposal which Secretary Shultz announced does not call for an immediate end of the interest equalization tax or the controls of direct foreign investments or the voluntary foreign credit restraint program that is administered by the Federal Reserve Board. The proposal is rather to phase out these programs over a period of 2 years. The hope is that during that period our balance of payments would improve sufficiently——

Senator PROXMIRE. Would that not make it much harder to achieve your goal of a balance-of-payments surplus within 2 years?

Mr. BURNS. It would tend to make it harder. But in some departments of life there are conflicting considerations. These restraints on private business have become very irksome. Also, as you may recall, the President committed himself to do this back in 1968, and there is a great expectation on the part of the business world that this will happen. So I think it is a reasonable approach.

Senator PROXMIRE. Let me ask you one other question before I yield to Senator Javits. The analysis that is persuasive with me is that it was not our inflation or even our projected inflation that was the principal reason for the run on the dollar. Our record, as you have indicated many times, is much better than other countries. You cannot find a country with a better record in the inflation area. It was the excess of dollars abroad, the enormous number of dollars that just kept pouring out. Now, that has gone on for the last 20 years, and it has made the dollar weaker.

So Lindley Clark this morning in the Wall Street Journal, makes an interesting suggestion and I quote:

> So the urgent need is to devise some way to fund those unwanted dollars, perhaps by persuading foreigners to invest them in some sort of special long-term, high-interest rate Treasury security. The exact mechanism that is devised is not really so important; what is important is to remove those dollars that now are a sort of time bomb, ready to blow up international monetary markets once again.

Do you think some device of this kind deserves study and maybe support?

Mr. BURNS. I have not read Mr. Clark's article and I am not entirely sure from your brief comment just what it is that he has in mind. There are two problems here. One is the massive sum, it now comes to almost $70 billion, of U.S. liabilities to foreign official institutions. These sums are largely invested on a short-term basis, and the funding of these obligations is technically feasible. To some degree, in fact, this has already been done. If that is what he has in mind I think it is a basically sound suggestion, and needs doing.

If, on the other hand, he is talking about the massive sums that are sloshing around in the Eurodollar market, then I do not know how that suggestion will get at that problem. How to get at the problem of the Eurodollar market I must say is a very baffling subject that central

bankers have been studying for the past 2 years and no good solution has as yet emerged.

I do not know which of those two Mr. Clark had in mind. The first is doable. As for the second, we have not yet developed a way of knowing how to deal with it.

Senator PROXMIRE. He is talking about the $70 billion. He refers to that.

Mr. BURNS. That is doable but I do not think it has the kinds of effects that have been suggested. Well, yes, it causes some problems at the Federal Reserve, some minor problems of that kind, and I think removing this overhang of dollars would be psychologically beneficial. I am all in favor of that. But as I say, this has been going forward, although a little too slowly.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. Thank you very much, Senator Proxmire.

Mr. Burns, I have to apologize for not being here sooner, but I explained to your secretary that we are moving today, it was a tough day to me to be here at all, but I have such great respect for you that I really made it a very big point to get in here at least at the tail end of your testimony.

I have a few questions that I would like to put to you. I will not duplicate those which were very kindly asked in my name by Congressman Conable, and I gather you have already responded to those.

But I did wonder, pursuing the line that Senator Proxmire has just opened up, at least, of the dollar flow, of the so-called Eurodollar market—which is a big overhang for our country, $60 billion—has any thought been given to funding that dollar overhang along the lines of the various plans like the Dawes and Young plans after World War I. At the present time the fact that this overhang is a drain, is a call on the credit of the United States which could be invoked at any time, is very unsettling to international markets and the international receptivity of the dollar.

Mr. BURNS. The answer to your question regarding the dollar overhang is "Yes." The International Monetary Fund and the Committee of Twenty are examining plans for funding the overhang through international financial institutions. Our Treasury has been pursuing the subject. In the past, we have funded to a degree our indebtedness with the German Central Bank and the Bank of Japan. But this so far has been done only on a rather limited scale and could be done on a comprehensive scale. The flow of funds through the Eurodollar market, however, needs to be distinguished from the dollar overhang. The Eurodollar market forms part of an extensive private international capital market. There are no plans to fund the sums that are circulating in the Eurodollar market.

Senator JAVITS. So it is a real possibility to deal with?

Mr. BURNS. Very much.

Senator JAVITS. And should figure in any international negotiations?

Mr. BURNS. Oh, yes.

Senator JAVITS. The other thing I wanted to ask you is this. I think the Fed won a rather important round recently in persuading a number of leading banks to roll back their prime rate. I realize the sensitivity of interrelationships in the money markets and even the availability of money for lending. But do you think this taught us anything about

the possibility of holding interest rates down notwithstanding many other factors which would boost them up?

Mr. BURNS. I think it has taught us something; namely, that at a time when our working people are being asked to limit the wage increases that come their way, and at a time when our business corporations are being asked to restrain their price advances and limit their profit increases, banks also should participate in this national effort. I believe that the recent restraint on the prime rate has taught many bankers that simple principle, and I must say they have been very good about it.

Senator JAVITS. Now, Mr. Burns, would you feel that the best way to do that is as it was done, to wit, with the Fed or should it in any way be cranked into the phase III machinery?

Mr. BURNS. Of course, it is part of the phase III machinery. The Committee on Interest and Dividends was set up by the President under his powers given him by the Congress in the Economic Stabilization Act and, as a matter of fact, the Federal Reserve System as such has nothing to do with this activity. It so happens merely that I serve in the capacity of chairman of the Committee on Interest and Dividends, a task that I would gladly turn over to someone else.

Senator JAVITS. But as a practical matter, Mr. Burns, you really feel that this has at least the capability for working in a way which would exercise an actual restraint, notwithstanding the general consensus among economists and the structure of the money markets which would indicate to him that interest rates will rise seriously in 1973?

Mr. BURNS. I think, Senator, that we must not expect a great deal from this effort. Open market rates of interest must remain free. If we attempted to interfere with them we would lose complete control over the money supply and bank credit.

Now, there are some administered interest rates that are of special interest to the American people, such as the interest rate on home mortgages, the interest rate on consumer loans and, to some degree, the interest rate on business loans. The Committee on Interest and Dividends has focused on this area, but there are limits to what the committee can accomplish or should try to accomplish.

We all must recognize the fact that banking institutions these days obtain their funds to a very large degree by going into the market and borrowing money. They borrow money by issuing CD's. They borrow money to a degree through the commercial paper market. They borrow money through the Federal funds market. With open market interest rates going up, the costs of obtaining lendable funds are rising for banks and, at a time like this their interest charges will go up.

However, a measure of moderation, particularly in the three areas that I mentioned, is still possible, and the committee has been directing its effort in this direction. Bankers over the country have been extraordinarily cooperative, and this fact should be recognized.

Senator JAVITS. Mr. Burns, can you give us any prediction as to interest rates in 1973?

Mr. BURNS. Central bankers are no better than any others in predicting interest rates, and, really, there are some subjects where, if they do have ideas, they ought to keep quiet and this is one of them.

I would not be surprised at a time when the economy is expanding and when loan demand is increasing if market interest rates did rise.

My hope and expectation are that the stability in long-term interest rates may be extended and that any rise that we may experience in that critical sector will be rather modest.

Senator JAVITS. So that you do, on the whole, feel that we can keep interest rates within a modest range?

Mr. BURNS. I would like to think so. But this is not an area where I am prepared to make any promise or flat prediction. It may become necessary for interest rates to rise.

Senator JAVITS. But you do assure us that as chairman of this committee you will do everything you can, consistently with principles you have stated, to keep them stable?

Mr. BURNS. Indeed, I do. I testified on the subject before the Senate Banking Committee recently and I gave a rather full exposition of the committee's practices and policies on that subject, and I certainly can assure you one again that this committee will remain vigilant and active.

Senator JAVITS. Mr. Burns, just two other points, and I shall desist. One is this. My staff tells me in hearing your statement, you did speak of rising food prices as a very serious impediment to price stabilization. Is there anything from your vantage point that you could think of to suggest to us to deal with that particular problem of the food sector?

Mr. BURNS. Well, I think that some important actions have already been taken by the administration to deal with this problem but it will take time before these actions become effective.

I have nothing to suggest except this possibility. I think that the American public will be just as well off from a nutritional standpoint if it spent a little less money on meat and spent more money on cheese.

Senator PROXMIRE. I would agree with that.

Mr. BURNS. On a purely voluntary basis, I think it might be a good idea if we had one meatless day or so a week. We would be just as healthy, and our food bills would be lower.

Senator JAVITS. Mr. Burns, do we have, in your opinion, adequate food advisory services for the housewife consumer in the Federal establishment or would you make any suggestion about beefing that up, especially at a time like this?

Mr. BURNS. I do not know the answer to your question but I think you have asked a very important question, Senator, and I cannot answer it. I think you might ask Virginia Knauer and find out just what she is doing. If she is not doing enough, Congress has ways of stimulating the executive now and then.

Senator JAVITS. It certainly does.

But you would certainly consider it a patriotic duty contributing importantly to the effort to stabilize the price level if the consumer would use his buying power in an intelligent way toward that end, especially in food?

Mr. BURNS. Yes, I certainly do.

Senator JAVITS. And this could be a very important instrument of governmental policy; could it not?

Mr. BURNS. I would think so; yes.

Senator JAVITS. Well, I can assure you, Mr. Burns, that I will pursue it, I am a member of this committee and the Government Operations Committee and which is dealing with the Consumer Protection Act and I will certainly pursue that.

The last question I have is the question of productivity which you and I have discussed before. What do you see as the situation for our country as it relates to the present productivity crisis? For me it seemed to me the present crisis was compounded of three factors. The factor of the domestic Federal budget deficit; the factor of inflation; and the verdict that the United States was falling short in our well nigh impregnable industrial products and technology. You and I have discussed this before and I just wondered what enlightenment you could give the country and to us on this particular subject.

Mr. BURNS. I have nothing to add to what you and I have discussed before. I only hope that the efforts that have been made in this field will be more productive really than they so far have been. We have talked about this extensively, Senator. You were instrumental in getting an appropriation from the Congress to push local productivity councils. To the best of my knowledge not much has been accomplished, and I think you ought to find out why it has not been, and just what it is that the Congress needs to do to energize the executive to greater action in this area. You and I have talked frequently about the accomplishments of local productivity councils during World War II. What we did then we can do now, and we can do it just as well or better. But we are not doing it.

Senator JAVITS. Well, thank you, Mr. Burns. I was going to ask you this. As a central banker do you appraise this factor, if we could improve it, as a major element in the situation of the dollar in the world markets?

Mr. BURNS. Our rate of productivity?

Senator JAVITS. Rate of productivity and the technology which goes with it.

Mr. BURNS. The rate of productivity improvement last year was good. On the other hand, the rate of improvement, if you take the last 5 years or so, was hardly satisfactory and I think we are falling behind much of the rest of the world.

Senator JAVITS. And that this verdict of a devaluation forced upon us really, by the acceptability of the dollar in world markets, would you say that this deficiency in productivity is an important fact?

Mr. BURNS. It is a significant contributory factor, yes, I would certainly agree to that.

Senator JAVITS. Well, thank you very much.

I am just informed that Senators Sparkman and Tower introduced a bill yesterday authorizing appropriations for the President's Commission on Productivity, and I certainly compliment my colleagues and will certainly work closely with them in this continuing drive which I consider, and you were kind enough to consider with me, so vital to our country. Thank you.

Senator PROXMIRE. I cannot resist asking one more question because what Senator Javits asked fits right into it.

The Wall Street Journal carried a recent editorial expressing considerable disagreement with you and I would like to read it to you because it seems to me it hits this subject right on the nose, and give you a chance to respond to it. It said:

> Chairman Arthur Burns' jawboning against higher interest rates in the United States caused far more alarm abroad than did phase II psyhcology. It signaled a willingness by Washington to focus on short-run political problems

at the expense of international monetary order. To the extent that it succeeded in artificially lowering interest rates here, moreover, it discouraged the repatriation of dollars held abroad.

Then it goes on to say:

If the Fed had, instead of worrying about the prime rate, bit into the money supply, with the German central bank at the same time expanding its money supply, dollars would have flowed back to the United States. Interest rates would stabilize here and Frankfurt could have stopped printing money to sop up the excess dollars abroad.

What is your response?

Mr. BURNS. I never quarrel with members of the journalistic profession.

Senator PROXMIRE. I am not asking for a quarrel. I am asking for an answer to the notion that you have been given an impossible task in trying to jawbone down interest rates or by political pressure bring interest rates below what the market would establish.

Mr. BURNS. I doubt if any financiers abroad know anything about activities of my committee on interest——

Senator PROXMIRE. They knew the prime rate was jawboned down, that was important financial news everywhere, it would seem to me to anybody who follows financial——

Mr. BURNS. So far as foreign financiers are concerned, they could not pay less attention to what our prime rates are. What they pay attention to are market rates of interest and those rates were going up and going up very sharply.

Now, the suggestion that capital movements are affected by the prime rate makes no sense at all.

Senator PROXMIRE. Well, does not the prime rate have influence on, some influence on, other rates or no influence? The extent that the prime rate is held down, does that have——

Mr. BURNS. Other rates, market interest rates, have some influence on the prime rate.

Senator PROXMIRE. But it does not work the other way?

Mr. BURNS. Stabilizing the prime rate has no such influence.

Senator PROXMIRE. If it does have any influence why jawbone? Why worry about it? If it does not have any influence, broad influence, on interest rates generally, why——

Mr. BURNS. Well, that is a good question. [Laughter.] It is a very good question. I think the advantages are very small, but it so happens that in this country there is a certain populist tradition and there is a great deal of interest in, a great deal of concern with, the question of what interest rates are charged to business borrowers. Unfortunately, when the prime rate goes up, this becomes headline news. People interpret that to mean that interest rates generally will be rising, mortgage interest rates will rise, consumer installment rates will rise, and so on. Well, that is not the way markets really behave. So to a large degree, we are chasing shadows here. I am quite ready to admit that.

However, I do think it is important for bankers, no less than for other business people, and no less than for our wage earners, to practice some restraint at a time such as this when we are trying to get our domestic house in order.

Senator PROXMIRE. What you are really doing is throwing a fish to the populist sentiment. You are giving the impression you are holding

down interest rates and maybe that will have a good psychological effect.

Mr. BURNS. No, no.

Senator PROXMIRE. But you are not in substance accomplishing anything. Is that right?

Mr. BURNS. No; I have not said that. I will never say that. [Laughter.] We are not accomplishing anything as far as open market interest rates are concerned. We do not seek to accomplish anything in that area. We do not seek to influence or control open market rates in any way. However, the rates that are charged by financial institutions for business borrowing, on home mortgages and on consumer loans, we are trying to influence. We have had some effects; I think these effects are broadly beneficial. Bankers over the country can feel happy that they, too, are participating in a broad national effort.

Senator PROXMIRE. You see, what worries me is the extent you are successful in holding down the prime rate, the prime rate after all, is a rate that banks make available to their best borrowers, the big corporations, the blue chips, that is where the funds, it would seem to me, under these circumstances would tend to go, instead of to State and local and housing and so on. I do not want to prolong this, but I think that you have indicated your response to the question that was raised and I appreciate it.

The committee will stand in recess. We had to cancel our meeting tomorrow because of changes in the committee schedules but we will reconvene on Thursday morning, in room 1202, in the Dirksen Senate Office Building, at 10 o'clock.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 22, 1973.]

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

RESPONSE OF HON. ARTHUR F. BURNS TO ADDITIONAL WRITTEN QUESTIONS POSED BY CHAIRMAN PATMAN

Question 1. Last week I noted with interest that the Federal Reserve for the first time gave notice in advance of its intention to pump funds into the System. I assume that the news accounts were correct—that advance notice was necessary to give dealers an opportunity to weed out securities from customers in view of shortages resulting from foreign central bank purchases of Governments with dollars accumulated during the crisis. However, I would like your comments on the System's advance notice and also on the implications of rising foreign central bank holdings of U.S. Government securities for the market in these issues and for monetary policy. I noticed, for instance, that the Federal Reserve Banks held $31,819,000,000 of securities in custody for foreign and international accounts on February 7, up $1,664,000,000 from the previous week. What was the amount held for comparable dates over the years since 1965?

Answer. On February 14, the Federal Reserve did give dealers notice one day in advance of its intention to make one-week repurchase agreements. This move was initiated at the end of a bank statement week in which a general scarcity of Government security collateral had made it difficult for the Federal Reserve to provide needed bank reserves through open-market operations. With a further reserve need projcted for the succeeding statement week, the System sought to get a start on meeting that need by announcing its willingness to make repurchase agreements for the full week. Dealers were given the option, in arranging RP's, to use collateral either from their own limited positions or obtained from customers. The advance notice was provided to give them additional time to round up scarce collateral from customers.

The general shortage of immediately available Government security collateral at mid-February was attributable to several factors. Foreign official account investments of the proceeds of speculative outflows of dollars were the most con-

centrated and unexpected influence. But even before the emergence of these demands, Government security dealer positions had been reduced to relatively low levels. At mid- February dealer positions in short-term issues had been substantially reduced when holders of nearly half the Treasury issues maturing at mid-February had elected to run off these holdings and in some instances to invest the proceeds in outstanding short-term issues, rather than exchanging into the new notes offered in the February Treasury refunding. In addition, money center banks and other institutions which frequently provide dealers with borrowed Government security collateral when dealers own positions run short, were limited in their ability to do so in February because their free collateral had either been reduced by sales to meet heavy recent loan demands or tied up as security against other commitments.

Attachment A compares the $33.3 billion of U.S. Government securities most recently (February 22) held in custody for foreign and international accounts, with amounts held for such accounts at roughly equivalent points in other recent years. As you can see, there has been roughly a fourfold increase in this total during the past three years. Virtually all of these foreign holdings reflect investments by foreign official institutions of dollars generated by the large, and persistent U.S. balance of payments deficit. Of course, the marked step up of growth in recent years has been sharply augmented by the large speculative outflows of dollars that have developed in the recurring periods of foreign exchange market turmoil.

At first glance one might assume that heavy, concentrated buying (or selling) of short-term U.S. Treasury securities by foreign official institutions would create serious complications for U.S. monetary policy and U.S. securities markets. In fact, however, such complications are largely transitory and of limited significance. In situations where foreign official accounts are buyers of U.S. securities, they are simply reinvesting the proceeds of U.S. dollar outflows; in effect, private dollar flows into foreign currencies are quickly balanced by a reflow of foreign official dollars back into the U.S. economy. As a result, once the process is completed the reserve position of the U.S. banking system experiences no net change. While bank reserves occasionally experience some minor temporary changes as transactions underlying dollar outflows and inflows are being cleared, these effects can be offset through Federal Reserve open-market operations.

When foreign official account activity in the market for short-term U.S. Treasury securities shows sudden marked changes, this may cause some temporary adjustment of spreads within the structure—as differentiated from the level—of U.S. interest rates. But once the official account buying or selling tapers off, rate spreads tend to shift back into a more normal pattern. This temporary distortion of the rate structure reflects the fact that foreign official account activity is typically concentrated in one narrow sector of U.S. financial markets—the market for Treasury bills—whereas the asset adjustments of private parties, which represent the balancing outflow of dollars offsetting foreign official inflows, take place across the full spectrum of U.S. financial markets.

Thus, changes in foreign official account demands for U.S. Treasury securities will not—taken by themselves—exert any lasting effect on either bank reserves or interest rates. There may be a need for temporary technical adaptation in the day-to-day operations of monetary policy during periods of rapid change in foreign holdings of U.S. Government securities. But the ability of monetary policy to pursue its basic economic and financial objectives is not significantly affected by the size of foreign holdings of U.S. Government securities.

Question 2. As you will recall, I wrote last week asking for information on foreign exchange transactions of branches of U.S. multinational banks. I don't expect that you have that information as yet but I would like to urge you to provide it to the Committee as soon as possible. In the meantime, it would be helpful to me and to other members if you would describe the ways in which the branches are supervised and, especially, how their activities are monitored from the point of view of policy considerations.

Answer. The principal means by which the Board supervises and monitors the activities of overseas branches of member banks are examinations and reporting requirements.

Examinations of overseas branches, like those of member banks, serve two primary purposes. The first is to assure that prudent banking practices are being followed that minimize risks to depositors' funds and to the viability of the institution providing financial services to the public. Essentially, this concern is with bank solvency and liquidity, both of which relate primarily to the type and quality of assets. The second purpose of examinations is to verify that

applicable laws and regulations are being observed. As a by-product of the examination process, the development of new banking practices often comes to light; this information is then available to bank supervisors to assist in the framing and evaluation of bank regulatory policy.

Examination responsibilities for the overseas branches of member banks are divided between the Office of the Comptroller of the Currency and the Board of Governors—foreign branches of national banks in the case of the former and foreign branches of State member banks in the case of the latter. There is a continuous exchange of views between the two agencies in these matters through which the Board is made aware of significant regulatory problems or developments in the foreign branches of national banks. The Board currently makes on-the-spot examinations of the foreign branches of State member banks on a periodic basis which are supplemented by surveys of branch operations from information available at head office.

Reporting requirements for foreign branches of member banks currently consist of two reports. At the close of each year, a member bank is required to file a Report of Condition for each of its foreign branches (or a consolidated report for the bank's foreign branches in each foreign country). This report is a financial statement showing the branch (or branches) assets and liabilities as of the end of the year; in an abbreviated form, the information reported parallels that contained in the Report of Condition filed by the member bank for its domestic offices. The Board also receives monthly reports from all foreign branches with significant operations which through a different format provides information on operations in dollars and in other currencies, and on claims on and liabilities to different types of borrowing and deposit customers.

Question 3. In connection with this last point, another important question comes to mind. When and in what form will the Federal Reserve Board release information on the outflow of dollars through the banking system during the last 2–3 weeks? An excellent analysis of outflows in 1971 and their implications for the Voluntary Foreign Credit Restraint Program was made by Governor Brimmer in a speech last March. I would like to request that the Board provide a similar analysis of events during the recent crisis as quickly as possible. I am frankly alarmed by the Administration's announcement that it plans to work for an end to capital controls, particularly in the light of a net liquidity deficit of $13.78 billion for 1972. In this connection, it would be useful to have data on outflows under the VFCR guidelines for calendar year 1972 in both exempt and nonexempt categories. Information on outflows during the latest crisis will also be needed to help both Congress and the public evaluate the wisdom of this policy.

Answer. Regular detailed statistical reports on foreign lending by U.S. banks are collected on a monthly basis by the Treasury and published in the Treasury *Bulletin* and the Federal Reserve Bulletin. *Data* for February will be published toward the end of April. However, certain information on foreign credits appears in the weekly condition report of large commercial banks. The following table gives some pertinent information for recent weeks up to February 28, 1973 (which is the latest available.)

WEEKLY CHANGES IN U.S. BANK CLAIMS ON FOREIGNERS

[In millions of dollars]

Week ended	Loans to foreign governments	Loans to foreign commercial banks	Foreign commercial and industrial loans	Total
January:				
3	−7	+30	−58	−35
10	−8	−72	−12	−92
17	+4	−143	+64	−75
24	+27	−6	+24	+45
31	+7	+124	+43	+174
February:				
7	+17	+286	+37	+340
14	+19	+751	−55	+715
21	+13	+165	+24	+202
28	−13	+45	+40	+72

These figures show that there was an unusual upsurge in lending in the early part of February. It is our understanding that for the most part such outflows

represented drawdowns by foreign commercial banks on the lines of credit for which they have commitments from U.S. banks.

We might also note that unpublished data for the three weeks ended February 14 show a net reduction of about $1.1 billion in liabilities of U.S. banks to their foreign branches, and a reduction of about $0.9 billion in liabilities to other commercial banks abroad—principally liabilities of U.S. agencies and branches of foreign banks to their overseas affiliates. These declines represent a withdrawal of liquid foreign funds earlier placed in the U.S. market through the foreign branches. A major influence on these flows of funds at the time was the very sharp increase in interest rates paid on deposits in the Euro-dollar market.

With respect to data reported under the VFCR program in calendar 1972, foreign assets held by U.S. banks for their own account and by U.S. agencies and branches of foreign banks rose by $3.2 billion (from a level of $14.5 billion) and about two-thirds of this increase was in foreign assets of types not subject to restraint under the Program.

U.S. banks reporting under the VFCR program increased their foreign assets by $1,572 million from $12,902 million. However, their holdings of foreign assets of the types subject to restraint under the Program increased by only $159 million (from a level of $8,890 million). The greater part of the increase in exempt assets was in export credit which have been totally exempt from coverage since November 1971.

For the year 1972, foreign assets held by VFCR-reporting agencies and branches of foreign banks for their own account increased $1,667 million (from a level of $4,041), and foreign assets of the types subject to restraint increased $935 million (from a level of $2,441 million). As in the case of banks, the greater part of the increase in exempted foreign assets was in export credit.

Tables showing data for banks and for agencies and branches for 1972 are enclosed. (See attachment B.)

Question 4. Please give your views on the so-called two-tier system used by France, Italy and Belgium whereby currencies used in commercial transactions are controlled at the fixed rate of exchange while those used in financial transactions—which would include speculation—are allowed to float. Do these controls apply to branches and subsidiaries of U.S. banks in countries which employ them? If so, do they appear to make operations in those countries less attractive than in countries which do not employ such controls?

Answer. France, Belgium and Italy established two-tier exchange markets to limit the effect of international transactions on their official reserves. These countries have not had long experience with two-tier markets as they are presently organized, especially Italy, where the system was established only in January 1973. Since the beginning of 1973 the differentials (measured as weekly averages) between the rates in the two markets have not exceeded 1½ per cent.

France initiated its present two-tier system in August 1971 to prevent speculative capital inflows from affecting domestic monetary conditions, and for the same purpose Belgium (in May 1971) modified the dual rate system it had long been using. Increases in net official reserves of the central bank produce corresponding changes in the reserve deposits of the commercial banks, and when these changes are large and sudden they complicate the task of monetary management. As now devised, these two-tier systems would shield the official reserves equally as much from capital outflows as from inflows. And, prior to its May 1971 modification, the Belgian system was designed only to protect against outflows.

Italy's very recent adoption of a two-tier system was motivated by concern over a balance of payments deficit. While the current account balance has remained strong, there has been a large net capital outflow in recent years, which in 1972 was of sufficient size to cause a substantial overall deficit in the balance of payments. The Italian regulations require identifiable capital movements (and certain foreign travel items) to go through the so-called financial or free market. If the rate in that market is allowed to float freely, the total payments and total receipts that go through that market must balance out, and so have no impact on the reserves. However, the separation between current and capital transactions is far from complete, since capital flows in the form of leads and lags in commercial payments go through the commercial lira market.

Evaluating the net benefits of two-tier system in comparison with those of alternative courses of action is a complicated task. There is a question of how successfully arbitrage between the two markets can be prevented. Moreover, a two-tier system cannot work without an extensive system of exchange control reporting and surveillance.

The regulations relative to the two-tier exchange markets in these countries apply to transactions by branches and subsidiaries of U.S. banks just as they do to transactions by other banks, and there is no indication that the regulations have reduced to any appreciable extent the attractiveness of banking operations in those countries.

Question 5. How many applications for overseas branches have been turned down by the Board and on what grounds? Have any been turned down because there appeared to be too large a concentration of branches in a given area or country, or because additional branches could not be justified in terms of furthering the foreign commerce of the U.S.? On what grounds has the Board approved applications for 73 branches in Nassau, a country with which we have very limited trade relationships?

Answer. The Congress in enacting the Federal Reserve Act in 1913 authorized the establishment of foreign branches by national banks, subject to the approval of the Board and such rules and regulations as the Board might prescribe, on the grounds that such foreign branches would contribute to the furtherance of the foreign commerce of the United States. The Board in carrying out its responsibilities under the statute has sought to foster a strong branch banking system overseas which would afford U.S. commercial and investment interests from all sections of the country access to adequate and alternative sources of financing and financial services for their international transactions. The criteria employed by the Board in approving the establishment of foreign branches have been mainly concerned with the condition of the bank and its ability to operate and manage a foreign branch. A bank's condition is reviewed with respect to the adequacy of its capital, the quality of its assets and the general reputation and capabilities of its management; in addition, for banks seeking to establish their initial foreign branch or other foreign operation, the bank's experience and expertise in international lending and financing are scrutinized. Only rarely have other policy considerations been taken into account in acting on an application to establish a foreign branch.

In the past decade, only four applications for overseas branches have been denied by the Board. Only one of these, the application by the Bank of the Commonwealth, Detroit, Michigan, for a branch in Nassau was denied on the grounds of an unsatisfactory condition of the bank. In some other instances, however, approval has been withheld pending corrective action by bank management with respect to capital, quality of assets, operational procedures or personnel requirements.

Another application for a limited service branch facility in Paris by the Union Bank, Los Angeles, California, was denied since the bank already had a "shell'" branch in Nassau. The disposition of this application is related to the question of Nassau branches which is discussed below.

Two applications for branches in Puerto Rico were denied in this period. The Secretary of the Treasury of the Commonwealth of Puerto Rico objected to the establishment of these branches by a bank headquartered outside Puerto Rico on the grounds that the banking needs of the Commonwealth could be adequately served by the banking institutions already operating in Puerto Rico. The Board acceded to the wishes of the Puerto Rican authorities in these instances. These two cases are the only ones where it might be said that local conditions of competition and concentration of banking facilities indirectly influenced the Board's decision. Normally these considerations do not enter as elements in the Board's actions on foreign branch applications: foreign banking authorities are the ultimate licensing agency for the entry of alien banks into their market and those authorities are in the best position to judge banking requirements in those markets; from the U.S. point of view, the public interest of furthering the foreign commerce of the United States is best served by permitting competitive alternatives among U.S. banks abroad, rather than confining branch facilities to the few very large U.S. banks who have long had foreign branches.

The branches in Nassau (and also in the Cayman Islands) are with two exceptions limited service facilities. The license for these facilities granted by the local authorities permit them to deal only with non-residents and in non-local currencies. In effect, these facilities are adjuncts of the Euro-currency market: they receive and place funds in the interbank setor of that market; they make loans and receive deposits in U.S. dollars and other currencies principally to non-U.S. residents. The facilities are referred to as "shell" branches because there is no contact with the local public and the transactions in the facilities are virtually all directed by the branch's head office or its other foreign branches.

A set of books is maintained at these branches (usually by a contract party) which is for all practical purposes the duplicate of the books kept at head office.

The Board's approval of the majority of these branches was based on considerations of fairness or equity. The smaller, interior banks had neither the business base nor the expertise in their home offices to support a full service branch overseas, particularly in a center such as London. Yet their home office operations were constrained by the limitations imposed by the Voluntary Foreign Credit Restraint Program as it applied to domestic banks and to the limitations imposed by the other elements of the Government's programs to limit capital outflows as a means of protecting the balance-of-payments position of the United States. Since the large banks with established overseas facilities were able for the most part to make foreign credits from those facilities and, after due consideration, the Board decided by majority vote that the operation of such branches would not be contrary to the public interest. That decision was importantly influenced by considerations of the equalization of competitive advantages between the banks with long-established branches overseas and the smaller banks and later arrivals to the international banking business.

For some banks with full service branches overseas already in existence, the Board approved "shell" branches in Nassau because their establishment would reduce the practical inequities of tax incidence on the bank's foreign operations without reducing the tax return to the United States Treasury.

In all of this, it was recognized that these branches contributed very little to trade and financial relations with the Bahamas. Rather these shell branches were viewed as adjuncts to the totality of foreign branch operations overseas in providing financing and financial services to U.S. business interests. However, because of the unique characteristics of these branches, they have been kept under special surveillance by the Board to assure that they were being used to develop new international business. Moreover, the Board concluded that the proliferation of this type of branch should not be encouraged and has followed the policy of not approving more than one "shell" branch per bank. It was for this reason that the previously mentioned application by Union Bank for a limited facility in Paris was denied.

Question 6. According to information obtained from the Board, international subsidiaries of U.S. banks had not taken advantage of statutory authority to engage in underwriting securities as of the end of 1967. However, a number of U.S. banks have subsequently joined with major European and Japanese banks in investment consortia and the Eurobond market has become a major factor in international finance. Since it is common practice for European banks to engage in underwriting, has there been an increase in the activity of U.S. banks in this area? If so, has U.S. participation in underwriting overseas been largely through affiliates whose other shareholders are European banks or are subsidiaries controlled by the U.S. banks also engaged in underwriting and to what degree?

Answer. Underwriting and dealing in securities has become an important activity in foreign affiliates of U.S. banks in recent years with the development and growth of the Eurobond market and to a much lesser extent a Euro-equity market. These affiliates are of two general types. consortium banks in which one or more American banks have combined with European and sometimes Japanese banks; and wholly-or-majority-owned subsidiary "merchant" banks. Among these affiliates, there is substantial variation in the extent and nature of their underwriting activities. The bulk of the business of these consortia and merchandise banks is medium-term lending, including the formation of large lending syndicates. In the underwriting area. activity has been mainly confined to Eurobond issues; participation in equity issues has been fairly rare. In Eurobond issues, only a few of these affiliates have been managers or co-managers of issues; the others have been largely among the principal underwriters or in the selling group. Among the more active affiliates in the underwriting business have been Bankers Trust International, (a wholly-owned subsidiary of Bankers Trust Company), Manufacturers Hanover Ltd. (a majority-owned subsidiary of Manufacturers Hanover Trust Company) and Western American Bank Ltd. (a consortium controlled by National Bank of Detroit, Security Pacific National Bank and Wells Fargo Bank). No data are available on the extent to which these European affiliates have participated in underwriting syndicates. More recently, interest has been developing in the establishment of similar types of affiliates in other areas, notably in Southeast Asia where local and international money and capital markets are in the process of formation.

Question 7. There seems to be general agreement that one of our major problems in the area of international monetary policy is what to do with the so-

called "overhang" of U.S. dollars flowing from one overseas financial institution to another. It was suggested at the time of the last devaluation that the dollar be devalued at the level of the market price of gold so that it could remain convertible. Of course, this would not have been acceptable to our trading partners and besides, as demonstrated last week, would have had the effect of merely driving the price of gold even higher. However, it was a fresh suggestion and after more than a decade of relying on the hope of somehow righting our balance of payments, it seemed at least to recognize that time is a critical element in this problem and that we cannot afford to rely further on long-range solutions. It would seem to me useful to have some discussion of how to deal with the immense volume of U.S. dollars which have already been accumulated abroad with little hope of repatriation through existing channels, and I would like to have your views on the subject.

Answer. The "overhang" of existing foreign official dollar assets in the United States is one of the major issues to be dealt with in the current negotiations on reform of the international monetary system. This issue is separate from (but related to) the problem of determining the conditions under which U.S. payments deficits and surpluses could be settled in reserve assets and it is this latter problem that is sometimes referred to as the problem of convertibility.

A number of proposals have been made for dealing with the overhang of foreign official dollar and sterling balances. Under one type of proposal, these balances would be transferred by their owners to the IMF, which would issue SDRs (or some other form of reserve asset) in exchange that could be freely used in official settlement of international payments. Another proposal would involve the funding of these balances into long-term obligations of the United States and the United Kingdom, which would be held by the individual countries concerned. In either of these cases, effective repayment or amortization of the U.S. debt could occur only if the rest of the world permitted the United States to achieve payments surpluses of sufficient size.

The feasibility of any particular proposal for dealing with the overhang will, thus, depend on the other elements of the reformed monetary system.

ATTACHMENT A

Marketable U.S. Government securities held in custody for foreign and international accounts [1]

[In millions of dollars]

As of late February:	Amount
1973	33, 250
1972	28, 288
1971	12, 826
1970	8, 055
1969	8, 426
1968	8, 550
1967	7, 319
1966	7, 887
1965	8, 136

[1] This caption valid beginning Sept. 6, 1970; figures prior to that date include both marketable and nonmarketable securities held for foreign account.

ATTACHMENT B

FOREIGN ASSETS OF U.S. COMMERCIAL BANKS REPORTING UNDER THE VFCR GUIDELINES

[Amounts in millions of dollars]

[Data as of end of month]

Category	December 1969 [1]	December 1970 [1]	November 1971	December 1971	December 1972	January 1973	Changes: December 1972 to January 1973	Changes: December 1971 to January 1973	Changes: November 1971 to January 1973
I. Foreign assets held for own account	10,143	10,424	11,698	12,902	14,457	14,097	−360	+1,195	+2,399
A. Loans, acceptances, deposits, and other claims	9,273	9,437	10,515	11,700	13,058	12,657	−401	+957	+2,142
B. Long-term securities	161	141	116	119	108	113	+5	−6	−3
C. Invest. in foreign subs	628	781	1,005	1,021	1,222	1,261	+39	+240	+256
D. Other long-term holdings	81	65	62	62	69	66	−3	+4	+4
II. Less VFCR exempt assets	794	1,120	3,111	3,947	5,348	5,105	−243	+1,158	+1,994
A. Canadian assets (change since February 1968)	164	266	218	536	927	710	−217	+174	+492
B. Del. subs. liab. offset			104	112	199	206	+7	+94	+102
C. Export credits other than to residents of Canada			2,789	3,299	4,222	4,189	−33	+890	+1,400
1. Participated in, or guaranteed, by Eximbank or insured by FCIA	522 (items 1–3)	791 (items 1–3)	(2) 1,388	(2) 1,429	1,607	1,654	+47	+225	+266
2. Guaranteed by Department of Defense			(2) 31	(2) 32	153	153	0	+121	+122
3. Other			(2) 1,370	(2) 1,838	2,462	2,382	−80	+544	+1,012
D. Deferred payment letters of credit [3]	180	63							
III. Assets subject to VFCR (I–II)	9,349	9,304	8,587	8,955	9,109	8,992	−117	+37	+405
IV. Aggregate ceilings	10,092	9,968	9,876	10,032	10,252	10,220	−32	+188	+344
V. Aggregate net leeway (IV–III)	743	664	1,289	1,078	1,143	1,228	+85	+150	−61
VI. Number of reporting banks	169	173	184	194	219	213	−6	+19	+27
Memorandum items:									
Claims held for account of customers	1,541	1,563	1,737	1,918	2,079	2,384	+287	+466	+647
Total own and customers' claims	10,814	11,000	12,252	13,619	15,155	15,041	−114	+1,422	+2,789

[1] Data do not include Export Term-Loan Ceiling (ETLC) and assets subject to that ceiling. On Dec. 31, 1969, the aggregate ETLC was $1,264,000,000, with total outstandings of $16,000,000 On Dec. 31, 1970, the aggregate ETLC was $1,423,000,000 with total outstandings of $190,000,000.

[2] Estimated.

[3] Deferred payment letters of credit held on Apr. 30, 1968, and currently outstanding.

ATTACHMENT B—Continued

FOREIGN ASSETS OF U.S. AGENCIES AND BRANCHES OF FOREIGN BANKS REPORTING UNDER THE VFCR GUIDELINES

[Million of dollars; end of month]

	November 1971	December 1971	December 1972	January 1973	Changes: November 1972 to January 1973	Changes: December 1971 to January 1973	Changes: Novembe 1971 to January 1973
I. Foreign assets held for own account	2,838	3,009	4,676	4,445	−231	+1,436	+1,607
A. Loans, acceptances, deposits, and other claims	2,817	2,987	4,660	4,415	−245	+1,428	+1,598
B. Other holdings	21	22	16	30	+14	+8	+9
II. Less: Own assets of the types not subject to restraint	964	1,066	1,799	1,859	+60	+793	+895
A. Canadian assets	250	273	389	342	−47	+69	+92
B. Export credits other than to residents of Canada	714	793	1,410	1,517	+107	+724	+803
1. Participated in, or guaranteed, by Eximbank or insured by FCIA			38	40	+2		
2. Guaranteed by Department of Defense			11	11	0		
3. Other			1,361	1,466	+105		
III. Foreign assets of the types subject to restraint (I-II)	1,875	1,943	2,878	2,585	−293	+612	+710
IV. Foreign assets of the types subject to restraint on Nov. 30, 1971	1,875	1,875	1,874	1,876	+2	+1	+1
V. Difference: IV–III	0	−71	−1,004	−709	+295	−638	−709
VI. Number of reporting institutions	49	51	60	62	+2	+11	+13
Memorandum items:							
U.S. customers' claims	232	233	447	400	−47	+167	+168
Total own and customers claims	3,049	3,220	5,107	4,815	−292	+1,595	+1,766

[1] This figure reflects an amount held by an agency that previously had been reporting on a consolidated basis with the U.S. subsidiary of its foreign parent bank.

RESPONSE OF HON. ARTHUR F. BURNS TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR PROXMIRE

Question 1. Many programs have been enacted in past years to help shield the housing industry from the impact of tight money. These include the establishment of a secondary market facility for conventional mortgages, and increased support of the mortgage market by the Federal Home Loan Bank Board and FNMA. In spite of these and other measures, however, it is probable that the housing industry will still be called upon to assume a disproportionate share of the cutback dictated by tight money. The Federal Reserve Board has recommended steps that the Executive Branch and the Congress might take to avert another housing disaster. In the absence of Congressional or Administration action, first of all, what can the Federal Reserve Board do under its present authority to deflect some of the impact of tight money on housing; and secondly, of the actions which are legally possible, which are appropriate and proper for the Federal Reserve System to undertake.

Answer. Under existing authority, the powers of the Federal Reserve to reduce the impact of general credit restraint on the mortgage market and on housing are relatively limited. The principal methods that could be employed are: (1) to raise Regulation Q ceilings on consumer-type time and savings deposits; (2) to purchase securities of the Federal housing credit agencies for the System's portfolio; and (3) in the event of serious liquidity problems confronting individual savings and loan associations and mutual savings banks, to make loans to the Federal Home Loan Bank, or to the Federal Reserve member banks, which would in turn extend emergency credit to the institutions experiencing difficulties.

A change in Regulation Q ceilings on consumer-type time and savings deposits could only be undertaken after consultation among the various Federal supervisory authorities responsible for determining the appropriate levels of these ceilings at insured commercial banks, mutual savings banks, and savings and loan associations. An increase in these ceilings, coordinated so as to avoid destructive competition among the institutions themselves, would be a constructive step if funds begin to be diverted in volume from savings deposits at banks and nonbank intermediaries by rising market interest rates. The amount by which these ceilings could be raised, however, is relatively limited. Earnings positions of thrift institutions have improved materially in recent years, but the institutions are not yet in a position to compete freely with market instruments in periods of general credit restraint.

The System has conducted open market operations in Federal agency issues since 1966—first through transactions involving repurchase agreements, later through outright purchases and sales. These operations have been taken with a view to improving the market for such issues. In order to accomplish that objective, the System has avoided acquiring a disproportionately large share of any issue, so that yields would not be reduced to the point where other investors were driven away. The magnitude of these operations could be expanded if the Federal credit agencies were borrowing in substantial volume to support the mortgage market. This would help to prevent a rise in yields on these securities relative to available investment alternatives. However, the magnitude of such purchases would have to remain modest in relation to the volume of outstanding issues to be consistent with the purpose of improving the market for such issues. Moreover, purchases of agency securities by the System would have to be consistent with the objectives of monetary policy in terms of its effects on bank reserves. This would mean a reduction in purchases of direct Treasury debt equal to the additional agency securities acquired.

Loans by the Federal Reserve to the Federal Home Loan Banks, or to member commercial banks, to assist individual savings and loan associations and mutual savings banks would be appropriate only under emergency conditions. Nonetheless, knowledge that emergency credit facilities exist might help to allay concern over the liquidity positions of financial institutions in a period of unusual credit stringency.

Question 2. In your statement you indicate that any rapid rise in commitments for future lending on the part of financial institutions will contribute to another inflationary round of spending by businesses and other borrowers. This seems to be an important and potential source of inflationary pressure. Does the Federal Reserve Board have adequate authority to control the total volume of

advance commitments by member banks, and, if not, should such authority be given to the Federal Reserve by the Congress?

Answer. The Federal Reserve has no specific authority to exercise control over the volume of advance loan commitments extended by member banks. This does not constitute a serious impediment to the ability of the Federal Reserve to influence overall bank lending policies in a reasonably timely fashion. But it must be recognized that, if banks enter into an excessive volume of commitment agreements with their business customers, two problems may arise. First, these commitments may result in business firms, particularly large firms, enjoying a potential advantage in obtaining credit during periods of credit stringency. Second, the banks obligated to meet these commitments may have difficulties in finding funds to meet these obligations. Thus, there is an important need for banks to exercise prudence in entering into such arrangements. This has been stressed repeatedly by Federal Reserve officials.

It would be difficult for the Federal Reserve to exercise direct control over the volume of advance commitments. A commitment to lend sometimes takes the form of a binding contractual obligation for which the bank charges a fee. More often than not, however, an advance commitment is an informal agreement or understanding between a bank and a customer, for which no written contract exists. The devising of methods to quantify these latter agreements would appear to present the greatest difficulty for imposing effective direct controls on bank commitment activity.

Question 3. Expectations of a reduction in the U.S. trade deficit during 1973 seem to be based on three major assumptions: (1) the United States will continue to enjoy a less inflationary economy than most of our industrial partners, (2) Some of the positive effects of the December 1971 exchange rate realignment will begin to be realized, and (3) Rates of economic growth will accelerate in our trading partners. But it would seem that the recent dollar devaluation and appreciation of the yen will this year counteract most of the benefits that could be expected from a low rate of inflation in the United States and the 1971 exchange rate changes. In addition, money GNP is projected to increase about 10 percent this year. In the past, imports have grown at an annual rate of 20 percent or more when our own growth rate has approached 10 percent. Can you really argue that the acceleration in economic growth overseas will be sufficient to overcome our own appetite for imports as the U.S. economy expands rigorously for a second year? After all, we seem to have a far higher income elasticity with respect to imports than most of our trading partners.

Answer. We do expect a reduction of the trade deficit in 1973, based on the three factors you mention. With respect to the situation vis-a-vis Japan, we expect the rise in the yen to be helpful over time in restoring competitiveness with Japanese products not only in the U.S. market but also in competition in third markets. We expect that the devaluation of the dollar will allow dollar prices of U.S. exports to rise, or, if U.S. exporters hold their dollar prices they should be able to increase the volume of their exports because their prices measured in foreign currencies will have fallen sharply. This would certainly be true in Japan, and we would hope also that strong growth in the Japanese economy and reductions in barriers against U.S. goods will be helpful. We also expect, of course, that prices of U.S. imports in terms of dollars will rise, but this should soon begin to cause some shift toward domestic substitutes, if indeed such a shift is not already under way.

It is true that as their income rises, consumers in this country tend to spend more for imports, and the percentage of their income spent for imports also tends to rise. But we can only rectify that over time by the kinds of shifts in comparative prices that should come from the realignments of exchange rates since 1970. Obviously, we will not get such shifts unless we pursue a vigorous anti-inflation policy in the United States.

Strong domestic demands for goods such as machine tools dampens the interest of American manufacturers in export sales. In export-minded countries such as Germany and Japan there seem to be greater efforts by producers to meet the demands of export customers, even in periods of strong domestic demand.

THE 1973 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 22, 1973

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

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

Present: Senators Proxmire and Javits; and Representative Reuss.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; John R. Karlik and Courtenay M. Slater, economists; Lucy A. Falcone, research economist; L. Douglas Lee, research assistant; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order.

I ask Mr. Cooper, Mr. Haberler, and Mr. Krause to come to the table.

Today our annual hearings on the President's Economic Report turn to international economic issues. Last week the President announced the second devaluation of the dollar in 14 months. Chief among the questions to be answered this morning are why was a second devaluation necessary; was its timing and amount appropriate; can we expect significant reductions in the U.S. trade and payments deficits in 1973, and especially, what more fundamental answers should we work toward to provide a more stable, less disruptive response to monetary crisis that are seeming to become a way of life.

From what I have heard about the views of our panelists, we will be exposed to a variety of points of view this morning, and a lively disagreement should ensue, I hope.

I am happy to report this morning that a fourth economist engaged in the preparation of balance-of-payments statistics and projections for the Commerce Department whom we had invited, will not appear, and I am distressed to know that he will not appear. This is in direct violation of the determination by the majority in the U.S. Senate to press hard for the appearances of executive department witnesses before congressional committees.

The Commerce Department declined to send Mr. David Devlin who is an Associate Director of Economic Analysis, on the ground that he did not want staff involved in policy matters.

Thus this committee is denied the benefit of the official Department of Commerce information and analysis on vital issues concerning our international economic relations.

This, I think, is one more direct affront to the U.S. Congress by this administration. It is an intolerable situation.

Again, it is difficult, if not impossible, for the Congress to adopt intelligent positions on economic issues if we are denied relevant information prepared by and available to the executive departments. Our request was for information of a factual nature and independent of any particular policy stance regarding the various international economic issues the United States now confronts.

The Commerce Department has chosen to supply us with no information whatsoever. We are not satisfied with this response and intend to pursue the matter further in coming months.

We are delighted and honored to have on our panel this very distinguished trio of international economists, including Mr. Richard Cooper, professor of economics at Yale University, and former Deputy Assistant Secretary of State for International Monetary Affairs; Mr. Gottfried Haberler, now associated with the American Enterprise Institute, a long and illustrious teaching career at Harvard University and I remember when I was a student at Harvard, he at that time was an honored and distinguished expert; and Mr. Lawrence Krause, now senior fellow at the Brookings Institution and formerly staff international economist for the Council of Economic Advisers.

Mr. Cooper, you might proceed in alphabetical order, beginning with you.

STATEMENT OF RICHARD N. COOPER, PROVOST AND PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. COOPER. Thank you very much, Senator Proxmire.

Senator PROXMIRE. I might say, before you gentlemen begin, that I regret very much that only Mr. Krause gave us an advance prepared statement.

I realize the situation has changed so greatly that you had to modify your prepared statements, but it helps even if you give us some notion of how you feel about these things so we can analyze, think about and discuss with the staff before the meeting, and have more orderly discussion.

Go ahead, Mr. Cooper.

Mr. COOPER. I have submitted a prepared statement, but with your permission I will just excerpt it.

Senator PROXMIRE. We would appreciate if you could confine your remarks to 10 minutes, so we can have a discussion.

Mr. COOPER. At present, 5 of the 11 currencies of the world are floating more or less freely in the market, and 2 additional currencies, the French franc and the Belgian franc, have split markets with half of the transactions taking place at floating exchange rates.

The world thus looks very different from that evisaged in the Bretton Woods Agreement, which calls for fixed exchange parities, and even in its Smithsonian amendment, which also called for fixed exchange rate parities, although to be sure with a wide margin of flexibility.

The proximate cause for this development is the recent devaluation of the dollar, which for a variety of reasons the U.S. Government thought was necessary and appropriate.

The devaluation has been widely applauded as a right and necessary move in view both of a huge U.S. trade deficit and of massive speculation against the dollar early this year.

I confess I have a rather different view of the alleged necessity for devaluation. I do not know if the exchange rates set in the Smithsonian Agreement of December 1971 were the right rates or not. But, apart from treatment of the pound, they were not obviously the wrong rates. We did not give them a chance to work. In today's world, it takes much time for relative price changes to have substantial effect. Experience after the British devaluation of 1967 suggests 18 to 24 months. Recent econometric work suggests as long as 3 years for maximum effect, and even then only 80 percent of the total effect has been felt. This is not surprising when one considers the kind of goods that major industrial countries increasingly trade: heavy machinery, specialized equipment, large ships and large aircraft, even whole factories on "turnkey" contracts. The time between contract and delivery can be very long indeed. And even raw materials are being purchased increasingly on long-term contract. This kind of trade, and that which takes place within multinational corporations, creates much inertia in altering source of supply following a change in relative prices.

Given these lags, a currency realinement cannot be expected to have immediate positive effect. We need greater patience than the American Government showed. In fact, depreciation can be expected to worsen the trade position of a large country in the short run, because import prices, measured in its own currency, will generally rise more rapidly than export prices. This happened to Britain in 1968, and it happened to the United States in 1972: thanks largely to the Smithsonian currency realinement, import prices—measured in dollars—for the United States rose about 4 percent more than export prices. This change alone would have worsened the U.S. trade balance by nearly $2 billion in 1972. On top of that, the U.S. economy experienced an extraordinary recovery from the recession of 1970–71, and on recent experience this recovery would have increased imports by an additional $8 billion. Taking these two factors together, the trade balance might well have deteriorated by nearly $10 billion between 1971 and 1972. In fact, it worsened by $4.4 billion, which even after allowance for a normal growth in exports suggests that the currency depreciation has already had a substantial effect, although the gap to be closed remains large.

My guess is that the extra 10-percent devaluation will prove to be too much with respect to most currencies. As the Smithsonian rates gradually take greater hold during 1973 and 1974, a number of other countries will find themselves in increasing balance-of-payments difficulty. The huge Japanese surplus suggests, however, that the value of Japan's currency may have been out of line with all others.

But the more fundamental issue is not whether the Smithsonian exchange rates were right or wrong. Once a major disequilibrium has arisen, we cannot be certain of the exact amount of exchange rate correction it requires. We do not know what is the "right" set of rates. This episode of the past several weeks underlines more strongly than ever the need for a monetary system that avoids the emergence of major imbalances in payments and one that corrects the inevitable tendenies toward imbalance promptly and smoothly. The prospect of large changes in exchange rates, imposed over a weekend, gives rise

to large-scale currency speculation, disruptive both to foreign exchange markets and to domestic money markets. The actuality of large changes in exchange rates subjects national economies to a severe jolt, throwing investment plans and profit calculations badly out of kilter and jeopardizing firms that have not adequately anticipated the change.

Both of these are costs avoidable. But avoiding them requires alterations in our view of exchange rates—either toward greater rigidity or toward greater flexibility. Greater rigidity would require countries to govern their national economies by the mandates of the balance of payments, a manifest impossibility for democratic governments in the near future. Therefore we need greater flexibility—exchange rates that change more frequently, but by smaller amounts than the changes of recent years.

Last fall the U.S. Government advanced a constructive proposal to the Committee of Twenty, now examining monetary reform, that would compare a country's actual reserves to an internationally agreed target level of reserves to determine whether adjustment is necessary. If a country's reserves exceeded or fell short of its target level of reserves, corrective action would be called for. If a country failed to act, international consultation would take place, and if necessary sanctions would be applied; for example, in the form of discriminatory import surcharges on the exports of a country in persistent surplus. The system would treat countries in urplus symmetrically with those in deficit.

The U.S. proposal has a number of defiicencies. As formulated, it might invite even more speculation than now exists, for as a country's reserves neared the "action" points speculation would become heavy indeed. Countries should be put under greater pressure to take early action than is exerted in the basically permissive U.S. plan. Second, given the adjustment lags noted above, keying exchange rate changes—the U.S. plan speaks only of "acceptable adjustment measures," but in the final analysis these must ordinarily mean changes in exchange rates—to discreptancies from target reserve levels will lead to very substantial overshooting; at a minimum, heavy weight must also be given to reserve changes; for example, balance-of-payments deficits or surpluses, but other criteria might also be used. Finally, the task of negotiating agreed reserve targets for all countries will be an exceedingly difficult one.

Despite these various technical problems, the U.S. proposal is certainly a step in the right direction. No government will tie its hands completely on adjustment, but just as the exchange rate is an important domestic economic variable, it is also an important variable to other countries. International coordination is unavoidable. The only question is whether it will be orderly or disorderly. The U.S. proposal outlines a scheme, to be sure in general terms, which would internationalize the process of balance-of-payments adjustment, and that is greatly to be welcomed.

International coordination must also be provided in another sphere, not covered by the U.S. proposal. Better exchange rate adjustment will discourage large-scale speculative movements of capital, but it will not eliminate large movements of capital altogether. Provision must be made, going well beyond the present swap facilities among central

banks, for lending to countries large amounts on short notice to cover large outflows of short-term funds.

The large amount of liquid funds now held in the Eurocurrency market and elsewhere, readily movable from one currency into another, suggests the need for a remedy to possible disturbance going well beyond the consolidation of official foreign exchange reserves that has been so often suggested. Consolidation of official balances alone would not protect the United States against massive switches out of privately held foreign dollar holdings, for instance.

Much of the turmoil of the last several weeks was not associated with U.S. balance-of-payments deficits, but rather involved the swishing around of these privately held balances.

So long as this possibility exists, the dollar cannot be made convertible, even with an adequate adjustment mechanism; the simple arithmetic prevents it, for switching only a fraction of private dollar balances—probably amounting now to over $70 billion—would quickly exhaust present U.S. reserves.

The right way to handle this problem is not to endow the United States with a huge amount of reserves through a special allocation of SDR's or a huge increase in the official price of gold, or to allow the United States to build up the required reserves through running many years of payments surpluses before restoring convertibility, but to create a new facility in the International Monetary Fund which permits it to be a true lender-of-last-resort at the global level, a central bank for central banks. The new facility would lend SDR's at short term in any required amount to deal with sudden shifts of private or official balances from one asset into another.

The scheme would work in this way. Suppose to take the events of early February, there was a sudden switching from dollars to German marks of $6 billion. The German Bundesbank absorbs the dollars in supporting the dollar-mark exchange rate. Under reserve-asset convertibility, the Bundesbank could convert these dollars into reserve assets at the U.S. Treasury. This would cut present U.S. reserves nearly in half.

With the new facility, the United States would borrow the equivalent of $6 billion in SDR's from the International Monetary Fund—this transaction would have nothing to do with normal borrowing under the U.S. quota at the International Monetary Fund, which is totally inadequate to the task—and would use this to buy the $6 billion in dollars from the Bundesbank.

If the switch from dollars to marks proved to be temporary, reversing itself within, say, a year, then the above sequence of transactions would simply be reversed: the Bundesbank would acquire dollars from the United States by selling SDR's, and the United States would repay the International Monetary Fund. The dollars would be sold into the market for marks.

If, on the other hand, the switch or some part of it proved to be lasting, the United States would be left with an obligation to the International Monetary Fund. This obligation would then be converted into long-term interest-bearing debt with a fixed amortization schedule over, say 40 years. The interest and amortization payments would be normal international payments and would, other things being equal, trigger the reformed adjustment process to allow the United States to

run the required surplus in its other international payments to repay the debt.

This type of emergency lending would not in principle be available to finance basic balance-of-payments deficits. But of course at the time of a massive movement of funds it is not possible at once to distinguish one type of funds from another. Therefore the lending should be available to cover any type of massive switch from one currency into another, including a switch made by the residents of the country experiencing the run. If after the large flow it was learned that a portion of it was due to a worsening of the country's basic balance-of-payments position, then the country would be obliged to repay the International Monetary Fund for any "unwarranted" borrowing, if necessary by drawing on the normal lending facilities of the IMF, based on quotas.

Such a facility would have special relevance to the United States, because of the very large amounts of dollars held abroad in private hands, increasingly being used abroad as well as dollars.

Finally, while there is much to be said for the consolidation of outstanding official foreign exchange holdings, obligatory consolidation is likely to meet stiff resistance on a variety of grounds. Thus a potential problem would remain in the possible switches of official dollar holdings into other currencies, or indirectly into primary reserve assets, as a dollar-holding country runs a deficit the counterpart surplus of which is with nondollar holding countries. Official dollar holdings would thus decline for reasons unrelated to the U.S. payments position, yet placing demands on U.S. reserves under a system of convertibility. The new IMF facility proposed here could quite comfortably cover such cases as well.

These two changes together—a strong presumption in favor of small and more frequent exchange rate changes, and the creation of a lender-of-last-resort facility—would mark a major improvement in the international monetary system, and would recognize management of the system for what it truly is, a collective international responsibility.

Mr. Chairman, let me close by saying what will now be obvious, that I focused most of my remarks not on the events of the last several weeks, which are now over, but on where we go from here.

It seems to me that we have experienced in the last several weeks was symptomatic of more fundamental weaknesses in the system than a mere overevaluation of the dollar. As I have indicated, one can even raise questions whether the dollar in January of 1973 was in fact overvalued.

Rather, the episode was just the latest one of a series of opisodes that have been predicted now by many international economists for some years, that until the international monetary system is substantially improved, we are bound to have financial crises from time to time whether it be triggered by politically motivated capital flight from Italy, or what have you.

The fact that the monetary system is so sensitive to such seemingly irrelevant events as what triggered the run in January, suggests that we will not reach the end of this matter by changing currency parities or by additional controls and what have you. We must go to the root of the problem.

Thank you.

[The prepared statement of Mr. Cooper follows:]

Prepared Statement of Richard N. Cooper

International Monetary Reconstruction

On February 12, less than 14 months after the celebrated Smithsonian Agreement of December 1971, the dollar was devalued a second time. Two other leading currencies, the yen and the Italian lire, were allowed to "float" in the foreign exchange market, removing the obligation of their central banks to support a fixed rate. Even before this latest turn of events, the British pound and the Swiss franc had been set free, and the Canadian dollar has been floating since 1970, so that by now five of the world's leading currencies are floating in the exchange market, while two others (the Belgian franc and the French franc) have split markets, with most non-trade transactions taking place at a variable exchange rate.

The world thus looks very different from that envisaged in the Bretton Woods Agreement, even as amended by the Smithsonian Agreement, which basically calls for fixed exchange rates.

Why this change, so rapidly after things seemed to be settled? There is a superficial explanation and a more fundamental explanation.

The superficial explanation is that the U.S. Government was never really satisfied with the pattern of exchange rates set in the Smithsonian Agreement. It thought that the dollar had not been depreciated enough relative to other currencies, especially the yen. The fact that the British pound was set free and floated down *below* the pre-Smithsonian dollar exchange rate suggests that the dollar was depreciated too much with respect to the pound. But the staggering Japanese trade surplus of $9 billion in 1972, an all-time high for any country, the huge German trade surplus in 1972 (other transactions only partially offset by the German and Japanese trade surpluses), and the $6 billion U.S. trade deficit all reinforced this view of the U.S. officials. For these various reasons, the U.S. government was psychologically prepared to devalue the dollar again, if the occasion should arise.

A totally extraneous event provided the occasion: large capital flight from Italy in response to political uncertainty there. It was under the financial pressure of Italian funds flowing into Switzerland that the Swiss authorities—most unexpectedly, given the expressed devotion of the Swiss banking community to a system of fixed exchange rates—allowed the Swiss franc to float upward. If the franc, why not the German mark, where the government was known to be sympathetic to floating? So funds began to move heavily into Germany. The movement out of dollars—where so much of the world's liquid funds rest when they are not seeking profit elsewhere—was aggravted by two developments in the United States: the shift from Phase II to Phase III in U.S. price and wage policy, from controls to voluntary compliance; and the attempts by the Federal Reserve to block a rise in interest rates charged by banks to their prime borrowers. To many observers both factors signalled renewed inflationary pressures in the United States, desipte the sharp decline in inflation during 1971–72.

I have a rather different view of the need for dollar devaluation from that of U.S. officials. I do not know if the exchange rates set in the Smithsonian Agreement were the "right" rates or not, a point to which I will revert below. But, apart from treatment of the pound, they were not obviously the wrong rates. We did not give them a chance to work. In today's world, it takes much time for relative price changes to have substantial effect. Experience after the British devaluation of 1967 suggests 18–24 months. Recent econometric work by Helen Junz of the Federal Reserve Board and Rudolph Rhomberg of the International Monetary Fund suggests as long as three years for maximum effect, and even then only 80 percent of the total effect has been felt. This is not surprising when one considers the kind of goods that major industrial countries increasingly trade: heavy machinery, specialized equipment, large ships and large aircraft, even whole factories on "turn-key" contracts. The time between contract and delivery can be very long indeed. And even raw materials are being purchased increasingly on long-term contract.

This kind of trade, and that between various parts of multinational corporations creates much inertia in altering sources of supply. Given the lags, a currency realignment cannot be expected to have immediate positive effect. We need greater patience than the American government showed. In fact, depreciation can be expected to *worsen* the trade position of a large country in the short run, because import prices, measured in its own currency, will generally rise

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more rapidly than export prices. This happened to Britain in 1968, and it happened to the United States in 1972: thanks largely to the Smithsonian currency realignment, import prices (measured in dollars) for the United States rose about 4 percent more than export prices. This change alone would have worsened the U.S. trade balance by nearly $2 billion in 1972. On top of that, the U.S. economy experienced an extraordinary recovery from the recession of 1970–71, and on recent experience this recovery would have increased imports by an additional $8 billion. Taking these two factors together, the trade balance might well have deteriorated by nearly $10 billion between 1971 and 1972. In fact it worsened by $4.4 billion, which even after allowance for a normal growth in exports suggests that the currency depreciation has already had a substantial effect, although the gap to be closed remains large.

Despite the long lags, relative price changes brought about by devaluation can be expected to improve the trade balance substantially—after buyers have had a chance to switch sources of supply, and suppliers have had a chance to take advantage of the new profitable investment opportunities. My guess is that the extra 10 percent devaluation will eventually prove to be too much with respect to most currencies. As the Smithsonian rates gradually take greater hold during 1973 and 1974, a number of other countries will find themselves in increasing balance-of-payments difficulty. The huge Japanese surplus suggests that the value of Japan's currency may have been out of line with all others.

But the more fundamental issue is not whether the Smithsonian exchange rates were right or wrong. Once a major disequilibrium has arisen, we cannot be certain of the exact amount of exchange rate correction it requires—and indeed an answer cannot even in principle be given without specifying also the macro-economic policies of all the leading countries. In short, we do not know what is the "right" set of rates. The episode of the past several weeks underlines more strongly than ever the need for a monetary system that avoids the emergence of major imbalances in payments, such as those that have plagued the monetary system since 1966, a system that corrects the inevitable tendencies toward imbalance promptly and smoothly. The *prospect* of large changes in exchange rates, imposed over a weekend, gives rise to large scale currency speculation, disruptive both to foreign exchange markets and to domestic money markets. The *actually* of large changes in exchange rates subjects national economies to a severe jolt, throwing investment plans and profit calculations badly out of kilter and jeopardizing firms that have not adequately anticipated the change.

Both of these are costs avoidable. But avoiding them requires alterations in our view of exchange rates—either toward greater rigidity or toward greater flexibility. Greater rigidity would require countries to govern their national economies by the mandates of the balance-of-payments, a manifest impossibility for democratic governments in the near future. Therefore we need greater flexibility—exchange rates that change more frequently, but by smaller amounts than the changes of recent years. It is tempting to think in terms of complete flexibility—freely floating rates—but the exchange rate is too important an economic variable for responsible governments, committed to national objectives of economic stabilization and growth, to adjure intervention in the exchange markets. We either need rules of intervention, to prevent conflicting intervention by different countries in the same currency market, or we need rules for more frequent changes in "fixed" exchange rates, changes small enough to discourage speculation, frequent enough to cope with divergent national trends in prices, productivity, and incomes. Such changes should take place promptly, to prevent the buildup of large imbalances. A number of proposals have been put forward, under such names as "crawling pegs" and "gliding parities."

Last fall the U.S. government advanced a constructive proposal to the Committee of Twenty, now examining monetary reform, that would compare a country's actual reserves to an internationally agreed target level of reserves to determine whether balance-of-payments adjustment is necessary. If a country's reserves exceeded or fell short of its target level of reserves, corrective action would be called for. If a country failed to act, international consultation would take place, and if necessary sanctions would be applied, e.g. in the form of discriminatory import surcharges on the exports of a country in persistent surplus. The system would treat countries in surplus symmetrically with those in deficit.

The U.S. proposal has a number of deficiencies. As formulated, it might invite even more speculation than now exists, for as a country's reserves neared the "action" points speculation would become heavy indeed. Countries should be

put under greater pressure to take early action than is exerted in the fundamentally permissive U.S. plan. Second, given the adjustment lags noted above, keying exchange rate changes—the U.S. plan speaks only of "acceptable adjustment measures," but in the final analysis these must ordinarily mean changes in exchange rates—to discrepancies from target reserves *levels* will lead to very substantial overshooting; at a minimum, heavy weight must also be given to reserve *changes*, i.e. balance-of-payments deficits or surpluses, but other criteria might also be used. Finally, the task of negotiating agreed reserve targets for all countries will be an exceedingly difficult one.

Despite these various technical problems, the U.S. proposal is certainly a step in the right direction. It calls for establishing the right kind of framework for considering balance-of-payments adjustment. No government will tie its hands completely on adjustment, but just as the exchange rate is an important domestic economic variable, it is also an important variable to *other* countries. International coordination is unavoidable. The only question is whether it will be orderly or disorderly. To make it orderly, the process of change must be depoliticized domestically, and placed under more effective international surveillance than the Bretton Woods Agreement has provided in practice.

International coordination must also be provided in another sphere, not covered by the U.S. proposal. Better exchange rate adjustment will discourage large-scale speculative movements of capital, but it will not eliminate large movements of capital altogether. Provision must be made, going well beyond the present swap facilities among central banks, for lending to countries large amounts on short notice to cover large outflows of short-term funds.

The large amount of liquid funds now held in the euro-currency market and elsewhere, readily movable from one currency into another, suggests the need for a remedy to possible disturbance going well beyond the consolidation of official foreign exchange reserves that has been so often suggested. In particular, consolidation of official balances alone would not protect the United States against massive switches out of dollars not directly connected with a United States payments deficit. So long as this possibility exists, the dollar cannot be made convertible, even with an adequate adjustment mechanism; the simple arithmetic prevents it, for switching only a fraction of private foreign dollar balances—probably amounting now to over $70 billion—would quickly exhaust present United States reserves.

The right way to handle this problem is *not* to endow the United States with a huge amount of reserves through a special allocation of SDRs or a huge increase in the official price of gold, or to allow the United States to build up the required reserves through running many years of payments surpluses before restoring convertibility, but to create a new facility in the International Monetary Fund which permits it to be a true lender-of-last-resort at the global level, a central bank for central banks. The new facility would lend SDRs at short-term in any required amount to deal with sudden shifts of private or official balances from one asset into another.

The scheme would work in this way. Suppose, to take the events of early February, there was a sudden switching from dollars to German marks of $6 billion. The German Bundesbank absorbs the dollars in supporting the dollar-mark exchange rate. Under reserve-asset convertibility, the Bundesbank could convert these dollars into reserve assets at the United States Treasury. This would cut present United States reserves nearly in half.

With the new facility, the United States would borrow the equivalent of $6 billion in SDRs from the International Monetary Fund (this transaction would have nothing to do with normal borrowing under the United States quota at the International Monetary Fund, which is totally inadequate to the task), and would use this to buy the $6 billion in dollars from the Bundesbank.

If the switch from dollars to marks proved to be temporary, reversing itself within, say, a year, then the above sequence of transactions would simply be reversed: the Bundesbank would acquire dollars from the United States by selling SDRs, and the United States would repay the International Monetary Fund. The dollars would be sold into the market for marks.

If, on the other hand, the switch or some part of its proved to be lasting, the United States would be left with an obligation to the International Monetary Fund. This obligation would then be converted into long-term interest-bearing debt with a fixed amortization schedule over, say, 40 years. The interest and amortization payments would be normal international payments and, other

things being equal, would trigger the reformed adjustment process to allow the United States to run the required surplus in its other international payments to repay the debt. This is entirely appropriate, for our assumption in this case is that foreign lending to the United States (held in the form of liquid balances, but hitherto long-term in fact if not in form) would have gone down, requiring long-term repayment.

This type of emergency lending would not be in principle be available to finance basic balance-of-payments deficits. But of course at the time of a massive movement of funds it is not possible at once to distinguish one type of funds from another. Therefore the lending should be available to cover any type of massive switch from one currency into another, including a switch made by the residents of the country experiencing the run. If after the large flow it was learned that a portion of it was due to a worsening of the country's basic balance-of-payments position, then the country would be obliged to repay the International Monetary Fund for any "unwarranted" borrowing, if necessary by drawing on the normal lending facilities of the IMF, based on quotas. And normal adjustment measures would, of course, also be taken.

Such a facility would have special relevance to the United States, because of the very large amounts of dollars held abroad in private hands. But Britain and other countries would also benefit. Private sterling balances remain large, and increasing amounts of such other currencies as German marks, Swiss francs, and even Japanese yen are being held by non-residents. So the problem is becoming a more general one, and this new facility would offer a general solution.

Moreover, we should not forget the even larger private *resident* balances in every currency. While movements abroad of resident funds are more readily subject to capital controls than is true for non-resident funds, large movements of resident funds will nonetheless be possible in practice, as both France and Italy have learned in recent years. Unless national reserves are to be large enough to cope with this contingency in the face of growing knowledge by publics everywhere about foreign exchange transactions, the lender-of-last-resort function would also cover such movements, which of course would be largely reversible.

Finally, while there is much to be said for the consolidation of outstanding official foreign exchange holdings, obligatory consolidation is likely to meet stiff resistance on a variety of grounds. If full consolidation does not take place, a potential problem would remain in the possible switches of official dollar holdings into other currencies, or indirectly into primary reserve assets, as a dollar-holding country runs a deficit the counterpart surplus of which is with non-dollar holding countries. Official dollar holdings would thus decline for reasons unrelated to the U.S. payments position, yet would place demands on U.S. reserves under a system of convertibility. The new IMF facility proposed here could quite comfortably cover such cases as well.

These two changes together—a strong presumption in favor of small and more frequent exchange rate changes, and the creation of a lender-of-last-resort facility—would mark a major improvement in the international monetary system, and would recognize management of the system for what it truly is, a collective international responsibility.

Senator PROXMIRE. Thank you, Mr. Cooper.

Mr. Haberler, please proceed.

STATEMENT OF GOTTFRIED HABERLER, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, D.C.

Mr. HABERLER. Senator Proxmire, thank you very much.

I submitted a prepared statement which I shall offer briefly.

Senator PROXMIRE. It is a nice, concise prepared statement, I noticed. Go right ahead.

Mr. HABERLER. If it can be put in the record.

Senator PROXMIRE. If you want it incorporated in the record and summarize it, that is fine, or read the prepared statement itself.

Mr. HABERLER. I have also a background paper which is a little

longer, which has not been published, and if that could be put in the record?

Senator PROXMIRE. We would be delighted to have that for the record, and that will be incorporated in the record at the end of your oral statement.

Mr. HABERLER. I can be brief because Professor Cooper's statement says many of the things I wanted to say.

Let me start by saying we have just gone through the second Smithsonian crisis. This has been brought to an end by decisive American intervention. It was not a pure dollar crisis; it was just as much a mark and yen crisis, because in our present system where the dollar is in the international reserve, official intervention and private transactions currency, which arises anywhere else in the world, easily leads to a so-called dollar crisis.

Suppose two currencies like the mark and yen are overvalue of and are ripe for appreciation. Dollars will flow from all over the world, not only from the United States, to Germany and Japan. This has happened in the last few weeks.

Let me discuss the mark and the yen, part of the recent crisis, then the American side and then wind up by saying a few words about the international monetary system as a whole.

As far as Japan is concerned, the problem, I think, is quite simple. Most economists, including many Japanese, would agree that the yen was overvalued. They had an enormous export surplus, they waste their own resources by overreporting and accumulating dollars. So in their own interests they should have appreciated the yen or let it float up.

The German situation is not really much different. Germany, too, had a very large export surplus last year despite two large upvaluations in 1969 and 1971 and orders from abroad for German goods were rising rapidly and they are very much afraid about inflation; therefore, appreciation or upward float of the mark was strongly indicated.

But both Germany and Japan had categorically refused to appreciate or to float and so it took an American offer to devalue the dollar to dislodge them from their impossible position.

If you think of it, the German performance is really amazing. They first rejected a float or appreciation, then they accepted in the form of the depreciation of the dollar. In the meantime, they swallow $6 billion at the old rate and now when these dollars go back now, as they have started already to do, they get 10 percent less in marks than they paid. So they suffered a loss of something like $600 million.

As somebody said, Mr. Schmidt, the German Minister of Finance, was ready to lose a few billion marks but he was not ready to lose his face. Fortunately, it is not our business; it is Germany's business.

If Germany and Japan had followed the Swiss example and had floated earlier in the game, the whole crisis could have been cut short. The difference would have been that they wouldn't have lost so much, the speculators wouldn't have gained so much; we would be in the same situation as we are, because if the Germans had floated up, other countries, surrounding countries, would have followed. The world would have gotten about the same change in parities as it got through this rather expensive process.

Now, so much about the Japanese and German side of the story. I now come to the American side.

The unsettling development in the United States was, of course, the large unexpected import surplus last year. The deficit in our trade balance, despite the fact that currencies were realined in the Smithsonian agreement, and despite the good inflation record of the United States in the last 2 years, we had less inflation than any other industrial country.

But as Professor Cooper has pointed out, the explanation at least ex post is not very difficult. The United States had a tremendous expansion last year and other countries, Japan and Germany, had a slight recession, what the Japanese call a recession. If their growth rate is less than 6 percent, they call it a recession. This combination of divergent cyclical movements or differential growth performance always is very bad for our balance of payments.

By the same token, we can expect an improvement in our balance when this cyclical pattern changes. When our economy slows down, as it has to when it reaches full employment or gets close to full employment, we can expect some improvement later this year or next year.

But I think most economists would agree that the cyclical improvement alone will not be enough to put our balance in equilibrium. We need the additional realinement of parities which we have got.

Now, let me ask the question what our policies should be in these matters? I think it was absolutely right to devalue the dollar in order to break the impasse caused by the Japanese and the German attitudes, despite the fact that the dollar was not really over-valued with respect to all other currencies, but only with respect to some other currencies.

Given this situation, I think it was a good idea to offer the 10 percent devaluation because many countries went along with the dollar and others depreciated against the dollar, only much less than 10 percent.

So I am not quite so afraid as Professor Cooper is, that the 10 percent might be too much. But I agree with him that we never know what the correct parity change is.

I think it would have been a great mistake to impose an import surcharge. An import surcharge would have been an unnecessarily heavy-handed measure. It would have aroused great hostility and it would have created a bad atmosphere all around.

Equally important, a surcharge operates only on imports and not exports, while a devaluation also stimulates exports. The surcharge does not discriminate between countries which are in equilibrium and those which have undervalued currencies, but the selective parity adjustment which we got through the devaluation discriminates in that respect in the right way.

So I think that to offer a devaluation was the right thing to do, although if the German and Japanese had acted earlier, it would not have been necessary.

But how about the future? I think in the immediate future, say in the next 2 years, we probably can expect an improvement in our balance for a number of reasons:

First, imports had gone up very much partly in expectation of what was coming. So we can expect a reduction in the import surge in the future.

Second, the return of speculative funds, this $6 billion which went to Germany, will improve our capital balance temporarily.

Third, the reversal of the cyclical situation which I mentioned earlier should make itself felt later this year or next.

Fourth, in somewhat longer run the change in parity should have a favorable effect on our balance.

But here, again, I fully agree with Professor Cooper, to predict the balance of payments is a very tricky thing. It depends on not only what happens in our country but also on developments abroad.

Therefore, I am very skeptical about long-run balance-of-payments forecasts. If I say that the balance of payments probably will improve in the next 2 years, I would never be sure about that. We have to expect currency crises in the future and we cannot exclude that the dollar again may get into trouble.

Now, this brings me to the final point I would like to discuss briefly; namely, the future of the international monetary system and the lessons which we can draw from recent and earlier experience with respect to the reform of the international monetary system.

Many people believe that the present system must be reformed.

I forgot one point which I would like to make. Let me go back for a moment to our trade deficit of last year.

One point which was entirely ignored in the discussion was that large trade deficit last year, which alarmed so many people, was from the domestic cyclical point of view an excellent thing because last year the economy was expanding very fast. To my mind it expanded just as fast as we should allow it to go. Any faster expansion would have produced inflationary pressures and an unsustainable boom. The import surplus of over $6 billion last year helped to keep down the speed of the expansion and to prevent it from degenerating into an unsustainable boom.

So it was by no means an unmixed disaster. I think we should keep that in mind.

But now let me go back to the international monetary system. A majority of the economists believes that the system has to be reformed drastically. If it is not reformed then the next time we have a currency crisis it will spell disaster, and disaster means that world trade will decline drastically or something like what happened in the 1930's.

Now, to my mind these worries about the system breaking down, the urgency that it must be reformed drastically are greatly exaggerated. To my mind the system on the whole has worked quite well. The proof of the pudding is in the eating. What is the pudding in that case? The pudding is the growth of world trade and the international flow of capital. An international monetary system is not the end in itself. It is a means to facilitate, stimulate trade and capital movement, and if you look at the facts you will find that world trade has grown by leaps and bounds throughout the whole postwar period. It was not interrupted, it was not even slowed down, by any of the many crises, the last one not excluded.

Also capital movements expanded last and have become sometimes even embarrassingly large. To my mind this happy outcome is not just

the consequence of good luck. The present system which is based on the dollar is a quite stable and sturdy system which can absorb heavy shock, and it has taken a lot of shocks. I think that this will also be so in the future.

Now that does not mean that it cannot be improved, but it means that it is not as bad as the continuous discussions about necessary reforms. When I speak of reform, I think of more modest things than the complete restructuring of the system.

As far as the United States is concerned, the greatest contribution we can make for the future working of international monetary system is further to slow down our inflation.

At the present time our inflation is less than elsewhere in the industrial world, although this perhaps is not quite enough. But I have no illusions if we continue to have a little less inflation than other countries, still there may be troubles.

We can be pretty sure, however, that the dollar will also in the future not be overvalued with respect to most other currencies, but only with respect to a few, and then what should be done is to urge the surplus countries to appreciate.

If there are one or two countries whose currency is out of line with respect to the dollar, obviously, the thing is for those countries to appreciate. If they didn't do it in this particular case, then we had to rescue them from the impossible position in which they were.

But now, as I said, we cannot be sure that our balance of payments will come in equilibrium very soon.

Suppose I make a pessimistic assumption; assume that we continue to have the large deficit and that there are some foreign countries which have correspondingly large surpluses. As I said, they should be urged to appreciate, but I also think that we should be lenient if they take their time. I think one mistake which most of us make is that we get much too much alarmed about dollars accumulating outside the United States.

To my mind, accumulation of dollars by other countries is no danger for us. Under certain circumstances, last year for instance when we had too rapid expansion, it was even a godsend that we had an import surplus and they had export surplus.

Now, the cyclical situation may be different on other occasions, I admit that, but broadly speaking, the fact that dollars accumulate abroad is nothing greatly to worry about.

Other countries have now $70 billion officially held liquid dollar balances; $70 billion. They cannot get rid of these $70 billion without letting their currencies float up and that is just the thing we want them to do and just the thing which they don't like to do.

So I still take the position that we should let them accumulate as many dollars as they want, and should tell them if you don't want them then appreciate or liberalize trade.

It is very often said surplus countries will restrict trade. But that wouldn't make any sense. If the surplus countries restrict trade, it would make the surpluses even larger. I don't know of any surplus country which has acted in such an absurd fashion.

What they are doing is to have restrictions on capital, inflows, they have dirty floating and double exchange rates. These are not nice prac-

tices, but I don't think they are not terribly destructive of world trade.

So I would take a rather relaxed position with respect to surplus countries.

One more point which I think is very important.

Senator PROXMIRE. I wish you would bring your remarks to a conclusion.

Mr. HABERLER. This is the last point.

Many of our policymakers are afraid that the accumulation of dollars abroad means more intense competition in the United States. To some extent this is true.

If the dollar accumulation results from trade deficits of the United States and the corresponding trade surplus of the other countries, then, of course, it means larger imports into the United States or smaller exports; that is correct. But the total accumulation of dollars abroad goes way beyond what can be explained in terms of the trade balance. And as far as the trade balance is concerned, I submit that the effect on the individual American import industry, say the automobile industry or any other industry which suffers from imports, the effect of the accumulation of dollars abroad is a minor one.

Let me explain this by assuming that the Japanese export surplus disappears because they have appreciated, let the yen float up and perhaps liberalize trade and they have internal inflation. Assume that the Japanese export surplus disappears. That will be spread over the whole range of exports and imports. They will import more and export a little less. To the extent that their imports rise their exports are not affected. And equilibrium will come about also through their exports and imports from other countries than the United States.

From that I conclude, and I could develop it at greater length, that the fear that individual American industries may suffer very severely from imports as a consequence of the accumulation of dollars abroad is greatly exaggerated.

Thank you.

Senator PROXMIRE. Thank you very much. We may bring those out in the question period.

[The prepared statement and background paper entitled "The Future of the International Monetary System and the Convertibility of the Dollar" of Mr. Haberler follow:]

PREPARED STATEMENT OF GOTTFRIED HABERLER

THE SECOND POST-SMITHSONIAN CURRENCY CRISIS

INTRODUCTION

The second Post-Smithsonian currency crisis has been brought to an end by a decisive American intervention. It was not purely a dollar crisis, but just as much a German mark and yen crisis. In our present system with the dollar the foremost international reserve, official intervention and private transactions currency, if any one or two important currencies, such as the mrak and the yen are ripe for appreciation, dollars from all over the world, not only from the U.S., will converge on the countries concerned. Even if the U.S. balance of payments were in approximate equilibrium, the situation will take on the appearance of a dollar crisis. In the present case the U.S. balance was not in equilibrium. Therefore we can also speak of a dollar crisis.

I shall first discuss the mark and yen part of the story, then the American side and finally make some observation on the system as a whole.

THE MARK AND THE YEN

Most economists, including many Japanese, agree that Japan should have let the yen float up or at least appreciate sharply, *in Japan's own interest.* Japan is wasting its resources by piling up export surplusses and accumulating dollars. It steps on everybody's toes and stimulates protectionist sentiments abroad, in Europe and the U.S.

The German case is not much different. Despite two substantial upvaluations in 1969 and 1971 the German export surplus reached a record level of DM 20.3 bill. in 1972. The surplus on current account was much smaller (DM 1.7 bill), but the basic balance showed a surplus of DM 14.3 bill. Since the export surplus was growing, and orders from abroad jumped in 1972 and are rising fast, and since inflation was rampant the case for letting the mark float up was very strong indeed.

Both Germany and Japan categorically refused to appreciate or to float. It took the American offer to devalue the dollar to dislodge them from their impossible position.

The German performance was amazing. Mr. Helmut Schmidt the German minister of finance rejected any float or appreciation partly because the French objected, but also because of the unfavorable effect on the export industries. Then he accepted an appreciation not only vis-à-vis the dollar, but also vis-à-vis sterling, the lira and scores of other currencies in the form of a devaluation of a the dollar. In the meantime Germany swallowed some $6 bill at the old rates. When these dollars leave the country the Bundesbank will receive some DM 1½ to 2 bill less than it paid for these dollars. Thus Mr. Schmidt did not mind loosing billions of marks in order not to loose his face.

But this is Germany's business and not ours.

If the German and Japanese had followed the Swiss example at an early stage and had let their currencies float up the crisis would have abated earlier, the speculators would have gained less and the losses of the Bundesbank would have been smaller. The float could have been a managed one and the outcome with respect to parity changes would have been about the same as it actually was following the devaluation of the dollar. For Germany's neighbors—the Dutch, Swiss, Belgians and Austrians—have learned that they court inflation, if they don't go along with a German upvaluation. France probably would have gone along for the same reason. An important difference would have been that Russia and South Africa and gold speculators would not have received a bonus and gold speculation would not have been encouraged.

THE AMERICAN SIDE OF THE STORY

The unsettling development was the unexpected record trade deficit in 1972. In hindsight it is not difficult to explain why our trade balance deteriorated in 1972 despite the Smithsonian realinement and despite the good American inflation performance compared with that of other industrial countries. The reason is that the year 1972 was a period of very rapid economic expansion in the U.S. combined with slow growth in Japan and Europe. This combination—differential growth performance—always is a drag on our exports and a stimulus for imports. By the same token we can expect an improvement later this year or next year when the U.S. expansion slows down (as it eventually must as we approach full employment) and foreign economies, especially the Japanese, get out of the doldrums of recession.

An important aspect of this situation, which has been completely ignored in the current discussion, is that our large import surplus in 1972 was ideally timed from the cyclical standpoint: It has helped to hold prices down and to prevent the economic expansion from going too fast. I take it that the expansion proceeded just about as fast as it prudently should be allowed to go. A faster expansion would degenerate into an unhealthy and unsustainable boom.[1]

I conclude that the large trade deficit in 1972/73 is by no means an unmixed disaster and that we can expect an improvement when the cyclical pattern

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[1] In passing I should mention that we had in 1972 an example of the situation, that advocates of fixed exchange rates like to mention (e.g. E. Bernstein and A. Laffer), where fixed rates with ample reserves work well for some or all concerned: Countries in deficit, the U.S., are in the expansion phase of the cycle and get the dampening effect they need: countries in surplus (Japan) are in recession (which for Japan means a growth rate of less than, say, 6%) get the stimulus they need. I am not an ardent advocate of the system of fixed exchanges, but I would not spurn the advantages that it affords on some occasions.

changes. But the cyclical change alone, without the aid of parity changes of the large surplus countries, would surely not be enough to restore equilibrium in our overall balance. Thanks to the devaluation of the dollar a substantial realignment of parities has been achieved. Thus there is a good chance, although no certainty that after some delay an improvement in our trade and overall balance will materialize.

What should our policy be? It surely was right to offer a devaluation of the dollar to break the impasse caused by German and Japanese attitudes, although the dollar was not overvalued *vis-à-vis* the majority of countries but only *vis-à-vis* a small number. It would have been a great mistake to impose a surcharge on imports instead of offering a devaluation of the dollar to induce others to change their parities. A surcharge would have been unnecessarily heavy-handed; it would have aroused great hostility and created a bad atmosphere all around. Equally important, a surcharge operates only on imports; it does nothing to stimulate exports. Hence a 10% surcharge is much less effective than a 10% devaluation. Moreover a surcharge hits imports from countries whose currencies are not undervalued vis-à-vis the dollar as much as imports from surplus countries The quick realignment of parities achieved by the dollar devaluation was therefore greatly superior to the surcharge method.

How about the future? As far as the immediate future is concerned, we can hope for a sizable improvement of the external balance from several factors: Expectations of coming troubles, including exchange rate changes has surely induced anticipatory imports. So we can expect a moderation in the import surge. The reflow of speculative funds will temporarily help to improve the capital balance. The reversal of the cyclical pattern mentioned earlier should make itself felt later in the year. And in the longer run, over the next two or three years, the realignment in parities will have its effect.

There can be no assurance, however, that the improvement will be sufficient. Balances of payments are notoriously difficult to predict, much more so than GNP or price levels, because they depend on developments at home as well as in foreign countries. It would be mere chance if the current pattern of exchange rates proved broadly right although the fact that several important currencies are now floating, however dirtily, provides a little more flexibility than there was before the crisis struck. A pattern of rates appropriate today, may be out of date tomorrow.

We should therefore be prepared for new crises in the future, although probably not this year. What can we do to prevent future crises or at least to bring them to an end more quickly and smoothly? This brings me to the last subject of my paper.

THE FUTURE OF INTERNATIONAL MONETARY SYSTEM

It is a widely held belief that unless the monetary system is drastically reformed the next crisis will spell disaster. There exist many proposals for more or less radical reform. I shall not offer a plan of my own and there is no time to discuss those which have been proposed by others. I am frankly skeptical that international agreement can be reached for radical reform. But I am not alarmed because I do not believe that great changes are necessary.

The monetary system is not an end in itself but a means to promote trade and capital flows. The fact that world trade has grown by leaps and bounds throughout the post-war period and that this growth was not interrupted or even visibly slowed down by any of the many currency crises in recent years including the last ones suggest that the system is not as bad as the continuous debates about complete reform suggest. The present system, based on the dollar, is really quite sturdy and can absorb strong shocks. It would require incredible mismanagement to cause its collapse.

The greatest contribution the U.S. could make for the future functioning of the system is further to reduce our rate of inflation. If nevertheless the deficit does not disappear we can be sure that, as in the past, the dollar will not be overvalued vis-à-vis most other currencies but only vis-à-vis a few. Then we should insist that these few be upvalued. But we should not get too much upset if the surplus countries are slow in reacting. We should realize that the accumulation of dollars abroad is no danger for us.

The surplus countries cannot get rid of their dollars without letting their currencies appreciate and that is just what we want and they are reluctant to accept.

If surplus countries use controls to stop the inflow of speculative dollars, it is capital import controls, not trade controls they would apply. Trade controls on their part would be counterproductive i.e., would increase their surpluses. No sur-

plus country has acted in such an irrational manner. Capital controls are not an ideal method of dealing with a surplus; but are not as destructive of world trade as import restrictions on the part of deficit countries.

If other countries accumulate dollars from a trade surplus with the U.S. this reflects of course, larger U.S. imports and/or smaller exports. It is this trade aspect of the accumulation of dollars of which American policy makers are afraid. While there is a small element of truth in this argument, it can be shown that this effect is very tiny indeed. Let me demonstrate this proposition by assuming that, the Japanese get rid of their trade surplus by upvaluation plus inflation plus trade liberalization. The effect will be spread over the whole range of Japanese exports *and* imports with the U.S. and with the rest of the world. To the extent that their imports go up, their exports need not decline and American industries will not feel any reduction of the competitive pressure from imports. Nobody can say before hand exactly how the adjustment will affect particular American industries which suffer now from Japanese imports. But the overall effect on the U.S. economy cannot be large because imports are only a small fraction of GNP and only a fraction of imports are due to the accumulation of dollars abroad.

We should, of course, continue to urge others, especially the surplus countries, to liberalize trade. But we should realize that the trade effect of the payments deficit is a negligible item in the U.S. economy.

THE FUTURE OF THE INTERNATIONAL MONETARY SYSTEM AND THE CONVERTIBILITY OF THE DOLLAR*

(By Gottfried Haberler)

I. WORLD TRADE AND THE INTERNATIONAL MONETARY SYSTEM

The international monetary system is not an end itself but a means to promote and facilitate international trade and capital movements. The fact that world trade has grown by leaps and bounds without interruptions throughout the postwar period suggests that the present international monetary system is not as bad as the continuous debates about necessary reforms seem to indicate. True, the system has been racked by numerous crises involving all major currencies—crises which in the last five years have followed each other at short intervals and have tended to become more spectacular. It is a remarkable fact that these crises have not interrupted or visibly slowed down the growth of world trade, contrary to repeated predictions by experts on the right and left. The monetary system based on the dollar carries the seeds of its own destruction, they will be the same as in the 1930's when the gold standard collapsed—world-wide deflation, depression and sharp contraction of world trade.

The dollar had its most severe crisis yet in 1971, but contrary to the diagnosis of many instant historians the dollar standard has not broken down; and world trade has continued to grow as if nothing had happened.

I believe that the happy outcome is not just due to good luck, but that the system is really quite sturdy and can absorb fairly strong shocks. It would require incredible mismanagement to cause its collapse. If there was a sharp turn towards inflation or protectionism in the U.S. there would be trouble. But even in that case which I hope and trust will not arise, there need and probably will not, be a collapse, but a more rapid reorganization.

Saying that broadly speaking the systems works is not meant to deny that it can be improved. In fact there is widespread agreement that it must be changed and elaborate official machinery has been set up to make proposals for reform. What will be the result? Will "the lab'ring mountain scarce bring forth a mouse?" Probably, but I by no means wish to belittle the work of the committee of the 20s. On the contrary their labor will be extremely arduous. Since the system is not all that bad, no more than a mouse of a reform is really needed. But we can be sure that, however tiny, the mouse will be presented as an elephant.

To illustrate how in the supposedly hard-boiled world of international finance small changes and gestures can make a deep impression, let me recall a recent episode. Last July when the Federal Reserve intervened in the exchange market by selling a few million D-mark and Belgian francs, their action was hailed by bankers and journalists as an event of major importance, an historic turning point in U.S. policy.

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*Paper read at Universite du Quebec at Montreal, Jan. 6, 1973. Revised Feb. 26, 1973.

The world of international finance was galvanized by official American pronouncements. Last May in Montreal Arthur Burns issued his Ten Commandments for international monetary reform and in September at the IMF meeting came Secretary Shultz's more detailed proposals which were later further elucidated in important speeches by Paul Volcker and Marina v.N. Whitman.

These pronouncements and proposals were extremely well received. What pleased European officials and bankers most in the American statements was that they held out the hope that the dollar may again be made convertible. Burns' Ninth Commandment speaks cautiously of "re-establishment of some form of dollar convertibility in the future" and Secretary Shultz stated "* * * that after [a] transitional period the U.S. would be prepared to undertake an obligation to convert official foreign dollar holdings into other reserve assets." He made it clear, however, and Mr. Volcker later emphasized that convertibility could come only after the international monetary system has been extensively reformed and the U.S. reserve and balance of payments position has sufficiently improved.

II. ASSET AND MARKET CONVERTIBILITY OF THE DOLLAR

Many regard convertibility of the dollar as the central objective or the capstone of the monetary reform and it will probably occupy a crucial and perhaps controversial position in the negotiations, despite the fact that only a few European countries have a strong ideological attachment to dollar convertibility. Japan does not give the impression that it cares very much about convertibility of the dollar into some ultimate reserve asset and most less developed countries seem to be quite happy with their dollars. At an international conference, a Hungarian banker-economist expressed a sentiment which is widely held also in the West, when he remarked after listening to European bankers bewailing their large dollar holdings: "These worries I would like to have myself!" [1] This attitude would, of course, change if the inflation in the U.S. accelerated again.

Convertibility of the dollar is closely linked with many problems of monetary reform. For example, the proper distribution of responsibility for exchange rate changes between surplus and deficit countries, the question of objective criteria for exchange rate adjustment and the desirable rate of SDR creation—all these and other problems look very different and take on additional importance and complexity if convertibility of the dollar is postulated. But before going into some of these problems a very important distinction must be made, namely between two entirely different meanings of the word: Convertibility of the dollar into some "ultimate" or "primary" reserve asset (Gold, SRD)—*asset convertibility*—on the one hand, and convertibility into other currencies in the market for foreign exchange—*market convertibility*—on the other hand.

In the current discussion on monetary reform convertibility is used in the asset sense. On August 15, 1971, the dollar was formally declared inconvertible (in the asset sense), but *de facto* it had been inconcertible for a long time at least for sizable drawings.

In the market sense however, the dollar has always been and still is fully convertible. That is to say foreigners, and with some restrictions Americans too, can use their dollars as they please to buy and invest in the U.S., they can invest, take their dollars out of the country and buy other currencies in the exchange market. Few other currencies enjoy the same complete market convertibility as the dollar. It should be observed that floating is fully compatible with market convertibility. Thus, the floating Canadian dollar is fully convertible in the market.

What is of primary importance for world trade is market convertibility. For trade, travel and capital flows it is essential that currencies can be exchanged freely in the market at fixed or fluctuating rates. (The question whether floating or fixed rates are more conducive for the growth of trade we may leave open in this paper.) Asset convertibility as such is important for trade only to the extent that it is needed to maintain market convertibility. Concretely, so long as other countries than the U.S. operate on the basis of fixed rates (apart from the permissible margin or band) and so long as the dollar remains the intervention currency they must be ready to intervene in the exchange market by buying and selling dollars for their currencies. In other words they must make their currencies convertible into reserve assets—dollars along with gold and SDRs constitute their reserve assets. In that sense asset convertibility is the means to pre-

[1] Janos Fekete in *Floating, Realignment, Integration* 9th Colloquium of the List society. Proceedings and Papers. Basel-Tuebingen 1972, p. 139.

serve market convertibility. This does not, however, apply to the U.S. So long as the dollar is the foremost reserve and official intervention currency there exists an unavoidable asymmetry between the dollar and other currencies. To this subject we shall return presently.

Here I note two things. *First* the fact that the dollar, the foremost private transaction currency, has remained fully convertible in the market is undoubtedly one of the most important factors responsible for the uninterrupted growth of world trade despite numerous currency crises. *Second* it is practically certain that it will take a long time to replace the dollar by SDRs or by something else or make it more equal, or in some respects (such as an intervention and reserve currency) fully equal, to other currencies. But world trade must go on and should go on growing—*pace* Club of Rome. It is therefore essential that the market convertibility of the dollar be preserved while the negotiations about the reforms, possibly including asset convertibility of the dollar, go on.

So much about market convertibility. From now on when speaking about dollar convertibility we shall mean asset convertibility.

Restoration of asset convertibility of the dollar faces formidable obstacles. There is the huge overhang of over $60 billion liquid or near-liquid liabilities to official institutions abroad plus many billion private liquid liabilities. There is the closely related fact that the size of the U.S. international reserve is much smaller than that of most other developed countries, not only with respect to the level of liquid liabilities but also to the volume of imports.

I shall not discuss in this paper radical solutions such as Rueff's proposal for doubling the price of gold and consolidating a large part of outstanding dollar liabilities through long-term loans to the U.S. ("reverse Marshall plan") or Bernstein's ingenious plan for consolidation of the reserves of all countries—gold, dollars, SRDs—in the IMF in exchange for "composite reserve units"—CRUs—which then would become the exclusive medium used in international settlements. I shall rather concern myself with some of the more modest reforms listed by Messrs. Shultz and Volcker as preconditions for eventual dollar convertibility.

III. REMOVING THE ASYMMETRIES

The dollar standard with the inconvertible dollar confers upon the U.S. the privilege—an "exorbitant privilege" in the words of General de Gaulle—of not having to worry about the balance of payments. But as Professor Fellner has pointed out,[2] other countries enjoy the "exorbitant privilege" of being able unilaterally to determine their exchange rate and thereby also that of the dollar. One country's privilege is another country's handicap. In my opinion neither privilege nor handicap are exorbitant and at any rate they cancel each other out pretty much. But be that as it may, let us use a less emotive language. How can the inequality or asymmetry between the dollar and other currenies be removed?

One asymmetry mentioned by Mr. Shultz is that under the present system with the dollar being generally used as intervention currency, the exchange rate between any two other currencies can under certain circumstances change by a percentage twice the width of the permissible band. Concretely with the present band of 4½ percent it is possible that, say the Italian lira, may depreciate by as much as 9 percent *vis-a-vis* the German mark, while the maximum depreciation—or appreciation—of the dollar *vis-a-vis* any other currency is only 4½ percent.

This is a well-known feature of the present dollar-based system. Much time could be spent on explaining it in greater detail and on the complicated procedures—multi-currency intervention—which have been proposed to eliminate this asymmetry. But I confine myself to saying that this asymmetry is no handicap for an inconvertible dollar and would not be much of a handicap for a convertible dollar for the reason that the countries that count the most in this matter, the members of the enlarged European Common Market, have for their own reasons greatly narrowed the band of permissible variation between their currencies which in practice also reduces the variability of their currencies *vis-a-vis* the dollar.

A more important asymmetry is that between surplus and deficit countries. Although general in nature, it has special relevance for the dollar, for reasons which will become clear presently. Ever since Keynes' proposals for reform, it has been a frequent criticism of the present system that it puts a disproportionate

[2] "The Dollar's Place in the International System," *Journal of Economic Literature*, Vol. X, Sept. 1972. Appeared also as an *American Enterprise Institute* Reprint No. 8.

share of the burden of adjustment on deficit countries. Keynes was thinking primarily of adjustment by means of internal monetary and fiscal policies, concretely of deflation and unemployment forced on deficit countries. This is not however, a live problem anymore for the simple reason that no country, certainly not the U.S., is willing to undergo real deflation to correct an external deficit. The methods used nowadays are currency depreciation or controls. The "burdens of adjustment" are thus those of changing exchange rates and of imposing controls. One would think that changing an exchange rate is an economically costless operation, apart from national prestige and other political and psychological considerations. But it is a fact that even economists speak of the economic burden of initiating a change in exchange rates. For example, John Williamson complains in highly emotional language that "it is not clear on what grounds of equity" the U.S. should "claim the privilege" of shifting the burden of adjustment on others by asking them to appreciate their currencies instead of depreciating the dollar.[3] It is odd that soon after Williamson wrote "Secretary Connally had to conduct a Dutch auction (starting at $40 per ounce of gold) before he found a devaluation that the French and the British would promise not to emulate",[4] in other words that he had to fight for the privilege to devalue the dollar sufficiently. Messrs. Shultz and Volcker surely are right that, *if the dollar is to be made convertible*, the rules of the game would have to be changed in such a way that pressure be brought on both surplus and deficit countries to change their parities. It will be very difficult to reach agreement on how to formulate the new rules and if and when a compromise is reached only experience over a considerable period will tell how viable the new system really is.

Before taking up some details let me point out how much simpler this whole tangle of problems is when the dollar is inconvertible—easier, I hasten to add, not only for the U.S., but also for the rest of the world.

If surplus countries instead of inflating or appreciating their currencies continue to accumulate dollars, the U.S. has no reason to worry except on largely fallacious mercantilistic grounds. The danger of deflationary pressure, of which Keynes was so afraid, does not exist under an inconvertible dollar. There are two main reasons why many American policy-makers take a different view. First they believe that dollar accumulation abroad may hurt particular American industries and so play into the hands of American protectionists and secondly they are afraid that unless the U.S. shows concern about its deficit and does something about it, the surplus countries will impose some sort of controls.

There is a tiny element of truth in the first argument. Elsewhere it was shown at greater length why this element of truth is very small indeed.[5] Briefly, since imports are a small fraction of GNP and only a small fraction of imports can be attributed to dollar accumulation—only that part of the latter which is due to a deficit in the *current* balance counts—not more than a minute fraction of import competition can be traced to surpluses of foreign countries.

The fear that surplus countries might impose controls, too, lacks foundation. Controls in the ordinary sense of import restrictions would be devoid of any sense because they would make the surpluses even larger. I do not know of any case where a surplus country has acted in such an irrational manner. The controls they have imposed are *capital import* restrictions. For example, France and Belgium have split the exchange market in two, a pegged one for current transactions and a free one for capital transaction. This is disguised appreciation or what is called "dirty floating".[6] It is objectionable on general grounds, but there are no special American interests involved and American policy was well advised to pay no attention.

I conclude that with an inconvertible dollar the U.S. need not worry about other countries running surpluses. But how about the rest of the world? The

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[3] John Williamson, *The Choice of a Pivot for Parities*, Princeton Essay in International Finance, November 1971, pp. 13–14.

[4] See Michael V. Posner, *The World Monetary System: A Minimal Reform Program*. Princeton Essay in International Finance, October 1972, p. 18.

[5] See G. Haberler and T. Willett, *A Strategy for U.S. Balance of Payments Policy*, American Enterprise Institute, Washington, D.C.: 1971, and G. Haberler, "U.S. Balance of Payments Policy and the International Monetary System". *Convertibility, Multilateralism and Freedom*, Essays in honor of R. Kamitz ed. by Wolfgang Schmitz, Vienna and New York, 1972. Available also as American Enterprise Institute Reprint No. 9.

[6] "Dirty floating" should be distinguished from "managed flexibility". The latter does not necessarily imply the former. If the management is confined to buying and selling in the exchange market at a uniform although not necessarily constant rate for the purpose smoothing out short run fluctuations or even to influence the trend, there is nothing "dirty" about it. Canada at present has managed flexibility, probably more so than in the fifties. But it is not a case of "dirty floating". Whether it is advisable to go beyond smoothing is another question which is not discussed here.

answer is the same. For the problem is largely an American one because surpluses are overwhelmingly accumulated in dollars. No other currency qualifies on a comparable scale for the role of reserve currency. True, there may have been some modest accumulations of German marks. To the extent that this happens the problem for Germany is different from that for the U.S. inasmuch as the mark, unlike the dollar, is convertible into reserve assets, that is into dollars, gold or SDRs. But the switch of official reserves into German marks has been on a small scale and Germany has a much larger reserve than the U.S., in absolute terms (about $24 against $13 bill) and even larger relatively to the level of imports and liquid liabilities. Therefore it need not worry so long as it keeps a proper proportion between quick assets and liabilities. If foreign countries accumulate German marks from their export surpluses, Germany should regard it as a contribution to its fight against inflation, although some special interests may get hurt.

I return to the case of the convertible dollar. Under that assumption the U.S. would have to adopt a tougher stance and insist on prompter adjustment. Since internal deflation is out of the question and controls are undesirable and in the longer run ineffective, the adjustment has to take the form of frequent parity changes which surely should include a greater number of appreciations by surplus countries than in the past.

The American proposal is that there should be internationally agreed rules defining the circumstances under which parity changes are to be made.[7] The proposed criterion is changes in a country's international reserve. If a country experiences "disproportionate gains in reserves" it should appreciate, if it has "disproportionate losses" it should devalue its currency. On the whole this seems to me a reasonable rule. The proposal was made in a conciliatory spirit, not as a take-it-or-leave-it proposition. The use of supplementary criteria is not excluded, nor are measures other than parity changes ruled out, such as expansionary internal policies in surplus countries or anti-inflationary measures in deficit countries.

But let us focus on the basic rule concerning parity change. Although reasonable, its application presents certain difficulties. To begin with the word "reserves" would have to be carefully defined. For example what American statistics (see *Economic Indicators*) call "U.S. official reserve assets, net", have not changed very much in recent years despite huge deficits. Obviously liabilities to foreign official agencies have to be included. In other words what counts is not *gross* reserves but *net* reserves in some sense of this ambiguous term. How about *private* liquid liabilities? To illustrate this point I mention that German experts have objected that under the proposed rule Germany would have been compelled to appreciate in 1972 because its reserves as conventionally defined rose sharply although their current balance was not in large surplus. Evidently increases in official dollar balances were to a large extent offset by what they regard as liquid or unstable private capital. The question arises whether it might be better to take the basic or liquidity balance as a criterion, rather than the official settlement balance as the American proposals do. Obviously the trade or current balance alone cannot be decisive.

On reflection the problem is one that has confronted and baffled the IMF for a long time—how to define and measure "fundamental disequilibrium". The Fund never succeeded in formulating an official definition, nor does any of the lengthy IMF documents of recent years dealing with exchange rate problems.[8] It will probably not be easy to reach an agreement now.

If a simple formula is wanted, changes in reserves is probably the best, provided certain short term private capital movements (liabilities and assets) are included. But when it comes to decide which of the many types of private short term capital flows to put below the line, an element of judgment inevitably must enter. The same is true with respect to the question what constitutes a "disproportionate" or "persistent" gains or losses of reserves as against cyclical transistory or *fortuitous* ones.

Before definite rules with precise definitions for parity changes are laid down, some thought should be given to the following possible consequences: The agreed signals will be read not only by the monetary officials but also by exporters, im-

[7] The American proposals were spelled out in greater detail in a memorandum to the Committee of 20s which was later published in the Annual Report of the Council of Economic Advisors for 1972, pp. 160–174.

[8] *The Role of Exchange Rates in the Adjustment of International Payments.* A report by the Executive Directors (IMF, 1970) comes nearest to giving a definition, pp. 47–51.

porters, corporate treasurers and speculators. Is it not very likely that whenever a country experiences substantial losses or gains of reserves the hands of the authorities will be forced by massive flows of funds? Is it not possible that under such a system we would get more instability than now? It could perhaps be argued that speculation would help to bring about the necessary parity changes. The "gnomes of Zurich" as helpers and allies rather than antagonists and scapegoats of the monetary authorities—what a change that would be!

The advocates of flexibility will say that floating is the answer. Whenever a currency is under strong attack by speculation—using the word in the broadest sense without any derogatory intention—let it float. With objective official rules guiding international investors and speculators, speculation and anticipatory capital flows may indeed become so strong that floating is the only way out, short of truly draconian controls. It should be noted that the American proposals do not rule out temporary floating. The use of definite objective rules for parity changes would greatly strengthen the case for flexibility. Let us also keep in mind that such rules become necessary only if dollar convertibility is to be restored.

Internationally agreed rules for parity changes, although necessary, are not a sufficient condition to assure eventual restoration of credible dollar convertibility. Time does not permit more than brief mention of some other conditions. There must be machinery to make sure that the rules are obeyed because with a convertible dollar countries will have less inducement to adjust than when they pile up inconvertible dollars. The American proposals face this problem squarely by suggesting pressures and sanctions on surplus and deficit countries alike to abide by the rules. Something would have to be done about the dollar overhang and the insufficiency of the U.S. reserve position. This implies that the problem of SDR creation on a massive scale would have to be tackled in earnest, which surely would raise the thorny and explosive problem of the Link. The Committee of 20 has its work cut out for it.[9]

IV. WHY CONVERTIBILITY

Life would be much easier, if the dollar remained inconvertible. Since it is so hard to restore convertibility and since in all probability the dollar will in fact remain inconvertible for quite some time, let us have a look at the disadvantages of the inconvertible dollar which convertibility is supposed to eliminate.

To begin with, recall that inconvertibility of the dollar into some ultimate reserve asset does not preclude convertibility into other currencies in the market. Market convertibility is of utmost importance for world trade and has been fully preserved all along.

The illusion seems to be still lingering in some quarters that (asset) convertibility of the dollar would put the U.S. under balance of payments discipline with respect to internal monetary and fiscal policies which is lacking under an inconvertible system. This is unrealistic. Internal policies are determined by internal objectives—employment, growth, price stability in some combination. In the words of Arthur Burns' Third Commandment "the international monetary system will have to respect the need for substantial autonomy of domestic economic policies . . . No country . . . should have to accept sizable increases in unemployment in order to reduce its deficits. Nor should a surplus country have . . . [to accept] high rates of inflation.

Inconvertibility does not prevent the Fed from intervening in the exchange market, if that makes some people happier. It makes no difference whether the Bundesbank buys dollars to prevent the mark from going through the ceiling of the band or the Fed sells marks to prevent the dollar from falling below the floor—except that the Fed's supply of marks is limited while for the Bundesbank the sky is the limit, because it prints the mark as President Klasen once put it.[10]

The basic trouble with the inconvertible dollar, as the advocates of convertibility see it, is this: It enables the U.S. to flood other countries with unwanted dollars, to export inflation, and to finance foreign investments and the take-over of foreign companies at the expense of foreign countries. Others speak of "real

[9] The complexity of the problem of making the dollar convertible is fully conveyed in Alexandre Kafka's subtle analysis *The IMF: The Second Coming?* Princeton Essays in International Finances No. 94 July 1972.

[10] Those who urge the U.S. to intervene systematically in the market to support the dollar probably have something much more ambitious in mind: They may wish to induce or force deficit countries to curb inflation or adjust parities. This raises all the major problems discussed in the text.

resources" or "unrequited exports" extracted from foreign countries. The magnitude of this problem can be easily exaggerated. Actually, there are not many countries that had to take many more dollars than they wanted and most of the time the great majority of foreign countries generate spontaneously more inflation than the U.S. does. But there is obviously is an element of truth in the complaint. Thus the U.S. exported inflation, as Harry Johnson pointed out, when it insisted for years on financing the war in Vietnam and "great society" expenditures by credit expansions without raising taxes. Moreover under certain circumstances and within limits the U.S., even if it has no inflation itself or less inflation than others, can put other countries under inflationary pressure by running a deficit.

To the extent that this happens others certainly have a right to feel aggrieved. The question is how can convertibility prevent this from happening? Since internal macro-economic policies are almost entirely independent of the state of the balance of payments and controls are undesirable and ineffective there remains only devaluation of the dollar. But the Smithsonian agreement has shown that an inconvertible dollar, too, can be devalued, although with difficulties. Convertible or not, it will always be a major operation to devalue the world's most important currency.

Whether a devaluation should take the form of an appreciation of other currencies or a depreciation of the dollar, in terms of SDRs or gold, should depend primarily on how many currencies are undervalued *vis-à-vis* the dollar. The chances are that it will be only a few. Then appreciation of these few will be less disturbing than depreciation of the dollar and of all other currencies which are pegged to the dollar. If the dollar were overvalued *vis-à-vis* the great majority of currencies depreciation of the dollar is indicated. But even in that case there will have to be many other parity changes because it is most unlikely that many other currencies will be undervalued by the same percentage.

That the dollar was devalued in the Smithsonian realignment was more a political decision to appease some European countries than a well considered economic choice. Great Britain probably was not happy at the time that it had to accept a depreciation of the dollar *vis-à-vis* the pound and must have regretted soon that it went along. The same is probably true of Italy and many other countries simply followed Sterling. So it was in reality not at all a clear case of the dollar being overvalued *vis-à-vis* the majority or even *vis-à-vis* a great number of other countries.

There is another consideration which in the opinion of some experts speaks in favor of depreciating the dollar rather than appreciating other currencies. If the appreciation method is chosen the domestic currency value of the SDR and gold portion of the reserves of the appreciating countries goes down while under the depreciation method it remains the same. This is played up by some experts as an undesirable or even dangerous loss of international liquidity.[11]

I cannot attribute much weight to this argument for the reason that under realistic assumptions the two methods are not very different in their effect on international liquidity. Thus E. M. Bernstein calculated before the Smithsonian agreement that the dollar value of aggregate international reserves would be $105.6 billion with the dollar parity unchanged as against $108.5 billion with a dollar depreciation of 7.6 percent (8 percent rise in gold price).[12]

Summarizing the results up to now, we have not discovered any economic disadvantages of the inconvertible dollar system that can be eliminated only by making the dollar convertible. The problem of international liquidity and the erosion of international reserves through inflation is raised in the next section of my paper.

V. U.S. INFLATION AND THE INTERNATIONAL MONETARY SYSTEM

At the present time the U.S. has the lowest rate of inflation of all industrial countries and lower than in most others. Furthermore over longer periods the U.S. dollar has lost less in real purchasing power than other currencies with only few exceptions. Despite these facts a good case can be made for the proposition that in a world of fixed exchange rates the U.S. sets the pace of world inflation. In other words, countries that peg their currencies on the dollar and keep them convertible in the market, are forced to follow approximately the

[11] It should not be overlooked, however, that if the dollar is depreciated the gold value of the dollar portion of reserves declines which some countries may dislike.

[12] E. M. Bernstein, statement submitted to the Joint Economic Committee, U.S. Congress, Sept. 1, 1971.

American rate of inflation. The reason is that internal U.S. macro-policies are independent of the balance of payment and the feedback from a deficit or surplus on the U.S. price level is quite small because of the small proportion of trade in U.S. GNP.

But I do not intend to enlarge on these propositions. Instead, I like to reiterate a proposal, earlier made by others and by myself, which would make the inconvertible dollar more acceptable and so save a lot of trouble especially in case of continued American inflation.

If the American inflation should accelerate again in the future there would be a lot of trouble. Dollar balances would pile up and their holders would understandably become restive. But even under such a pessismistic and, let us hope, unrealistic assumption the present system in which the inconvertible dollar plays such a large role, the dollar standard for short, would not collapse. Monetary authorities around the world hold some sixty billion dollars as reserves. They cannot get rid of these dollars without letting their currencies appreciate sharply; this they will not accept. But of complaints recriminations, speculation and ill-considered measures to prevent speculation there would be plenty and the dollar would probably be devalued in the end in a more or less disorderly fashion. These troubles, and lesser ones if dollar balances went on accumulating slowly, as may happen even without excessive American inflation, could be avoided or at least greatly alleviated, if the U.S. could bring itself to offer a purchasing power guarantee for foreign official dollar holdings. There is a precedence for that in the exchange guarantee of Roosa bonds and Swap agreements. This latter kind of guarantee, too, might be considered, but a purchasing power guarantee in terms of an appropriately constructed index of dollar prices of internationally trade commodities would be economically more meaningfol.[13]

Under this plan foreign official dollar holders would have an option to hold, either as at present dollars which they can invest in the U.S. at the ruling interest rates, or special U.S. government bonds with a purchasing power guarantee. The guaranteed bonds would yield a lower interest, say 2½ or 3 percent, because the current high market rates contain an inflation-risk premium. The opportunity cost to the U.S. treasury of such a scheme would be small or possibly nil. For if inflation continues or accelerates and the guarantee becomes operative, interest rates in the market would rise which would raise the cost of the usual method of financing.

Such a scheme need not hold up negotiations for reform. But by making the present system more equitable and acceptable it would provide more time for working out a major reform.

VI. CONCLUDING REMARKS

Let me return to the point from which I started. The present international monetary system has served the world well, much better at least than the perennial criticism and calls for reform suggest. The proof is the uninterrupted growth of world trade despite an unending series of currency crises. There are several reasons for that. I mentioned one, the maintenance of full market convertibility of the dollar and other major currencies. The most important factor, however, is undoubtedly that all Western countries have maintained high levels of employment and growth. So long as the major countries avoid serious depressions, a contraction of world trade as in the 1930s canot happen unless there occurred a veritable explosion of trade and payments restrictions. This has not happened and although protectionism is still strong and growing, it is unlikely to happen on a large scale for two reasons. First, if countries avoid severe unemployment, pressure for import restrictions remains comparatively weak; it would become irresistible in case of a serious depression: Second exchange rates are no longer so rigid as in the 1930s. The continuous demand for greater flexibility or at least for more frequently parity changes should not obscure the fact that broadly speaking parity changes have in fact become the principal method of balance of payments adjustment. What is especially important is that deficit countries have become less willing to hold on independently to overvalued parities. Unwillingness of surplus countries to change parities is much less of a threat to the expansion

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[13] This proposal has been made by William Fellner *loc. cit.* and earlier in a different form by Franco Modigliani and Hossein Askari, (*The Reform of the International Payments System.* Princeton Essays in International Finance No. 89, Sept. 1971, p. 14.) who proposed that the SDRs are given a purchasing power guarantee by appreciating SDRs in *terms of dollars* when dollar prices rise.

of world trade because imposition of trade restrictions by surplus countries would be self-defeating and absurd. No surplus country has acted in such an irrational manner. To say that under the present system necessary parity changes have been made in the end is, of course, not meant to deny that they are often unduly delayed and that the adjustment process can and should be made smoother.

Prompter and smoother adjustment is most desirable under an inconvertible as well as a convertible dollar. Since convertibility is still far in the future I confine myself to indicating how the inconvertible system could work. Let us distinguish two cases. First assume there is no or little inflation in the U.S. Then the problem is in practice reduced to getting deficit countries to adjust promptly, either by a gliding or trotting peg (as Brazil does) or in milder cases by occasional discontinuous devaluation and transitional floats. Even if there is no or little inflation in the U.S., there may be a few persistent surplus countries. They then have a choice either to inflate or to appreciate. Not much inflation would be involved if the U.S. has none. So the choice of the surplus countries would not be a difficult one and can be safely left to them.

Second, assume the U.S. has a certain amount of inflation so that several foreign countries get into an embarassing surplus situation confronting them in the end with the choice either to appreciate their currency (or let it float up) or to submit to a rate of inflation which they regard as unacceptable. In that case, there will be trouble. But the choice has to be made and it can be made easier by a purchasing power guarantee for official dollar holdings.

There is a good chance, in my opinion, that the surplus countries will be only few in number, as was in reality the case—appearances to the contrary—at the time of the Smithsonian agreement. Then they should make the adjustment. But if dollar balances carry a purchasing power guarantee the nasty problem of determining whether the dollar should be devalued or some other currencies upvalued (in SDRs and gold) which caused so much trouble in 1971 and held up the agreement, will be effectively defused.

From an economic standpoint I can see no reason why such a system should not be acceptable and last for quite some time. In the meantime negotiations could continue on more ambitious reforms—such as gradual replacement of the dollar by SDRs, changes in the intervention systems and what not.

Senator Proxmire. Mr. Krause, I would appreciate it if you could confine your remarks to 10 minutes.

STATEMENT OF LAWRENCE B. KRAUSE,[1] SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Krause. I will try, Senator Proxmire. It is a great pleasure for me to be able to appear before this committee once again.

The balance of payments of the United States is going to reach equilibrium; only the timing and structure is unsure. I feel certain about this prediction, because the unusual conditions which kept markets from bringing about an adjustment no longer are dominant. The conditions to which I refer are the willingness of other countries to provide goods and services to the United States in return for IOU's, combined with the willingness of the United States to let economic events in other countries influence our domestic economy without a policy response. Neither the United States nor other countries want this to continue, so the market—more or less—will be permitted to make an adjustment. Governments quite appropriately will interfere with the speed of adjustment, particularly when a large disequilibrium has been permitted, but recognition is spreading that trying to prevent an adjustment is a losing battle, as was demonstrated again by recent events.

[1] The views are those of Mr. Krause and should not be attributed to other staff members, officers, or trustees of the Brookings Institution.

DOLLAR DEVALUATION AND OTHER POLICY ACTION

The willingness of the United States to formally devalue the dollar, along with the adjustment of other currencies in order to help resolve the financial crisis, shows both good judgment and maturity by the Nixon administration. Let me add that while it is true there is uncertainty about what the proper exchange rate should be, I think that the direction of exchange required was quite clear. I would like to remind this committee it has been 2½ years since our major trading partner, Canada, appreciated relative to the dollar and over a year since the other appreciations have taken place. So it is not yesterday. There has been quite a bit of time for some improvement to show through. In addition, we have had some unusual luck in terms of special exports in the agricultural sector and at higher prices. So that I think there was enough time to show the path toward improvement and the fact that the path wasn't there indicated an exchanged rate change was required.

By prompt action, the crisis was confined to financial markets, was speedily corrected and was not permitted to contaminate more basic economic and political relations among countries. Changing the monetary price of gold has little substantive meaning as long as the United States holds to its resolve—as it should—not to buy or sell monetary gold. It will not make a classical gold standard more attractive to monetary reformers, nor does it have much effect upon the free market price of gold. The free gold market has been reacting to basic economic and political uncertainties and is little concerned with the much lower monetary price of gold.

The decision of the administration to remove our controls on the international flows of capital within 2 years was also proper. These controls were instituted to improve the balance of payments at a time when devaluing the dollar was not possible and are now both unnecessary and inappropriate. I only wish a similar decision had been made with respect to private trade in gold by Americans. While not a critical issue, the private trade in gold is a natural activity and carries no antisocial implications. Furthermore, the absence of private trade prevents the creation of a viable futures market in which industrial users of gold could hedge against the risks of drastic price changes.

I am somewhat more ambivalent over the administration's effort to utilize the monetary crisis to promote trade legislation. The President needs legislative authority to enter negotiations with our trading partners this year, and I strongly support this effort. However, linking trade negotiations to an exchange-rate change perpetuates the myth that these two actions are concerned with the same problems when, in fact, their differences are greater than their similarities. Furthermore, the administration's rhetoric describing relations with our trading partners is not helpful. The United States, to my knowledge, has never extended unilateral tariff reductions to other major trading nations. West Germany and Japan have taken such actions but not the United States. Also, other developed countries have not demanded unilateral concessions from us as we have of them. Thus, I see little merit in argument that the United States has been "had" in matters of trade restrictions. At the same time, I do believe that a movement to much freer trade would increase our exports somewhat more than our imports because of the potential I foresee in agricultural exports by the United States.

WORKING OF THE EXCHANGE-RATE MECHANISM

In view of the apparent lack of responsiveness of the U.S. balance of payments to the last devaluation, some criticism and skepticism have been expressed over the usefulness and appropriateness of this instrument to deal with the problem. Such criticism is misplaced. Currency devaluation may not be a perfect instrument, but it is the best that exists as long as most countries will not permit exchange rates to float cleanly in the market. To be sure, trade flows are more affected in the short run by relative income growth than by exchange rate changes, but unless a country is prepared to suffer prolonged periods of excess unemployment or unnecessary inflation, the money growth mechanism does not provide a policy instrument for dealing with balance-of-payments disequilibriums. Other policy instruments, such as an across-the-board import surcharge, is dependent on the price mechanism for its effectiveness.

In addition, to the remarks Professor Haberler made, I would also point out that devaluation affects services and capital flows, where an import surcharge would only apply to a very small part of the accounts. My rough guess is that a 30-percent surcharge would be required to get the same effect as a 10-percent devaluation. Such a massive surcharge would obviously be inequitable to Americans and highly disruptive to international commerce.

The devaluation of the dollar will help correct the U.S. deficit, but no one can be sure when that correction will appear and whether it will be sufficient or excessive. Despite some improvement in econometric technique and computer technology, it is still almost impossible to predict the U.S. balance of payments or that of other countries within tolerable limits of accuracy for policymaking. In view of this uncertainty, policymakers must be prepared to change the value of their currency rather frequently and quickly in response to evidence that an existing parity is untenable. Strong statements of resolve that a particular parity will be held do not convince the market and serve only to embarass the prime minister or central bank governor making them. For what it is worth, my guess is that the U.S. trade accounts will show a marked improvement by the end of this year. This is a conditional projection, based on the expectations that the real growth of the U.S. economy will be slowing by year's end, that our major trading partners will be growing at rates in excess of their long-run trends, and that the impact of the dollar devaluations will be felt by then.

The reasons why devaluations affect the trade accounts only with a considerable lag are many and varied. In addition to the points made by Professor Cooper, some other are important. After devaluation, for instance, American steel producers may feel that they will be able to compete with foreigners and begin to expand their domestic capacity. Likewise, multinational firms may decide to locate their next increment in capacity in the United States rather than abroad, but such decisions may not affect trade flows for a couple of years. These long lags suggest the possibility that a depreciation or appreciation could be excessive. In such cases, reversals of currency changes should be made.

While the devaluation of the dollar was necessary, the financial crisis which brought it about was not. Unfortunately, existing international monetary arrangements do not appear to allow exchange-rate changes of major countries without such a crisis. The current international monetary negotiations are trying to correct the inadequacies of this system. The United States took an excessive amount of time to prepare its ideas for reform, but at least a U.S. plan now exists. Other countries are even more deficient in initiative. The leisurely pace of these negotiations seems out of keeping with the state of financial markets. One can hope some urgency will now be felt to push them along.

The U.S. proposal quite properly seeks to speed up the adjustment mechanism to correct balance-of-payments disequilibriums. My reservation concerning the proposal questions whether it goes far enough in that direction. The reserve-change test which the United States recommends to signal a needed adjustment measure may be adequate for a country like the United States, whose currency is used for intervention purposes in exchange markets, but it is too insensitive for other countries. With wider bands of permitted spot exchange-rate fluctuations around par values—or central rates—quite a bit of information is contained in the movement of the spot rate itself. A change in par value or other adjustment measures by these countries should be undertaken before a large change occurs in their reserve holdings. Indeed, waiting until governments have been intervening in the market for some time and in one direction may induce currency speculation, unless par value changes are very small so as to make the gain not worth the effort.

It is possible that we are approaching the problem of providing a workable adjustment mechanism from the wrong end. Rather than attempting to negotiate some flexibility into a fixed rate system, it might be better to start with fully flexible rates as the norm and negotiate the circumstances in which governments should be permitted or encouraged to intervene in the market. Such an approach would raise the basic question of how much fixity of exchange rates countries need or want.

For countries desiring monetary independence and having a viable capital market, very little fixity of rates is required, since relative stability is assured. For instance, for Canada, only the ability to slow down the rate of change of exchange rate seems necessary. For members of the Common Market, however, intra-Community stability is needed, but that can be achieved through intervention with member-country currencies, leaving the European Community as a bloc free to float vis-a-vis other currencies.

If the present tack of negotiations should fail to make progress, a turn toward negotiated flexible exchange rates may be the best alternative. In the absence of any agreement, the system seems to be evolving toward flexible rates anyway but without making clear the rights and responsibilities of individual countries. Unless some rules of the game are recognized, the possibility of competitive depreciations exists and is a very serious matter.

Thank you, Senator Proxmire.

Senator Proxmire. Thank you very much, Mr. Krause.

Mr. Cooper, just last weekend, I understand, in Claremont, Calif., you made a proposal which you have repeated here this morning and I welcome enthusiastically. I was very interested in the New York Times editorial of Sunday which embraced your proposal and suggested that what we need now is a Federal Reserve Bank for the world, a lender of last resort. They pointed to something you didn't bring out this morning or in the article, at least, it was in the paper at Claremont, that the experience of individual countries had been that before they had central banking they had instability and that the institution of a central bank lender of last resort was most helpful.

I discussed this matter, after I had read that editorial I called Leonard Silk who wrote it in the New York Times and told him how impressed I was by it and he gave you full credit as author to the idea and I discussed this with Senator Fulbright, who would have jurisdiction of legislation calling on the administration to begin negotiation of this kind, and he seemed very favorable to it.

I asked Mr. Burns when he appeared before us on Tuesday and I just reread Mr. Burn's reaction and that was favorable reaction. He said our Government hadn't made that proposal but that he felt that it was a constructive idea, that it should be considered by all thoughtful people, that the Federal Reserve Board would study it carefully and perhaps the time has come, he said, in view of the improvement in our international situation.

Under what seems like these favorable circumstances, what would you think of a resolution that might be introduced in the Congress calling on the administration to formulate plans to try to negotiate along this line? I take it that is the kind of thing that will be necessary to negotiate to strengthen the International Monetary Fund to provide its capability as a lender of last resort; is that correct?

Mr. COOPER. Yes, sir; I am pleased to hear that Mr. Burns is receptive to the idea. Establishment of such a scheme would, of course, ultimately require legislation since the Bretton Woods Agreement Act would have to be amended to give the IMF the authority to engage in this new facility which I outlined earlier this morning, just as it had to be amended to permit the International Monetary Fund to create SDR's.

I would have thought that a resolution from Congress, in view of the fact that legislation would ultimately be required, would be helpful both to reinforce whatever inclination the administration may have in that direction but also to signal the rest of the world this is a serious matter and taken seriously not only by the administration but also by Congress.

Senator PROXMIRE. The sequence would be in your view a resolution, a reaction on the part of the administration, then some negotiations, and finally legislation following the conclusion of negotiations, if those negotiations, of course, were successful?

Mr. COOPER. That is right.

Senator PROXMIRE. Legislation would be the final act; is that right? Legislation, I presume, ratifying an agreement or, would it take something more than that?

Mr. COOPER. No, it would require a statutory amendment. The scheme that I propose would require an amendment of the Bretton Woods Agreement Act.

Senator PROXMIRE. Maybe I am confusing the situation by failing to understand whether this amendment would be an action by the Congress of the United States or by the members of the International Monetary Fund.

Mr. COOPER. It would require an act of Congress to do that, and since a number of other issues that are being discussed in connection with monetary reform might also call for further amendments of the IMF charter, the whole thing should perhaps be treated as a package. Some of the things that have been proposed would not require additional legislation. There is adequate authority or flexibility within the ambit of the International Monetary Fund to do them. For example, some of the features in the U.S. proposal would not require any legislation at all, others could be permitted by a flexible interpretation of existing legislation.

But any major change in the adjustment process, certainly one that involved the possibility of frequent changes in the par value of the U.S. dollar, would require legislation. So would putting into force the kind of lender-of-last-resort facility that I have suggested.

Senator PROXMIRE. How would you provide for the discipline? Maybe I have an instinctive feeling it is wrong but feeling it might be missing. If you had a lender of last resort to bail out countries which had been extravagant in permitting their economies to become too exuberant, too expansive and too inflationary, and needed to borrow on that account. Is there a possibility that political pressures in some countries might be such that they might become chronic borrowers? How would you impose restraint?

Mr. COOPER. There is, I think, no technical difficulty after the fact. In distinguishing roughly, not to the last penny or even to the last million dollars, between large outflows that are due to balance-of-payments deficit such as might arise for example, the suggestion you are making, from an overexuberant expansion of the economy under political pressure, and flows that are due to speculative runs by foreign holders of the currency in question. After the fact, and within the degree of accuracy that our balance-of-payment statistics permits that kind of thing can be roughly sorted out. It is not necessary to sort it out exactly. It cannot be sorted outwhile the run is taking place, however, and one does run the risk in the short run that a facility which is designed to serve a different purpose also helps to finance a balance-of-payments deficit that is out of control. The only suggestion I can make there is that the rules be understood to exclude financing of basic balance-of-payments deficits. Therefore, if after the passage of time, as the balance-of-payments statistics come out, it turns out that this facility was misapplied, then the country would be obliged to draw on its normal existing IMF drawing rights and repay the special facility right away. That would put it on a fixed 3- to 5-year repayment schedule.

Senator PROXMIRE. Use some of the techniques we use with our central banks in these cases to have a higher interest rate, too, so that the temptation to borrow might be diminished?

Mr. COOPER. I would envision that the borrowing would be at a respectable interest rate so there would be no incentive simply to borrow to get money; yes. A classical central bank calls for lending unlimited amounts at a penalty rate.

Senator PROXMIRE. Would you comment Mr. Haberler on Mr. Cooper's interesting proposal in making the IMF a lender of last resort and extending a central bank concept to international money. Do you think it is practical? Do you think it could be done? Could you hear me? I asked you to comment on the proposal we have been discussing with Mr. Cooper, his proposal.

Mr. HABERLER. I didn't get that.

Senator PROXMIRE. I would like to know whether you think it is practical and whether you think it is desirable?

Mr. HABERLER. My reaction is this. I am a little skeptical about the international negotiability of anything like Professor Cooper's scheme. You see, the system is tailored for the United States and I don't believe that other countries would like that. We could not very well extend it to all countries. The fund could not finance the balance-of-payments difficulties of all.

Senator PROXMIRE. Why not?

Mr. HABERLER. Of all countries.

Senator PROXMIRE. Why not?

Mr. HABERLER. The United States is in a special position.

Senator PROXMIRE. Why couldn't you finance the balance-of-payments difficulties of other countries within the limits Mr. Cooper suggested?

Mr. HABERLER. The United States is in a special position of the dollar which makes these speculative flows very large for us. Therefore, there would be a good point in financing these flows. But I ask myself first, is it necessary? After all, the dollar finances itself, so to speak. I really don't know whether we need any special IMF facility for that. Applied to other countries, I think if you propose such a scheme, say, to the IMF as a whole or say to the Group of twenty, or to the Europeans, they will say why should the IMF finance the American balance-of-payments difficulties, and on the other hand, the United States could not very well say, yes, this applies to all countries.

Senator PROXMIRE. I thought Mr. Cooper answered that in his statement when he pointed out there would be a time period involved here and that, for example, with respect to the $6 billion purchase of dollars with marks by Germany that there would come a time within a quarter of a year or a half of a year when the United States would have to be brought to account, that there wouldn't be an indefinite financing by Germany.

Mr. HABERLER. Suppose that such a scheme had been in effect and had been negotiated, what difference would it make for the United States? The United States itself would make this difference, that we would owe $6 billion SDR's to the IMF and there would be an exchange guarantee. In other words, if the dollar goes down we would have to make up the difference. So it really, I think, boils down to this—giving an exchange guarantee. I, myself, have proposed another type of guarantee.

Senator PROXMIRE. Before we get into that let me ask Mr. Cooper to respond to your objection.

Mr. COOPER. I think we are dealing in somewhat different frameworks. Mr. Haberler is quite right to point out that, in effect, since August of 1971 the United States has this facility. That is what a dollar standard is. That is, other countries are willing to accept dollars

without limit. They jumble with it but they nonetheless accept dollars without limit so that the United States alone among countries has this facility. The reason for suggesting the facility is not to put it in place of what we now have, the reason for suggesting it is that in the context of monetary reform the other countries have shown very strong interest and we in this country have agreed that some form of convertability of the dollar should be established. The details of that form of convertability, of course, are far in the future because there are many other things on the agenda as well which take logical priority.

My view is that it would be unwise for the United States to agree to any kind of convertability of the dollar unless some device could be found to handle not only the official dollar balance which Mr. Haberler mentioned are $70 billion, the standard solution to that that has been suggested is to consolidate them someway. I have some questions about that. But even if one were to consolidate all of the official dollar holdings, there are the large private dollar holdings outstanding and I think it would be unwise for the United States to agree to any condition for convertability without some way of coping with those and it is in that context that I suggest this lender of last resort facility which I should hasten to add is not in fact original with me, this is an idea which I guess goes back to at least Walter Bagehot as applied to national countries and in the international context has been mentioned in one version or another by international economists for the last decade.

Senator PROXMIRE. I know that there was a Bagehot's conception similar to this 100 years ago.

Mr. COOPER. Yes, sir. But my point is that it is in the context of a reform of the monetary system that seems to be such a facility is not only desirable but essential. One can ask the question, as in effect Mr. Haberler did in his testimony, whether or not we can't live with the system which we now operate. What is wrong with it? Is reform all of that necessary?

It is, although he did not use the terms, it is, in effect, a stance by this country of benign neglect toward the international monetary system. I find myself in a somewhat awkward position in this respect because I do myself believe and have argued for a number of years that the United States paid too much attention to its balance of payments. But, having said that, I think it is too far to go to the other extreme and say we should really ignore our balance of payments.

Senator PROXMIRE. You have these practical advantages that Mr. Haberler pointed to, world trade has increased, capital movements have flourished, that we have had general prosperity during this period of crisis. What has been the fundamental price we have had to pay for that or will have to pay for it?

Mr. COOPER. Let me indicate the price I think we will have to pay for that and it has to do with the broader political context in which international economic relations took place.

It seems to me if the United States shows no interest in dealing with the matter which is of high importance not to the national public elsewhere because international finance is an esoteric subject, but to the officials, both the economic officials and political officials, who are concerned with what they perceive to be as De Gaulle called it, the exhorbitant privilege of the United States, and others are less scathing

in their use of adjectives, but none the less have basically the same view, the situation that we now have, I think, is not tolerable to other leading countries who are feeling their economic oats, increasingly probing degrees of independence from the United States, how possible that is, and so on, and while we can easily write out, I would say not just a year but even maybe well into the middle of the decade with no effect on a dollar standard, it is, I think, a corrosive arrangement of our economic relations with the United States and with other countries who are important to us.

Senator PROXMIRE. Do other countries pay the price of more inflationary pressures with this kind of a situation? Is that an element or not?

Mr. COOPER. I think the price we will pay will come in two forms. One is the concrete one in that they will increasingly find capital movements from the United States into those countries less and less attractive. They already are having some unattractiveness politically. But the advantages outweigh that. My guess is that as time goes on under a dollar standard regime in which in effect foreign central banks are financing the U.S. investment in those countries, it will become less and less possible for countries to sustain an open environment as far as foreign investment is concerned.

That is a concrete cost that I would suggest we will see more and more of.

Second, and somewhat less tangibly but none the less I think possibly more important, is the fact that the tone of economic relations will steadily worsen and that in turn will influence the willingness to cooperate wih other countries.

Let me give an example which is in today's paper. One has to be careful about making direct linkages. EEC is being very sticky on the question of compensation to the United States over the entry of Britain, Ireland, and Denmark. United States contends that under the GATT rules it warrants compensation. EEC is arguing that it doesn't.

There are many issues of this type that come up year in and year out in which countries must reach an accommodation on economic relations between themselves, which if the accommodations are ones that are made in an atmosphere of good tone, will redound, it seems to me, more to the advantage of the United States than the countries, and while I would guess, not be prepared to say that if August 1971 hasn't happened, the EEC would be turned completely around on this position. That kind of forecast can't be made. None the less, it seems to me their willingness and Japanese willingness to negotiate on issues that are important to all of us is influenced by their perception that the United States does what it can do to work toward a cooperative world and the fact of the situation at the present time is that the benign neglect stance regarding the role of the dollar in the world and U.S. balance of payments is not perceived abroad rightly or wrongly to be a cooperative stance.

Senator PROXMIRE. Mr. Krause, I would appreciate it if you would comment on this, too.

Mr. KRAUSE. I strongly endorse the idea. I must, since I also wrote a bit on this concept last year in an article in International Currencies Review. I think it is a necessary part of an international monetary reform because it addresses the fear that countries have of short-term

capital movements, but there are some things that should be clear about the proposal.

Senator PROXMIRE. So you favor having the International Monetary Fund as the lender of last resort?

Mr. KRAUSE. Yes, sir; but there are some aspects of it one should be clear on. Somebody has to decide how much of a capital flow is a short term speculative flow and how much is a basic deficit. That decision process will have to be taken in the International Monetary Fund; it cannot be left to the country who has an interest involved. So it involves a tremendous transferring of sovereignty to the managing director or staff of the Fund itself, something I happen to approve of, but it is an important aspect which should not be forgotten.

Second, what a scheme like this does is protect the asset values but does not solve, for instance, all of Germany's problems when it has such an inflow. The inflationary consequences are the same whether there is a lender of last resort or not. Incidentally, it is a useful scheme for the United States, but it could be made available to all countries.

Senator PROXMIRE. Mr. Haberler.

Mr. HABERLER. Since I introduced the word "benign" neglect in connection with the balance of payments I think I am entitled to say that it does not mean that we should not take no interest in the international monetary system. We have been working in that area all along as members of the IMF and recent intervention through devaluing the dollar that certainly was not benign neglect.

Now, to come back to Professor Cooper's proposal. I did not realize that he meant it only in the context of restored asset convertability of the dollar; that is, a restructured international monetary system. I might mention that this background paper which I put into the record deals with the convertibility of the dollar.

I agree with Professor Cooper that convertibility is far away in the future and that it would be very unwise for the United States to accept prematurely any convertiblity obligation. But I would like also to stress that convertibility has two meanings. In one sense the dollar is convertible: It is convertible in the market, and that is the important thing. Anyone, American or foreigner, can use his dollars as he wants to buy and sell, invest, disinvest, and so on. The market convertibility of the dollar is a tremendous contribution to the world economy. The dollar has been convertible in that sense all along. This is one of the reasons of why the world economy has developed as well as it did despite all of the financial crises because of the dollar on other major currencies have remained convertible in the market. So in that sense the dollar is convertible and should remain convertible. But the convertibility into gold or SDR's or any other ultimate reserve asset, that would be major change in the international monetary system and I am afraid this is very far in the future.

Senator PROXMIRE. I would like to ask you, Mr. Krause, because you seem to be the principal champion we have here this morning of the devalution. I am inclined to approve it. I said I thought it was necessary and we had to go along with it.

The Congress is going to act on it within the next few weeks. We are holding hearings in the Banking Committee next week and we are going to mark it up the week after that.

But I am not at all satisfied that you economists have given us a sufficient analysis of its impact. First of all, the economic profession was almost universally wrong in the last devaluation. Mr. Burns admitted he was wrong on Tuesday. Since it went into effect the balance of trade and balance of payments have worsened. You do attribute that, and I suppose rightly, part of it at least to the economic expansion we have had in the last year. But I am not satisfied that is a complete explanation. At any rate, there is a pitifully inadequate analysis, it seems to me, of the impact this devaluation will have upon our trade. In the first place, we have been told this morning once again, we are told persistently that there is an immediate adverse effect from devaluation. Our imports will cost more and it will take time for the imports to diminish in relationship to the exports. During that time we have more dollars going out because we are paying more for imported goods than before.

We are told also that we get less for our exports. It will take time for our exports to increase and until they increase we will have less yen and marks coming in because the price of our exports will go down, on an exchange basis.

If people can sit back and say eventually you are going to get an improvement. How do we know? Do you know anybody who sat down and made an analysis of the elasticity of demand for exports or elasticity of demand for the imports? The exports and imports we are looking at are peculiarly inelastic. We are not going to import a gallon less of oil, we are going to import a whale of a lot more. The price is going to be some $700 million higher. We are going to be paying out $700 million more for the oil. Undoubtedly we will probably import now as much wine, maybe very nearly as much in the way of television sets from the Japanese. They have a colossal cost advantage in making color TV and even black and white. It is hard to find specific products of a large kind that are responsive to these kinds of changes.

Then when you look at our exports you find the same kind of situation. Are we going to sell a lot more aircraft abroad? We already sell 85 percent of all the aircraft in the world. That is our biggest export. Computers are next. Are we going to sell more computers because of some 10-percent reduction in price? I doubt it. We might. But I doubt if it's very elastic. I doubt if we will get back as much as we have to pay out. Food is the one commodity they say is a big winner from devaluation. But is it? The aggregate is bigger than the others and could bring in more. But think of the social revolution we are expecting Europe to accept. It means that they are going to have to reduce the number of their farmers, and they have been very resistant in doing that. They are going to have to adopt a situation which would drive their farmers into the cities. They don't want to do that. They have resisted. The farmers in Germany, France, Italy, and so forth, have been successful in persuading the politicians to resist it. So under these circumstances, I just wonder if we are too easily and readily accepting this devaluation as something that is going to give us a pretty solid improvement in our situation.

There is one other element and that is the devaluation is going to have an inflationary effect on this country and a deflationary effect abroad.

How are you going to expect reduction of Japanese exports from Japan without a profound effect on their economy? If you are going to do that, if you are going to have a recession there it will tend to reduce their costs and make them more competitive. And how you can have a stimulation of exports on top of an exuberant economy we have now without tending to inflate our economy, plus the fact we are losing the competition from steel, competition from autos, and so forth which will have an inflationary effect.

In light of all of this, do you think adequate analysis has been done to show the devaluation is going to have a desirable effect that we think too many of us have accepted without too much thought?

Mr. KRAUSE. I would be the first to admit the inadequacies of the economics profession in its ability to look forward to see what effect devaluation has.

It is a very difficult task to forecast a balance of payments. It is only in the context of such a forecast that you can measure a change. You must be able to predict every domestic economic effect; all of the foreign economic effects of the devaluation itself, plus the evolution of the foreign economies, and that is really a very, very difficult assignment.

Senator PROXMIRE. Let me interrupt to say there is one element of that that particularly intrigues me.

You take a country like Japan, which imports such an enormous amount of its raw material that it uses in the process of export, the cost of those imports are going to be reduced. The cost of the imported goods which they use to process and then export might very well exceed their wages, the wages they pay their workers.

At any rate, it is close to it.

If you are going to subtract, reduce that cost sharply and it is going to be reduced because the yen is revalued and the dollar is devalued and other currencies tend to also be less than the yen, then they are going to get sharp reduction in cost from this angle, so that is another complicating fact that I think has been completely overlooked.

Mr. KRAUSE. The reason for overlooking this effect is the difficulty of measuring it. I think in theory we have always noted that these complications exist. The disparity occurs in putting numbers on what the consequences of the devaluation are going to be.

Senator PROXMIRE. Would you agree or disagree that the economic profession flunked the test last time, that they indicated to us that devaluation would have a more quick and more desirable effect than it actually did have so far?

Mr. KRAUSE. I am hesitant to give them an "A," but I am not going to give them an "F."

Senator PROXMIRE. How about a "D"?

Mr. KRAUSE. I think the answer is that when we talk to each other, we recognize all the inadequacies. When we get into a public forum we find that it is difficult to bring out all of the complicating factors, without sounding like one is refusing to make any positive statement at all.

I think economists have a problem when we are forced to make a projection, when in fact we know in our heart of hearts that we are unable to make such a forecast.

Senator PROXMIRE. That is what I get out of your statement this morning, you seem to be very sanguine about this and I think the feel-

ing that you think it is right, it was necessary, desirable, it is going to help substantially, and if not immediately rather quickly. I am wondering if you have an analysis that supports that.

Mr. KRAUSE. I am convinced I know the direction of change it should go.

Senator PROXMIRE. Have you made any analysis of the elasticities we have?

Mr. KRAUSE. Every experience with devaluations, in the postwar period and before that, shows it helps the balance of payments.

Senator PROXMIRE. Take the last one.

Mr. KRAUSE. It has helped the balance of payments.

Senator PROXMIRE. How do you know?

Mr. KRAUSE. Relative to what it would have been.

Senator PROXMIRE. There are so many other factors?

Mr. KRAUSE. When you take those into account also.

Senator PROXMIRE. It depends on how you take those into account?

Mr. KRAUSE. The most important factor is growth of the economy, and if we are going to rule that out as a policy instrument, then we have to go to something that is less important but something we can deal with.

Senator PROXMIRE. You have to make an assumption on how the economy is going to grow in the next year. You may or may not be right. The best economic forecasts are good for 6 months. Then you might as well ask a taxi driver. Then you may have to make an assumption of further economic growth and we will not be in a very good competitive position.

Mr. KRAUSE. That is why we make conditional forecasts. The devaluations will help relative to what it would have been, but we can't guarantee a particular change in the trade balance when it is so greatly affected by matters which are even harder to predict than the consequence of the devaluation.

Indeed, when I was within the U.S. Government, I noted that we were unable to predict the balance of payments 1 year ahead. We weren't even able to predict it one-quarter ahead with the degree of accuracy needed for policy determination.

Senator PROXMIRE. All we accept is a prediction of what is going to happen to the balance of payments in the next 6 months.

Is it going to be adverse? We don't know what the effect is going to be.

Mr. KRAUSE. The devaluation will have a positive effect more than 6 months from now. When other factors will overcome the devaluation is something we are not prepared to predict.

Mr. COOPER. I will stick my neck out a little bit on this.

Let me make several observations.

In the first place, Senator Proxmire, in direct response to your twitting skepticism about the effect of devaluation, let me suggest that the very arguments that you have put to us, the alleged insensitivity of our import demands and the insensitivity of foreign demand for exports to price changes, suggests that if devaluation would not work, inflation would not hurt. After all, inflation in this country also works on our prices relative to prices aboard. And I would suggest that——

Senator PROXMIRE. I don't follow that.

Mr. COOPER. Because if our prices go up by 3 percent a year, and German prices stay the same, for example, either demand for our goods relative to German goods is price sensitive or isn't.

Senator PROXMIRE. I misunderstood. You mean it won't hurt our exports and imports?

Mr. COOPER. It won't hurt the balance of payments. I was addressing the external side. One cannot comprehend the course of the U.S. balance of payments and trade balance over the last 20 years without making allowance for the fact that, first, from 1955 to 1959, when we had a substantial deterioration in our trade balance, and then from 1966 to 1971, when we also had a very substantial deterioration in our trade balance, those two deteriorations were associated with inflation in this country more rapid than inflation in our leading competitors. By inflation I mean here not rises in the cost of living index, because that includes a heavy component of services and wages, but I mean prices of——

Senator PROXMIRE. Well, I think I would certainly accept that.

I don't want to shift scenery too fast. How about the fact that the devaluation can only have an inflationary effect on our own economy?

Inflationary because imports will cost more. Inflationary because we will get less competition from abroad. Inflationary because devaluation stimulates our economy in areas where we will have a shortage of skilled workers and maybe a shortage of resources?

Mr. COOPER. There is no question that a successful devaluation—and I would argue that this devaluation will be successful, but we can come back to that—will have an expansionary impact on the typical devaluing economy.

Indeed, in a sense, that is the purpose of it. It is the obverse of what Mr. Haberler suggested earlier, in a period of rapid expansion having a deteriorating trade balance is a helpful thing.

Senator PROXMIRE. We were told over and over again, our problem is inflation, the problem is not lack of sufficient growth, we had a record growth and this year they are suspecting another great year, as the President said.

Mr. COOPER. I use the word "expansionary" and not "inflationary" and that was the deliberate choice. Let me explain what I mean by saying that is the purpose of devaluation.

The point of devaluation is how to keep the country's balance of payments in equilibrium and still maintain the domestic economy on an even keel.

We could always improve our balance of payments by running the economy into a massive recession. That, however, has enormous domestic costs.

There is another way to improve the balance of payments and that is where devaluation comes in. It is expansionary and at the same time permits you to reduce domestic demand without reducing domestic output and employment.

It substitutes a call on American goods and services from abroad; that is the expansionary component of it.

Senator PROXMIRE. How does it reduce domestic demand?

Mr. COOPER. In order to make it work, there must be a reining in of domestic demand, to make room for the improvement in the trade surplus.

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Senator PROXMIRE. There isn't any in this case?

Mr. COOPER. We now have a trade deficit of $4½ billion.

Let us assume, just for the sake of argument, that the economy is operating at a level now which is at about the right balance between inflation and unemployment.

I do not believe that is actually so, but let us assume that it is so. Then the only way we could get back to trade balance, from a $4½ billion deficit, is to cut down on domestic consumption by $4½ billion, without cutting down on domestic production by anything.

We have to reduce consumption in this country relative to our production and in order to improve the trade balance. That is just in the arithmetic of the matter, and in that sense then the devaluation itself is expansionary; it increases foreign demand for domestic goods. We therefore have to take requisite contractionary policies, to make room for the improvement.

Senator PROXMIRE. And we are not going to take any of those steps; we know we are going to have a fiscal policy which provides for a 7½-percent growth in Federal spending; we are going to have no increase in taxes; we are going to have a monetary policy which follows an 8½-percent increase in the money supply last year; we are going to have a price and wage control policy that is weaker and less comprehensive.

Put all of these things together, there is no indication to me we are going to have any restraint on domestic consumption.

Given that, I would say following your analysis, you would expect no significant improvement in the balance of payments; you are not going to get reduction in consumption?

Mr. COOPER. You may well be right in that. I would not put such a pessimistic cast on at least the intention of the administration as distinguished from the possible outcome. Mr. Burns has said that.

Senator PROXMIRE. Mr. Burns yesterday said that he expected a lesser percentage increase in the money supply this coming year, but you know I wouldn't expect him to say anything else. His remarks have to be so vague they don't mean much.

You may get down to a 7- or 7½-percent increase in the money supply and that would be less expansive than last year.

He also said he would not permit any stringency to develop in the credit markets that mean no real bite from monetary policy.

Mr. COOPER. To the extent that the motivating spirit behind monetary and fiscal policies is full utilization of domestic resources, then a devaluation which stimulates foreign demand for American goods does make it easier for Mr. Burns to carry out his professed aim: namely, to take a somewhat tighter rein on the domestic credit base in confidence that foreign demand will pick up some of what would otherwise be the slack.

I would also argue, Senator Proxmire, to relax my assumption for a moment, that there is still room in the economy for expansion of output and, therefore, as long as some restraint can be maintained on domestic demand, the economy can produce more to improve the trade balance.

Senator PROXMIRE. I would agree with that.

I have been one of the consistent critics on the high unemployment figure.

Although last year we grew, as I indicated, at a very rapid rate, it is a question of timing, isn't it, Mr. Cooper? After all, we would all like to get unemployment down low.

The administration claims they think it can go down to 4½ percent at the end of the year. I am introducing an amendment to the Stabilization Act, specifying a goal of 4 percent by April 30, 1974.

That is the end of the Stabilization Act. And I think we should move in that direction.

But my problem is whether devaluation might overheat the economy at the wrong time and wrong way at the time when it is expanding rapidly.

Mr. COOPER. Well, I have already indicated in my statement that I am not as persuaded as most others are that this particular devaluation was even necessary or desirable, but I was addressing your more general question about whether devaluation works.

May I make two further points?

One has to do with the very similar circumstance in which we now find ourselves to those that Britain found itself in, in 1967.

Britain, after years of delay, devalued the pound by 14 percent, in November of 1967. That was followed by a financial crisis, indeed a world gold crisis in early 1968, and 6 months after the devaluation the British balance of payments was in worse shape than it had been in any years before the devaluation.

I followed the literature of that time closely, because as a result of a Brookings project in which Mr. Krause was also involved, I had put myself on the line about what the effects of the devaluation would be. I had said it would work strongly, perhaps even too strongly.

Six months after the devaluation, there were remarks very much along the lines of yours in questioning Mr. Krause: Will it work? Won't it worsen the situation? And indeed, in 1968, Britain's balance-of-payments position was substantially worse than in 1967.

But things began to show signs of improvements by the end of the year and by 1969 Britain was running a much smaller trade deficit but it was still a trade deficit.

In 1970, Britain actually ran a small trade surplus, and by 1971 it was running the largest trade surplus that Britain ran in this entire century.

There was, to be sure, some deflation of the domestic economy that influenced that also, but even when one makes allowance for that, there was a very substantial impact on Britain's balance of payments, not in the year after the devaluation, but visable 2 or more years after devaluation.

Senator PROXMIRE. That is very interesting and it may be helpful.

I do think there is such an enormous difficulty, just a difference in quality, not quantitatively, between the British economy and ours, their overwhelming dependence on trade and our relative insulation from that?

Mr. COOPER. That makes substitution of foreign for domestic goods harder, not easier. It is harder for a country where foreign trade is very important to make the substantial substitutions of domestic for

foreign goods which are necessary than is true for a country in which foreign trade is relatively less important.

Our economy has much more expansibility and much greater possibility for substitutions. These have to be set against the very correct points that you made; namely, the nature of our exports, in particular, the fact that they tend to be relatively price insensitive.

Senator PROXMIRE. I have some more questions, but I will call on Mr. Reuss.

Representative REUSS. I appreciate the Senator's usual courtesy, and I particularly apologize to our superb panel for being absent even a short while.

Because I haven't heard the questions, be kind enough to stop me on some of these if they have already been fully asked.

Let me try. I did make a few notes.

Mr. Krause, in your statement you say, and I quote:

> The decision of the administration to remove our controls on the international flows of capital within 2 years was also proper. These controls were instituted to improve the balance of payments at a time when devaluing the dollar was not possible and are now both unnecessary and inappropriate.

When last I revisited the matter of the effect of our controls on international flow of capital, both direct investment and bank lending, the Department of Commerce testified in May or June 1971, that the removal of those controls was likely to add around $7 billion a year to our deficit, at least at the start.

I would think that the removal today or a year from now would result in somewhat less than $7 billion predicted 2 years ago, if that was a valid prediction.

And I will, in a moment, invite you to comment on those numbers. But my question is this:

I take it from the structure of the sentence of yours that I just read that you are saying: Let controls be lifted over capital lending and investing abroad, if that results in a greater balance-of-payments deficit than what we have now been undergoing, more flexibility in exchange parities, plus the demonstrated ability to devalue the dollar, make this possible.

Is that what you are saying?

Mr. KRAUSE. That's correct.

Representative REUSS. I see nothing wrong with saying it.

Mr. KRAUSE. I would not endorse the estimate of how large an effect it is likely to have but the implication is exactly correct.

Representative REUSS. Let us divert ourselves with the arithmetic long enough for you to comment on both the validity of the Department of Commerce estimate, almost 2 years ago, and what you think it would be like today, what number would you assign?

Mr. KRAUSE. The most important consequence of removing the controls, relates to the refinancing of previous borrowings abroad because the controls never did stop the absolute amount of our direct investment abroad; they just changed the source of financing of it. Nor did they seriously impact on bank lending because, through the Euro operations, they were able to lend as much as they did in the past.

So it is only a question of how much of the financing, refinancing will occur at what time, and that is a function of relative monetary conditions at the time you remove the controls. If we are moving

toward tighter monetary policy, then you will see very little refinancing at that time. It is a question of when in fact the refinancing might occur and I am of the belief if it starts to be bunched, then the market will tighten up and will convince a lot of others to stretch it out. So it is not a sort of basic economic factor; it is one and for all portfolio adjustment, and I don't see that as a serious problem.

Representative REUSS. So while I gather you would just as soon not make a guess as to the arithmetic, you think that the balance-of-payments impact of the relaxation of controls on capital moving would be on almost any hypothesis less than the $7 billion predicted a year——

Mr. KRAUSE. Let me make a kind of prediction. I think it could even be positive to the U.S. balance of payments.

Removing our controls makes the dollar more convertible and makes it more useful. It removes one of the reasons that there is a Eurodollar market, because the dollar abroad was worth more than a dollar at home, because you didn't come under these restrictions. The more U.S. restrictions are removed, the more you are likely to see a return of that banking activity back to the United States.

Representative REUSS. As to the more fundamental point raised by your quotation, I gather that you do not necessarily agree, that in fact you disagree, with Mr. Arthur Burns of the Federal Reserve, who testified here earlier this week that he was determined that the devaluation of a few days ago was the last devaluation of the dollar?

Mr. KRAUSE. I am certainly not confident and I think determination is misplaced. One should not have that kind of feeling toward an exchange rate.

Representative REUSS. Each one of you in your testimony indicated, I believe, the feeling that the international monetary negotiations now going forward at a somewhat languid pace by the Group of Twenty ought to be accelerated, and that the sooner the trading and investing world can arrive at a fundamental monetary reform along the general lines scheduled by Secretary Schultz at the IMF last September, the better?

I think I have not misstated anyone.

Let me now ask this question: Would you agree with Mr. Burns of the Fed, the other day, when he said that Congress could be doing a useful thing if it gently did what it could to encourage and prod both our own Government and foreign governments to step up the pace of those negotiations?

I will just ask each one whether you would agree.

Mr. KRAUSE. I certainly would, yes.

Representative REUSS. Mr. Haberler.

Mr. HABERLER. I am rather skeptical. There is certainly pressure now to accelerate the negotiations and try to come to some understanding, but if I visualize all of the difficulties, I doubt very much whether we should have a radical reform in the foreseeable future and I am not so alarmed by it because, as I see it, the present system works and probably will work better in the future if you have a little more flexibility than we had in the past.

So my answer is, I don't expect; I may be wrong, but I don't expect any major developments in the Group of Twenty. They will come up

with something, but it will not be, I believe, a really radical reform of the system.

Representative REUSS. I think opinions may differ as to the necessity of radicalism in the reform. However, you have said that your favorite medicine would be a little more flexibility, however arrived at, which is as far as I am concerned a commonsense way of putting it.

That certainly is high on the agenda of the Group of Twenty, but the Group of Twenty, as you know, has been meeting once every month or two or for a day or two since they do seem to be on the right track, and since they are bright men, good technicians surely, wouldn't it be a good idea for someone to gently hint that they should meet a little more often?

Mr. HABERLER. To meet more often with——

Representative REUSS. Yes, the 20 now meet about once every 2 months for a couple of days.

Some of us, including myself, feel that while one should not get hysterical about it all, monetary crises every time you look around really aren't very constructive.

Because we have survived them so far is no assurance that we will without some trauma. Therefore, wouldn't it be a good idea if the Group of Twenty would crank up its timetable just a little bit and see whether it can't reach agreement on the nonradical, a little more flexibility, kind of reform?

Mr. HABERLER. Yes, sir; more flexibility of exchange rates, more frequent changes, not wait as long as the Germans did.

This is the important thing. And if they bring out the report in that vein, that what we need is more flexibility, either individual currencies floating all the time or in other cases adjustments being made more frequently with a transitional float, if they report out something along that line, I think that will be very useful.

But I would not call it a radical change of system. A radical change of the system would be if they tried to replace the dollars by SDR's or consolidated the dollar overhang, or something like that.

But more flexibility you really could have under the present system.

Representative REUSS. We don't though, because we have left it to chance. More flexibility, which you favor, would be facilitated by some sort of agreement by the IMF members as to how they are to encompass more flexibility; would it not, by the Group of Twenty coming up with some sort of agreed language or formula whereby there can be more flexibility?

Mr. HABERLER. You mean a formula like the American scheme proposed by Secretary Schultz' reserve changes——

Representative REUSS. Not necessarily.

That was the first attempt. I think Mr. Cooper, amongst others, has made some sensible criticisms of the exclusive reliance on reserve levels, as an additional number of the need for parity change.

But, something must be done, must it not, to prevent a recurrence of the Germans' situation last month, where, as you have ably pointed out, the German authorities largely at the behest of their own export lobby, resisted greater flexibility?

Shouldn't there be some progress, so that the next time around there isn't such nearly disastrous resistance?

Mr. HABERLER. I think very instructive here is what the Swiss did. They were the least inclined toward flexibility but still they learned the lesson to let the franc float so no dollars went into Switzerland.

They all went to Germany and the Germans took the loss and the Swiss had no loss.

So I hope other countries will learn the lesson and will do the same.

The Swiss are not even members of the IMF. If they were members of the IMF, they could do it too, as Canada does.

So I think what we should work for is to educate countries, show them how they could stay out of trouble and if the Committee of Twenty does that and if the IMF comes up with some resolution pointing up these matters, that will be very useful. For that I think it wouldn't be necessary to change the charter of the IMB, it would be done inside of the present charter by stretching a little bit.

Representative REUSS. But it does need a piece of paper, an agreement, an interpretation, a general counsel's opinion?

Mr. HABERLER. Everyone can rely on the lawyers; they can interpret it in the reasonable way.

Representative REUSS. How about you, Mr. Cooper, would you think it would be constructive if gentle hints were conveyed to the Twenty that everybody likes them and wants them to get together more often?

Mr. COOPER. I share Professor Haberler's pessimism about what is likely to come out of the Group of Twenty. Rapidly at the pace at which it is now operating for that reason I think that some encouraging prodding, cajoling, would be helpful, yes.

Representative REUSS. Professor Haberler, I would have another question for you.

On the last page of your prepared statement, you tend to say, I won't read the exact words, that if foreign countries accumulate dollars and run a big trade surplus with the United States, and keep on running it by in effect intervening to keep their currencies underevalued and the dollar overvalued, you tend to be rather encouraged about it. You say that, while they are going to sell more exports to the United States, this is after all rather small in relation to the U.S. gross national product, so that it doesn't matter very much.

I think I have tried to say what you have in there. At any rate, I would have this question:

In being as unconcerned as you apparently are about the accumulation of large amounts of dollars in foreign central banks, as a result of their floating dirty, aren't you overlooking the political implications? That is to say, if Japan keeps on floating dirty, intervening to undervalue the yen and overvalue the dollars, and as a result the markets of the United States continue to be subjected to large and growing Japanese imports, larger and faster growing than would be the case were the two currencies properly equilibrated, aren't you going to get, particularly in the ranks of American labor, an over overwhelming impetus for protective legislation of an unsound type, putting imports quotas on everything, erecting exclusionary protective walls and, therefore, wouldn't it be prudent to be a little more concerned about dirty floating, if I may use that word?

Shouldn't we at the very least deplore it?

Mr. HABERLER. This is a very touchy question, I realize. You say the Japanese have a large export suplus and I say take it easy; don't worry about it.

The American industries which suffer from Japanese competition, automobiles, or whatever it is, may take a different view.

I am under no illusion that large export surpluses by any foreign country will always be argument for American protectionism. They will use any kind of argument to further their interests.

As an economist, I have to point out that the impact is really quite small. Japanese exports stepped on many American toes long before they developed this large export surplus and the export surplus as distinguished from their whole volume of exports is really not so terribly large.

As I say in my prepared statement, assume they get rid of the export surplus by liberalizing imports, by inflating a little more, and by devaluation.

The effect will be spread all over their imports and exports. The imports will rise. To the extent that their imports rise their exports will not fall. So to that extent, we don't get any relief from Japanese competition, but free trade and freer trade obviously hurts some people and this type of trade which is created by an undervaluation of the foreign currencies is no exception to the rule, and I am a freetrader and therefore, I say in the end free trade is a good thing, even if it hurts some particular interest.

As far as protectionism is concerned, I believe the strongest factor which stimulates protection is not these dollar accumulations and so on, but unemployment.

If we had a recession and there was an increase in unemployment, then the drive for the protectionist measure would become very strong indeed.

Representative REUSS. Doesn't unemployment in part come about because in, let us say, portions of the electronic industry, American factories face from Japanese factories not just the normal competition from free trade, which for us freetraders is a price to pay, but the equivalent of legalized dumping by the deliberate intervention of Japanese central bank, in our model, to maintain an undervalued yen, which enables them to export to this country and elsewhere much more than they otherwise would be able?

Mr. HABERLER. The extra imports due to undervaluation of foreign currencies—I would not call it dumping—is not different in its impact from any other imports.

Representative REUSS. Let me at this point turn to your two colleagues.

There seems to be, Mr. Cooper and Mr. Krause, a friendly difference of opinion with me and Mr. Haberler on the question of whether dirty floating has to be swallowed as a necessary incident of free trade or not.

I don't think it can be. I think that it gives free trade a bad name, because it enables it to pursue legalized dumping.

Therefore, I put it to you that there ought to be a strong sentiment against intervention, when it keeps us in fundamental disequilibrium.

Mr. Cooper, whose side, if either?

Mr. COOPER. I agree with what you say although perhaps for somewhat different reasons.

I see fully the arguments that many economists make for freely floating exchange rates.

I believe that not only will that not happen but that it is undesirable that it happen.

In the first place, it is worth recalling that a number of governments are themselves large transactors in foreign exchange anyway, for nonmonetary reasons.

To give two examples that bear on the United States: Britain has a large official debt to repay to the United States every year, going back to the Anglo-American loan of 1946. So the British Government is in the market for dollars just as a transactor. The United States, in turn, has to buy many marks for its forces in Germany.

To contemplate a regime in which exchange rates are freely floating and determined solely by "market" forces is in fact literally impossible. The British Government must take a position in the market.

Representative REUSS. Let me clarify what I am saying.

I didn't mean to outlaw interventions. What I did mean to outlaw was those interventions which are persistently made in the face of a fundamental disequilibrium of the currency concerning which the intervention is made.

Thus, I pick the Japanese because that does seem to me, at least in recent times, to have been a case where the yen and the dollar were palpably out of equilibrium, the dollar overvalued, the yen undervalued, where the Japanese export lobby quite misguidedly, I think kept persuading the central bank to buy dollars until dollars ran out of their ears, and the net result of it was that the Japanese were able to unload goods within our borders at a delivered price demonstrably much less than would be the case under the most admirable Adam Smith free trade.

Let us have all kinds of powers to intervene, to protect against flood, famine, assassination, short-term capital movement. I think your suggestion on that is an admirable one.

But do you think continuing intervention to do the bidding of one's own export lobby is a good thing?

Mr. COOPER. Those are two questions and to answer them accurately really requires setting a framework or perspective in which to answer them.

If one's objective is to maximize the standard of living of the American public, yes, that is a good thing, and that is the position that economists tend to take.

Representative REUSS. We on the JEC have our duties: maximum employment, maximum production, maximum purchasing power.

Ours is not to reason why.

Mr. COOPER. I said standard of living.

Representative REUSS. Maximum purchasing power.

Mr. COOPER. Standard of living. Then any time you can find an arrangement in which people elsewhere in the world, for whatever absurd reasons they may have, are willing to subsidize the American consumer, from the point of view of maximizing the American standard of living, that is a good thing.

Now, if you ask, do you think that I think this is a tolerable arrangement, then I have to become a quasi-political scientist and say no, that is not a tolerable arrangement in the sense that it won't, in fact, be tolerated, and, therefore, we need some kind of international rules to prevent that from happening.

Why won't it be tolerated?

Because people have objectives other than maximizing the material standard of living of the country. They look to employment, for example; employment takes on a value in its own right.

I daresay if we found a vast cornucopia, whether it be from elsewhere in the universe or from Japan, such that we could all enjoy our standard of living without lifting a finger, there would be profound objections to that in this country.

There is a psychological ethic which says work in itself is a good thing and certainly people don't like to find themselves in involuntary unemployment. What you call dumping or quasi-dumping through the exchange rate, even though it improves the material standard of living, nonetheless has costs in other dimensions by which we measure our welfare, such that it would not be tolerated; and, therefore, the international monetary system as to take that into account. The behavior we have seen in Germany and Japan and in other countries in recent years suggests a strong production orientation in these countries, rather than a consumption orientation. As you suggested, in Japan producers are much stronger politically than the consumption-oriented public.

You may have been out of the room when Mr. Haberler suggested that it was absurd from a welfare point of view for the Japanese to be doing what they have been doing for the last 5 years. That shows something about political forces in Japan.

But we are not immune to those forces here either, and are not likely to be in the foreseeable future. That orientation has to be taken into account in arranging the monetary system and, therefore, it seems to me we do need rules of intervention. Even if we had a flexible rate system we would need rules of intervention to prevent systematic undervaluation by a country of its exchange rate.

Representative REUSS. Thank you.

Senator Proxmire. I do want to turn to Mr. Krause, but I have already imposed on you.

Senator PROXMIRE. Senator Javits.

Senator JAVITS. I apologize, gentlemen, for not having been here at the start of the hearing.

I have many other committees and we had hearings before the Foreign Relations Committee, but there are a few things which I have checked through and, with the aid of Mr. Krumbhaar, I would like to ask you about.

One is, I noticed the feeling which is put forth by Mr. Krause, the most forcibly, that frequent changes of parity will be necessary in the future.

He says "policymakers must be prepared to change the value of their currency rather frequently and quickly in response to evidence that an existing parity is untenable."

I would like to ask the panel (1) whether there is agreement on that; and (2) what comment they have on the very flat assertion Mr.

Burns made on Tuesday, that he wants this to be the end of devaluation.

An economists, do you think this is a bad thing, that we must have an end to it, or do you think that it is a good thing so that it gives us greater flexibility in the operations of the international money system?

Mr. Krause.

Mr. KRAUSE. Well, I have addressed myself a bit to that problem already. I think we will need changes of exchange rates and that one can have resolve about inflation and one can have resolve about unemployment, but that an exchange rate is not something to resolve about; it is something that has to adjust and you can't get committed to it.

Senator JAVITS. Mr. Haberler, can I have your view on this same question, on the same question of whether or not we should make it our policy not to have any further devaluation?

Mr. HABERLER. I say the devaluation was necessary to get others to change their exchange rate.

If the Germans and Japanese had followed the Swiss example and had let their currency float, in time the crisis would not have taken on this proportion and it wouldn't have been necessary for us to devalue.

So our devaluation was a means to get others to make necessary realinements.

First, the Germans and Japanese and then a number of other countries.

So I hope the next time they will do it on their own and not ask us to devalue the dollar to make the necessary changes.

So I agree with Arthur Burns, but I would say for us to devalue the dollar in order to get necessary exchange rates changes is not a very high price to pay to get the whole thing over.

Suppose we assume that the others don't make the adjustments, then you get the crisis continuing and that would be bad.

Therefore, the price we pay by devaluing the dollar is not a very high one, I believe.

It has some implications for less-developed countries. The reserves of the less-developed countries consist largely of dollars; so if the change in the exchange rate is brought about by devaluing the dollar, the less-developed countries will lose on their international reserves.

Senator JAVITS. What do you say to that, Mr. Cooper?

Mr. COOPER. I do not know the context in which Mr. Burns made his statement.

Taken at face value, I think it was an unwise statement, but if I can take the liberty of interpreting what I think he meant was that we won't have another devaluation in the near future.

Indeed, it is part of the American plan, as I understand it, to move toward a system in which there is much greater symmetry, including symmetry with respect to the United States being able to change the value of its currency, when that is necessary, so I assume that Mr. Burns was not talking about all time, but only the near future.

And since I have some question about the desirability even of the most recent devaluation, I certainly think that another one would not be necessary in the near future.

However, having said that, I agree entirely with the position that Larry Krause took, that a pledge not to devalue is not something we should run our flag up.

Senator JAVITS. Thank you for a very interesting response.

The other question I would like to ask again, starting with Mr. Krause, is: I am very interested in your reference to the fact that Americans should be allowed to hold gold, which you make in your statement.

I notice, also, in Professor Cooper's prepared statement:

> * * * in giving his own idea of what we ought to do, the right way to handle this problem is not to endow the United States with huge amounts of reserves through a special allocation of SDR's, or a huge increase in official price of gold.

Now that discusses the gold proposition. As you know, I am a New York Senator, and have a good deal of observation on these questions out of so-called Wall Street.

There is a lot of sentiment there that (1) Americans ought to own gold; we ought to materially increase the price of gold, treat it at $80 an ounce. That would go a long way toward giving us our position which we enjoyed in the days when Fort Knox was loaded.

And I just wondered what you would think about this proposition, therefore, of attacking this whole issue through the gold channel.

As you know, so I don't mislead you, I have joined with Congressman Reuss in the very strong position that gold is a commodity and forget it as far as money, or at least the world credit, is concerned.

Mr. KRAUSE. My feeling is that you have linked really two different things. One is the right of Americans as individuals to own gold, which I strongly support, and indeed, I feel this is the time to do it. You should permit it at a time when the speculators have forced the price up so high that it will not be a serious matter if it went up a bit further. It may in fact drop.

But the second is the question of the official price of gold. We have changed the official price of gold for the purpose of getting a change in the parity of the exchange rate. A massive rise in the price of gold will not serve that purpose because other countries won't stand still for a massive appreciation of their value of their currenty relative to the dollar. So it solves none of our basic problems to have a massive change in the price of gold, and, indeed, it might force us back into a very restrictive kind of international monetary system.

Senator JAVITS. Professor Cooper, you are the only other one writing on this.

I wonder how you felt on that.

Mr. COOPER. There is one problem which a rise in the price of gold might solve, and, that is, endow the United States with enough reserves to cover the outstanding balance. For that purpose, why stop at $80? Why not go to $150 or $200 an ounce?

I just think it is an absurd way to deal with this problem. We are capable of doing better than that, and I agree entirely with the statement of you and Congressman Reuss; it is an important nonferrous metal and ought to be——

Senator JAVITS. Ought to be treated that way?

Mr. COOPER. Yes, sir.

Senator JAVITS. We both have taken that position and are very glad you sustain it.

That sustains, too, the idea of ownership. If it is a metal why can't people own it quite freely in this country as in most others?

The last question I had went to Professor Cooper's idea that we ought to create what really amounts to an international central bank for central bankers.

Now, do you interpret the Shultz-Nixon presenation to the International Monetary Fund last fall as that kind of a proposal or is your difference further off, and while you are commenting, Professor Cooper, give us your comparison also with Professor Triffin's ideas on this same subject.

Mr. COOPER. I view the proposal I make here as being supplementary to the kind of things that Secretary Shultz has proposed. The U.S. proposal to the Committee of Twenty was aimed mainly at what is called in the jargon "the adjustment process," how to get better balance-of-payments adjustment.

I think it is correct to put the emphasis there.

My observation here is that even if we do as well as we can with the adjustment process, that will not alone suffice to permit the United States to restore some kind of reserve asset convertibility, which is strongly desired by other leading countries, because of the problem of large outstanding dollar balances. Therefore, we need improvements going beyond the adjustment process. My suggestion for creating a new facility at the IMF to be a lender of last resort to central banks is designed to fill out the program; as it were, to add this component to it, not to substitute for what the administration has proposed.

Now, you asked also how does it compare with the suggestions of my colleague, Robert Triffin. He has concentrated much of his attention on the problem of outstanding official dollar balances. As you know, he has made various proposals, all having a common theme that the official dollar balances must be consolidated in some way, preferably in the IMF, and that the reserve currency role of the dollar and, indeed, all national currencies should be very sharply curtailed.

In one particular proposal, for example, he suggests that countries not be allowed to carry any more than 15 percent of their total international reserves in foreign exchange. That is just an allowance for so-called working balances. Any dollars acquired above that would be fully converted into reserve assets, presumably SDR's.

What Professor Triffin leaves out of his analysis, and it seems to me vital, is the problem of private foreign holdings of dollars today. Private foreign holdings in marks, yen, Swiss francs, Dutch guilders, and other currencies are also growing, and, of course, British pounds are still widely used.

The internationalization, if you like, of these national currencies separates each country's balance-of-payments position from the international flows with respect to its own currency. We have seen that clearly in the past few weeks, when money moved from the Eurodollar market into Germany. This may have nothing to do with the U.S. balance-of-payments position, but it involves dollars. My suggestion is really designed to deal with that. and if we had a facility that was adequate to deal with the private dollar balances, it could, if we chose, also deal with the official dollar balances. In that respect it represents a possible substitute for the Triffin suggestion regarding consolidation of official balances, although it is not incompatible with

Triffin's proposal. But we could consolidate all official balances, and would still have the problem of private balances.

Senator JAVITS. Is there any member of the panel who wishes to comment otherwise?

Thank you very much.

Senator PROXMIRE. I would like to ask a couple of more questions.

First, I would like to just make a statement.

Mr. Cooper, you kind of wiped me out in pointing out what happened to Britain with their 1968 devaluation, that it worked very well, and I would point out that in that case. No. 1, Britain just clamped down in a way there is no intention in this country of doing. They held wages down. They deliberately created unemployment, so they could force domestic industry into export. We know we are not going to do that and, No. 2, there has been no analysis (1) again of the elasticity of demand for British exports, which I think was probably fairly substantial.

The analysis I have seen of the elasticity of demand for American exports indicates there is not much.

At any rate, I think there is such enormous difference, it is hard to draw an analogy from their success to our present experience.

I would like to ask one other question along the same line that we have all addressed with respect to Mr. Burns' testimony.

On Tuesday, Mr. Burns said we should bring our balance of payments into balance within 2 years. I questioned him on that.

I said balance of trade maybe, but he insisted he was talking about balance of payments in 2 years.

Now, I would love to see that done but it seems to me far too unrealistic unless we take action which might be highly undesirable and expect other countries to take action which it just seems to me would require a social revolution in Japan and perhaps in the Common Market.

How do you feel about that?

We have had this unfavorable balance of payments now since 1948 or 1949, and as we all know, it is not even very big lately.

Mr. KRAUSE. I think I have to ask you what definition of the balance of payments you are using.

Senator PROXMIRE. Liquidity.

We had a favorable balance on official settlements about 3 years ago. That is why the basis that we have is measured much longer.

Mr. KRAUSE. Either definition that includes the possibility of short-term capital inflow, which is a conceivable way in which our accounts will be balanced over the next couple of years, in view of the large outflow that has taken place, that may well be possible.

But as to the basic point of whether we should put a time dimension on how long we have to correct the disequilibrium, that I think I would be very hesitant to do.

I think the size of the disequilibrium is large and the faster you do it, the more likely you are to put intolerable pressures elsewhere in the system.

You do gain something by rather slow adjustment which goes on longer; after all, the disequilibrium was not created overnight and should, I think, not be corrected very quickly.

Senator PROXMIRE. Happy to hear that.

There has been a lot of stress on the unfairness and there is a lot undoubtedly to it, the unfairness of the Japanese and others in restricting importation of American goods.

But we had members of our staff of the Joint Economic Committee go to Japan last year; they had an interesting report.

In that report, they indicated there was a great deal of concern on the part of the Japanese of the serious failure on the part of our own exporters in this country, their deliveries are late; the quality of their deliveries often drops as soon as the U.S. market improves.

This is especially true as our economy begins to boom. They lose interest in what is going on in Japan. They lose interest in that market. The Japanese said we fail to adapt our products to their culture.

So this isn't a one-way operation, in their view. Maybe they are wrong; maybe they exaggerate the situation. But I suspect if we are going to have a booming economy over the next year or so, we are not going to increase our exports to Japan or use the kind of aggressive salesmanship many of us thought we were practicing.

Do you have any view on that?

Mr. KRAUSE. If those conditions exist, it will be ameliorated by the devaluation, since you will now be able to earn higher dollar profits on your exports, and there is nothing like profit to change a businessman's view of a market.

Senator PROXMIRE. Is 10 percent enough or 17 percent in the case of the yen?

Mr. KRAUSE. Seventeen percent is a tremendous margin as a percent of sales value. That is a very large margin and I would think it would be very attractive.

If you were exporting in the past, you are going to make tremendous gains from just maintaining that market, and I think you would push it a lot further.

Senator PROXMIRE. It can be tremendous depending on what you are talking about. We are not going to sell another jet, another 747 to Japan on this basis. They buy what they need, computers, the same.

Mr. KRAUSE. I think we can exaggerate the degree to which the U.S. exports are confined to high technology products.

Senator PROXMIRE. What else do we sell in a big way?

Mr. KRAUSE. There is a whole host of intermediary manufactured products that we sell, and they are not very exciting in terms of the consumer market, although, even there, there are American washing machines and refrigerators that one sees in Japanese department stores.

Senator PROXMIRE. You have to have, as I say, a kind of revolution in Japan of increasing their consumption in a substantial way, which seems unlikely, especially if they follow a policy of restricting their own exports.

Mr. KRAUSE. Well, just as there are cultural lags in the United States, there are those in Japan.

Recognizing that for 200 years they have been attuned to thinking themselves as a country without national resources, and must save every bit of imports they can. This gets built in throughout the culture and economic policy.

That has only changed in the last few years and they have taken a lot of policy action.

No doubt, they should take a lot more. But I am not pessimistic over their ability to change. Once they have made up their minds, they can move pretty rapidly.

Senator PROXMIRE. I just have one final question for Mr. Cooper.

At the time the devaluation was announced, there was a lot of speculation in the press by some economists of adverse reaction to phase III, feeling we were getting soft on wage and price controls in this country, and moving into an atmosphere in which our inflation would be worse.

I think that was greatly exaggerated. I don't think that is a big element.

If it was it was certainly irrational because our inflation is so much less than it is abroad. My question is: Would you recommend that the Congress try to stiffen phase III and provide for stronger controls than the administration is apparently putting into effect?

Thinking particularly of requiring advanced notice before prices are increased, for which there is no requirement in phase III, and advanced approval, which they don't require in phase III, and stiffer profit margin test which was applied in phase II, an effective enforcement staff, which has been reduced by 50 percent.

Do you feel Congress should write these changes into law, because we are writing this legislation and we will mark it up within a few days in the Senate?

Mr. COOPER. The whole question of price and wage controls in a most difficult one because, on the one hand, in a free economy they are offensive.

If controls are operative they inhibit the free play of market forces which by and large are healthy for the economy.

On the other hand, no modern economy has really found a way other than true engineered recession to cope with cost inflation and so that is really the dilemma:

I guess I would put my position this way, and say I regret it very much that this administration delayed as long as it did in moving in this area and then having once decided to move, in this area, it went much further than would have been necessary a few years before.

A kind of too much delay and then too much.

I suppose with everyone else we will come to relaxation but not to the point that it makes the problem worse and I think that something like, for example, advanced notification is a highly desirable feature.

I also think that wage guidelines, guidelines for wage settlements with some teeth to them are, without being absolutely rigid, are a desirable feature of modern——

Senator PROXMIRE. Advance notification, advance approval of substantial wage settlement?

Mr. COOPER. And of price increases in oligopolistic industries.

Senator PROXMIRE. I am going to ask Congressman Reuss if he would preside.

Representative REUSS (presiding). I will preside.

I shall be very brief, because the panel has been very patient. They have been here a long time.

I do want to get to Mr. Krause on the question which I asked of your two colleagues, which I will briefly recapitulate.

The question is this: Should the United States view it with displeasure and disquiet if an important trading partner persists in intervening in the exchange market to maintain an undervalued currency of its own and an overvalued dollar, in order that it may swell its exports to the United States?

Is that something that we should welcome or deplore?

Mr. KRAUSE. My response, Congressman Reuss, is very much along the same lines as Professor Cooper's. From a consumer point of view, I think it is highly desirable that they take those actions.

The problem that arises is that you don't have a guarantee that they will continue doing it.

There is no sustainability in it. In other words, Japan may well find themselves with an inflation one day, and they will not want to give their resources away, and they will then choose the time to adjust their exchange rates when it fits into their domestic economic policy, but that may be just the wrong time for the United States to adjust to it.

We may then have arrived at a point of full use of our resources and to have those resources cut off from abroad will be very inflationary.

If it was sustainable, I would endorse it, but it is not sustainable, and, therefore, we want to make the adjustments when it fits in with our domestic economic needs, that is, the way that we can make the adjustment with less pain.

Representative REUSS. Now, one final question of the panel, on the same subject.

It has been said by a member of the panel that if Japan or any other country wants to subsidize American consumers throughout all eternity by deliberately intervening so as to keep its currency undervalued and the dollar overvalued, and let us assume that in such a situation the U.S. Government could take appropriate methods to create other jobs to replace those that are lost in American factories. I still put it to you that all is not really so glorious, because while this is happening, during the years that a deliberate sharp balance of trade deficit by the United States and surplus by the other countries is acquiesced in, that other country's central bank ends up owning U.S. Treasury securities that pay 5 or 6 percent interest.

We find then ourselves owing vast sums not as a domestic debt from one American to an American, but from America to foreigners, and we have to pay interest on those debts.

Already the amount of liquid liability owed by the U.S. Government overseas, three-fourths of it to central banks, is something like $85 billion. That will go down some, but it won't go down below the amount that reflects the actual basic balance-of-payment deficits we have been suffering in recent years.

So, my question: Isn't there a real question of overindebtedness to foreigners, which should not concern just a few nuts but responsible people?

I am not going to ask you all to answer, but anybody who would like to respond.

Mr. COOPER. I can perhaps start anyway.

You point to a consequence which neither Mr. Krause nor I identified earlier. I had made the analogy to a cornucopia. But as you imply,

these are not gifts. We are really borrowing against the future because they collect our I O U's in exchange for the trade surplus that they are generating. Then the question one has to ask, still with the consumer orientation which Krause and I have adopted, whether this lending is not a good thing from the national point of view?

On the assumptions that you laid down; namely, this trade surplus will last, it is not likely to be cut off on short notice. I would have thought that being able to borrow from the rest of the world at U.S. Treasury bill rates, for long periods of time, is a good bargain. We can add to our capital stock; we can add to our social overhead, we can even add to our consumption to some extent. Given the high private rate of return on investment in the United States and presumably somewhat comparable rate of return on social overhead investment, while the problem you point to is an appropriate qualification to the argument we were putting earlier, it does not turn the argument around so long as interest rates are suitably low.

Representative REUSS. Well, before going on, Mr. Haberler, I think I have to say that I have the gravest doubts about the wisdom of loading up an interest-bearing debt on the American taxpayers which will have to be met, at least the interest will have to be met, by real resources, when we don't inquire what it is that we are importing. If we could import low income housing and a national health care program and a fine new sewage disposal works, I would say fine, let's con the rest of the world in grubstaking us to this.

But if we are going to import Mercedes, and Shawtumu enrole 1929, and colored television, and then you ask the average American wage earner to pay back that debt in years to come, or at least the interest on it, I can't believe that that is so glorious. I think we need to get microeconomic about it at this point, and see what in the world it is that we are importing.

Mr. COOPER. May I comment on that?

I understand what you are saying. It seems to me you are posing a choice which we face under the postulated circumstances. They are making resources available, whether they be in the form of heavy electrical machinery or colored television sets or Mercedes, they are making resources available. That means that we can run at a level of activity at full employment higher than we otherwise would in terms of our total consumption and investment expenditure on goods and services. Then it is up to us.

It has nothing to do with the Japanese at that point; it is up to us whether we choose to put in low-income housing or to buy automobiles. Indeed, it is the responsibility of the Congress in particular to determine how the Nation uses its available resources in a noninflationary way. That trade surplus of Japan becomes the counterpart deficit to us, and it relaxes the budget constraint for the country as a whole, permitting us, if we choose to take the opportunity, to put more into low-income housing without worrying about the inflationary consequences.

If we miss that opportunity, then we both might regret it. But we have to be clear where the responsibility lies. It is with us in America. It is not with Japan.

Representative REUSS. I shall have to review our colloquy and I am obviously confused, but as of the moment my point was that you can't

import low-income housing or health programs or a sewage disposal plant. Many of the things which you can import are, I suspect, luxury oriented and I really don't know why it is inevitably the part of wisdom to subsidize everybody's imports when we ought really to be inquiring what does this country need.

Mr. COOPER. I was taking perhaps too seriously the assumption which I thought you gave us, which is that we take the appropriate steps in this country to assure that full employment is maintained.

To put it concretely, if we import subsidized colored television sets we produce fewer colored television sets in this country. We release labor and capital resources in that way. We can take steps to assure that the released resources are employed.

How we choose to use those released resources is up to us. We could well use them for producing housing or for putting in sewers and so forth. It is not the goods that are important; it is the fact that resources are released for other uses under a policy of full employment, and we can use them in the ways which we choose. But all of this is somewhat hypothetical.

Representative REUSS. It is, and I am responsible for giving you this assumption about our ability to find full employment.

Things haven't worked out that way and I doubt that they will. It is my fault, not yours.

Mr. HABERLER. I fully agree with what Dick Cooper said and he said it so well, I really think I shouldn't add; the important thing is that the situation can last or not.

If it lasts, as Larry Krause pointed out, then it is good. If you assume that they may shift around, first export a lot and then stop it, that, of course, would be bad.

But I think this is an unrealistic assumption.

Only one more point: we talk about liquid liability, the liquid debt. We should not forget that we still invest abroad, on a net basis. The overall investment position, the American investment position has increased all the time. In 1 or 2 years there may be an exception, but overall we export more capital than we import and it is then an exchange of short-term against long-term capital, and we earn more on the long-term capital, on the direct investment than we pay on the short-term debt. So I think from this standpoint, it is a good thing.

Representative REUSS. Thank you very much, gentlemen. As always, you have contributed immeasurably to our learning on this committee, and we thank you very much.

We now stand in recess until 10 o'clock tomorrow morning in this place.

[Whereupon, at 1 p.m., the committee recessed, to reconvene at 10 a.m., Friday, February 23, 1973.]

APPENDIX

[The material in the appendix was printed in the context of the hearing day of Thursday, February 22, 1973]

PRICE COMPETITIVENESS IN EXPORT TRADE AMONG INDUSTRIAL COUNTRIES*†

(By Helen B. Junz, Board of Governors of the Federal Reserve System, and Rudolf R. Rhomberg, International Monetary Fund[1])

More than three years have passed since the revaluation of the German mark initiated a period of greater flexibility in exchange rates, and about one year since a new rate structure was agreed at the Smithsonian conference. Academic researchers and government officials everywhere are scrutinizing current trade data for signs indicating the effectiveness of the realignment, particularly any solid start toward reversals in the deficit of the United States or the surpluses of Japan, Germany, and Canada. The magnitude of the prospective total effect had been assessed largely on the assumtpion, unconfirmed by empirical work, that the response of trade flows to changes in the exchange rate would resemble that to changes in foreign trade prices in general; and the timing of the effect was almost pure guesswork.

It need hardly be emphasized that the question of the magnitude and the timepath of the response of trade flows to the realignment have come to be of eminent practical importance. Should the absence of a large equilibrating effect of recent changes in exchange rates on trade flows during 1972 be taken as an indication that the realignment was insufficient or merely that most of its effect is yet to come? Will 90 per cent of the total realignment effect have worked through by the second half of 1973, as is often alleged, or only by 1975 or even later?

In the present paper we try to contribute to the discussion of these topics by providing some empirical estimates of the time dimension of responses of export flows of manufactured goods among industrial countries to changes in relative prices and by testing whether these responses are significantly different if changes in relative prices are brought about by alterations in exchange rates or by changes in export prices measured in national currencies. We do not, however, attempt a full analysis of what is generally called "competitiveness." Variation of relative prices is only one of the determinants of export market shares—the basic element in our analysis—and, furthermore, changes in these shares cannot, by themselves, serve as an adequate indicator of a country's external competitiveness.

As to the timing of trade effects, collective wisdom, based mainly on intuition rather than empirical study, put the time it would take for most of the effects of the Smithsonian realignment to work through at somewhere between eighteen months and two years. However, there are reasons why one might expect the adjustment to take longer than that. This becomes clear when the overall delay in the response is decomposed into various elements. First, there is a *recognition* lag: it takes time for buyers and sellers to become aware of the changed competitive situation, and this delay may be rather longer in international than in domestic trade because of language and distance obstacles to the spreading of information. Second, there is a *decision* lag: it takes time for new business

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*This paper was presented at the Annual Meeting of the American Economic Association in Toronto, December 28–30, 1972. It forms part of a larger study on the role of prices in export trade among industrial countries.

†The authors wish to thank their colleagues at the Federal Reserve Board and the International Monetary Fund for helpful comments and acknowledge in particular the contributions of Anne McGuirk who wrote the computer programs and supervised the collection of the trade data and of Josephine Bertelsen, Edna Harris, and Deborah Hunt who collected the trade and price data.

[1] The copyright material in this paper was printed with the kind consent of the authors.

connections to be formed and new orders to be placed. Third, there is a *delivery* lag: even if import orders are placed soon after the change in relative prices has occurred, published trade flows—and, ordinarily, payments—will respond only when the goods are delivered: this may vary from a few months after orders are placed, e.g., for certain consumer goods, to a few years for electrical generating equipment. Fourth, there may be a *replacement* lag: in some instances, inventories of materials must be used up or equipment allowed to wear out before any new materials or equipment can be bought. Fifth, there is a *production* lag: producers have to become convinced that a profit opportunity which they perceive in certain markets is sufficiently large and permanent to warrant the expense and effort of shifting from supplying one market to supplying another or of adding capacity in order to supply the additional market; the extreme case in this category would be a supplier deciding to manufacture a new product line or reactivate an abandoned line because of new market opportunities created by price and cost changes.

Reflection on these various lags makes it plausible to think of the overall lag of trade flows behind price changes to be properly measured in terms of years rather than quarters. In fact, in an earlier study [2] we found that longer-run elasticities of substitution were higher than short-run ones and that the explanatory power of the price variable also rose when longer unit periods of observation were used. In part, this might be so because a certain amount of random variation disappears when data are averaged over longer periods, but these results also indicate that exploration of longer time lags might be fruitful.

As to the response to exchange rate changes compared with that to other relative cost changes, the generally larger size of par value changes and the publicity that attaches to them argues for a more immediate response than that to price changes in general. On the other hand, if par value changes are undertaken—as they have tended to be—to correct large disequilibria which have cumulated over some period of time, relatively large resources shifts with a correspondingly long response time may be required. These two factors could well offset each other, so that reactions to exchange rate changes might appear neither faster and stronger nor slower and feebler than reactions to price changes measured in national currencies. Although this need not be true in the short run, the homogeneity assumption made in economic theory argue that the long-run response to par-value changes, other things being equal, should not differ from that to relative price changes in general.

Approach. In order to explore the two questions raised—that of the timing of the effects of relative price changes on export flows and that of any differential response to different types of price changes—two kinds of calculation were performed. In the first, proportionate changes in market shares were related to proportionate changes in relative export prices. This yields a price elasticity of market shares, a concept that is akin to, though not identical with, the elasticity of substitution. In the second calculation, proportionate deviations of exports from a standard set by previously attained market shares are related to proportionate changes in export prices. This furnishes price elasticity of exports at a given size of export markets. Such an elasticity should be expected to be somewhat lower than the true partial price elasticity of exports since it leaves out of account any effect of a change in the price of exports on countries' imports, that is, on the size of export markets available to all exporting countries together.

Both calculations take the level of demand for exports from all supplying countries as given and concentrate on the role played by export prices in determining its division among competing exporter countries. The effects of changes in economic activity, domestic prices, inventories, and a number of other factors affecting the demand for imports need not be taken into account separately since they are implicit in the measure of market size. However, this procedure cannot eliminate the effects that variation in income may have on the commodity composition of demand. To the extent that a market comprises goods with markedly different income elasticities of demand, changes in economic activity may well influence the market shares of supplying countries producing different goods. In order to minimize these possible distorting effects, some of the share calculations reported below use data for 18 separate commodity groups. In a further attempt to reduce the effects of both cyclical and random fluctuations, all calculations were repeated with the dependent and independent variables

[2] H. B. Junz and R. R. Rhomberg, "Prices and Export Performance of Industrial Countries, 1953–63," *IMF Staff Papers*, July 1965, 12, 224–271.

averaged over longer periods of time, namely, over periods of two, three, or four years in length.

The number of annual observations available is small for calculation of the two types of elasticity from time series alone, especially when it is intended to test for lags of several years in the response of export performance behind price changes. By postulating that the relevant elasticities are constant as between markets or exporting countries, or both, as well as over time, calculations utilizing observations pertaining to all exporters, markets, and years can usefully be made.[3] Comparison of results obtained with subsets of this sample can give some indication about the degree to which the postulate of uniformly constant elasticities is justified. This postulate is supported by the finding in our earlier study that the elasticities do not seem to vary by size of market share, although this test was not repeated with the present data.

Since true price indices for manufactured exports are not available for most countries, unit value indices were used as the explanatory price variable. In view of their well-known shortcomings, some of the calculations were repeated with "export-weighted wholesale prices", for which components of wholesale price indices were recombined with weights corresponding to the shares of various commodity groups in the total trade of the industrial countries. The purpose here was to test, first, whether these price indicators are more satisfactory than unit value indices and, second, whether they performed at least sufficiently well to justify their use in connection with export data disaggregated by commodity, for which unit values are not generally available.

To measure the changes in relative prices of exports in a particular market, each country's price index (be it unit value or export-weighted wholeslae price) was divided by the weighted average of the price indices of all exporters, with their shares in that market in the preceding year taken as weights. There may be considerable variation in this index for any particular country across markets if that country faces different competitors in different markets and if price movements diverge among suppliers.

A better approximation of changes in dollar unit values to actual price changes was sought by adjusting the unit value index for the deviation of the spot exchange rate from the par value. This was done on the assumption that for statistical purposes most trade values are converted into dollars at par and that, therefore, price variations arising from fluctuations of the exchange rate around par are not reflected in the published unit value indices. Lack of data precluded a corresponding adjustment for the cost of forward cover. Tests with adjusted and unadjusted indices suggested the use of the former.

In our previous study, export values were deflated by unit value indices and the resulting export volume data used in most computations. The present study, by contrast, uses mostly the original export value data. Market shares are therefore measured in value terms, except where noted otherwise. It should be remembered that elasticities of value shares with respect to concurrent price changes are algebraically greater by unity than the corresponding elasticities of volume shares. However, value and volume elasticities with respect to lagged price changes do not differ.

Results. Selected results of the calculations yielding price elasticities of market shares are shown in Table 1. Lags of changes in market shares behind changes in prices of up to five years were explored. When annual periods are used, the total number of percentage changes in market shares is 1859—corresponding to 11 percentage changes for 1958–69 (allowing for 5 lags in price data going back to 1953) for 13 exporting countries in 13 markets. In six simple regression equations under A of Table 1, percentage changes in market shares are related, alternatively, to concurrent and lagged percentage changes in relative prices.. All regression coefficients are statistically significant at the 95 per cent confidence level, but the proportion of statistical explanation achieved, as measured by the coefficients of determination, is very low. Changes in value shares seem to be

[3] The data, taken from publications by the Organization of Economic Cooperation and Development (OECD) and the United Nations (UN) and from OECD trade data tapes, comprise annual exports of manufactures of 13 industrial countries to 14 industrial markets for the period 1953–69. The 13 exporting countries are Austria, Belgium-Luxembourg, Canada, Denmark, France, the Federal Republic of Germany, Italy, Japan, the Netherlands, Norway, Sweden, the United Kingdom, and the United States. Switzerland could not be included because data are incomplete, but it is used as an additional market for the exports of the 13 exporting countries included in the study. Exports of manufactured goods are defined to include Standard Industrial Classification (SITC) sections 5–8 of the revised United Nations Code.

related more closely to price changes three years earlier than to those occurring at any other time.

Since it is less important to choose a single optimal time lag than to obtain a notion of the whole time profile of the expected adjustment, price elasticities of market shares were estimated simultaneously for all lags from zero to five years (B of Table 1). Three of the six elasticities are statistically significant, those corresponding to the unlagged price and to lags of two and three years. Here, too, the level of explanation of changes in market shares is very low, 2.2 per cent. However, the lag pattern seems plausible: from a concurrent value elasticity of −0.5 the response declines at first, but it rises again to a peak of −1.0 in the third year before falling off for the longer lags. One should expect some immediate response to a relative price change, particularly as measured in unit values (which represent delivery rather than contract prices) for items that are produced quickly and are relatively homogeneous across suppliers. For many other goods one would expect lags of more than one year in the adjustment of buyers and suppliers to the changed price situation. The effect over the long run of price changes on value market shares is measured by the sum of the estimated yearly elasticities, —2.88. The long-run elasticity of market shares defined in volume terms is, therefore, —3.88.

TABLE 1.—AVERAGE "PRICE" ELASTICITIES OF MARKET SHARES IN MANUFACTURED EXPORTS OF 13 INDUSTRIAL COUNTRIES [1]

	Lag of market shares behind "price" variable (in years)					
	0	1	2	3	4	5
Annual percentage changes (1859 observations):						
A. 6 simple regressions with indicated lags:						
Unit-value elasticity	−0.75	−0.55	−0.83	−1.21	−0.52	−0.46
t ratio	(3.3)	(2.4)	(3.5)	(5.4)	(2.3)	(2.1)
$\bar{R}^2$	.005	.003	.006	.015	.002	.002
B. 1 multiple regression with all lagged unit-value terms included: [2]						
Unit-value elasticity	−.52	−.29	−.58	−.98	−.24	−.27
t ratio	(2.2)	(1.2)	(2.4)	(4.2)	(1.0)	(1.2)
3-year percentage changes (507 observations):						
C. 6 simple regressions with indicated lags:						
Unit-value elasticity	−1.10	−1.42	−1.59	−1.78	−1.81	−1.58
t ratio	(3.8)	(5.0)	(6.1)	(7.0)	(7.3)	(6.9)
$\bar{R}^2$	.026	.045	.067	.087	.095	.084
D. 6 multiple regressions with unit values split into exchange-rate and local-currency components; indicated lags:						
Exchange-rate elasticity	+.14	−.86	−1.43	−1.70	−1.71	−1.35
t ratio	(0.3)	(1.9)	(4.1)	(5.0)	(4.8)	(4.1)
Local-price elasticity [3]	−1.47	−1.48	−1.73	−1.90	−1.87	−1.70
t ratio	(4.8)	(5.2)	(6.3)	(7.1)	(7.4)	(7.2)
$\bar{R}^2$	.048	.048	.070	.090	.095	.098

[1] All industrial countries other than Switzerland. Shares in 14 industrial markets (including Switzerland) are calculated for the 12 years, and the 4 3-year periods, 1958–69; there are thus 11 annual and 3 3-year percentage changes in 13 market shares for each of the 13 exporting countries. The price variable is based on export unit values.

[2] The constant term is 0.019 with a t ratio of 3.2; $\bar{R}^2$ is 0.022. The sum of the 6 elasticities, −2.88, indicates the long-run elasticity of market shares in value terms with respect to changes in unit values. The corresponding elasticity of market shares in volume terms would be −3.88.

[3] The local-currency price index is calculated by dividing the unit-value index by the exchange rate index.

The fact that the explanatory power of the price variable is rather low does not detract from the results to any appreciable extent. Although random fluctuations in the annual changes apparently swamp the systematic relationship being explored, the latter is nevertheless statistically significant. Moreover, a large number of pooled observations in the form of percentage changes would tend to yield a $\bar{R}^2$. For both these reasons the extent to which price changes explain changes in market shares is increased when longer unit periods are chosen. Under C the equations shown under A are repeated with three-year averages (507 observations). The coefficient of determination is highest when market shares are lagged behind prices by three to five years, with a peak for the four-year lag. In this case almost 10 per cent of the variation in market shares is explained by relative price movements. The estimated price elasticity for either a three-year or four-year lag is about —1.8.

Under D, these calculations are repeated with the price variable split into two parts: the relative exchange rate and the relative variation in prices measured in national currencies. At least for the three and four-year lags, the response to price changes seems to have been the same however these changes came about. The national currency price elasticity is statistically significant throughout. The relative exchange rate variable becomes significant only when lagged by two years or more. This pattern, confirmed by other calculations not shown in the table, may reflect the fact, discussed above, that the explanatory price variable represents delivery rather than contract prices. This is particularly important for par-value changes, when splitting unit values into local-currency and exchange-rate changes tends to give too much weight to the exchange rate component in the concurrent year.

In the second type of calculation, the variable to be explained by relative price changes is the deviation of a country's exports from what it would have achieved if its shares in all markets had remained constant from the preceding unit period to the current one. The data are pooled over all exporting countries and time periods, so that 65 observations are available when a two-year unit period is used and 26 observations when a four-year unit period is used. Market shares are assumed to be constant alternatively in value terms and in volume terms. For the value equations, deviations of exports from the constant share assumption are calculated for each of 18 commodity groups and these excesses and shortfalls are then summed. For the volume equations, disaggregation by commodity group was not possible since unit values are available only for total exports of manufactured goods. Tests using export-weighted wholesale prices for this purpose still need to be made.

In these calculations, prices explain deviations of exports from constant market shares to a rather high degree, 20 per cent for the two-year averages and around 40 per cent for the calculations with four-year averages (Table 2). The implied price elasticity of exports (in value terms) lies mostly between —1 and —1.5 and between —2 and —3, for the respective sets of estimates.

TABLE 2.—AVERAGE "PRICE" ELASTICITIES OF MANUFACTURED EXPORTS OF 13 INDUSTRIAL COUNTRIES [1]

	Lag of exports behind "price" variable (in years)					
	0	1	2	3	4	5
2-year averages (65 observations):						
Value of exports:[2]						
Unit-value elasticity	−0.75	−0.90	−1.43	−1.16	−1.41	−0.98
t ratio	(2.0)	(2.9)	(4.4)	(3.9)	(5.0)	(3.6)
$\bar{R}^2$	.045	.106	.226	.185	.272	.160
Volume of exports:[3]						
Unit-value elasticity	−1.93	−1.70	−1.85	−1.26	−1.74	−1.36
t ratio	(4.6)	(4.8)	(4.6)	(3.3)	(4.8)	(4.0)
$\bar{R}^2$	.237	.256	.236	.133	.259	.193
4-year averages (26 observations):						
Value of exports:[2]						
Unit-value elasticity	−2.84	−2.79	−2.53	−1.97	−2.26	−2.24
t ratio	(3.7)	(4.6)	(4.5)	(3.8)	(4.4)	(4.2)
$\bar{R}^2$	.337	.444	.431	.353	.418	.394
Volume of exports:[3]						
Unit-value elasticity	−4.26	−3.75	−3.07	−2.33	−2.64	−2.70
t ratio	(4.4)	(4.5)	(3.7)	(3.1)	(3.4)	(3.4)
$\bar{R}^2$	.420	.433	.335	.256	.298	.302

[1] The dependent variable is the percentage deviation of actual exports from those that would have been achieved if market shares had been maintained at the average of the 2 or 4 preceding years, respectively. The independent variable is the percentage change in relative unit values either unlagged or, alternatively, lagged by 1, 2, 3, 4, or 5 years.

[2] Constant shares exports in value terms are calculated by 18 commodity groups and then aggregated.

[3] The volume of exports is derived from value figures by deflating them with the unit-value index. Constant shares exports in volume terms are calculated for manufactures taken as a single commodity.

These results, also, do not show as clear an indication of the time profile as was obtained in the year-to-year calculations. When two-year averages are used, a lag of four years appears best, but only marginally better than a two-year lag. With four-year averages, the various lags are even less distinguishable. These results nevertheless confirm the hypothesis that the lag structure attaching to the response of trade flows to relative price changes is rather longer than the

18 months often postulated. By averaging prices over longer time periods, a certain average lag is already built into the relation. Price changes at the beginning of any unit period will affect share changes at the end of it, so that even the concurrent price variable implies an average lag of half a unit period. Therefore, the lag structure deriving from these equations is not really comparable with that reported for year-to-year changes. It clearly would be useful to repeat these particular equations with the same dependent variables but with concurrent and lagged price variables for single years as independent variables so as to obtain further confirmation of the time profile found in the single year equations.

The calculations made in volume terms generally confirm those in value terms. However, there is some reason to put somewhat more reliance on the computations in value terms because in these equations it was possible to abstract to some degree from short-term changes in the structure of demand—that is, changes associated with fluctuations in economic activity—by stipulating that market shares be constant not only for manufactured exports in the aggregate but also for each of 18 different commodity groups.

Results obtained for the calculations with export-weighted wholesale prices are not shown separately. They tended to confirm those derived from unit values and, from a statistical point of view, were not more conclusive than those discussed above. Therefore, the wholesale price proxy for export price movements is not likely to be a generally better indicator than that derived from unit values. However, results were much better than those obtained in the earlier study with raw wholesale price indices. In fact, they were sufficiently satisfactory to warrant the use of export-weighted wholesale prices in statistical experiments with disaggregated commodity groups.

Conclusions. The response of trade flows to relative price changes quite clearly seems to stretch out over a rather longer period than has generally been assumed, perhaps around four to five years. Almost 50 per cent of the full effect appears to work through during the first three years, and about 90 per cent during the first five years, following a price change.

Separation of the exchange rate change component from the price change in local currency shows in general that, after an initial "perverse" effect, the response to exchange rate changes is very similar to the response to price changes measured in local currency.

Of course, there is considerable uncertainty as to how these results might apply to a particular country or in particular circumstances. Still, they indicate that a large part of the response of export flows of manufactured goods to the exchange rate changes of 1969–1971 may occur only in 1974 and later, and 90 per cent of the full effect may not be realized before 1976.

Basic Facts Concerning Needed Reforms of Both the Adjustment Mechanism and the Process of Reserve Creation

(By Robert Triffin)

The accompanying table should make it crystal-clear that some agreed limitation on the untrammeled use of reserve currencies in international settlements and reserve accumulation is a vital prerequisite to the correction of the major shortcoming, by far, of the *adjustment mechanism* as well as of the process of *reserve creation.*

I. THE ADJUSTMENT MECHANISM

The huge surpluses accumulated since 1949, and particularly in the last three years, by countries other than the United States (line I B) were fed overwhelmingly by recorded (line I A) and unrecorded (about half of line I C) U.S. deficits.[1] These deficits, and the corresponding surpluses of other countries, could never have been sustained for so long and on such a scale if the bulk of them (4/5 for the period as a whole, and 9/10 in the last three years) had not been financed by the willingness of foreign countries to accept U.S. liabilities as monetary reserves rather than accept the need for a readjustment in their own and in U.S. policies and/or exchange rates.

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[1] Approximately equal, by the way, to the $75 billion increase of U.S. direct investments abroad from the end of 1949 ($11 billion) to the end of 1971 ($86 billion).

II. THE PROCESS OF RESERVE CREATION

Gross reserves, as reported by the I.M.F., have about *doubled* for the world as a whole, and more than doubled for countries other than the United States from the end of 1969 through September 1972. That is to say, *they have increased as much in less than three years as in all previous years and centuries.*

This reflected essentially their flooding by "reserve currencies," whose holdings *tripled*, and particularly by recorded official U.S. liabilities and unallocated foreign exchange reserves—largely Euro-dollars—both of which nearly *quadrupled* over this less than 3 year period.

Even over the longer run (from the end of 1949 through last September), the $105.5 billion increase in world reserves was overwhelmingly derived (84%) from the accumulation of *national* reserve currencies as *international* reserves ($85.6 billion) and the devaluation of the dollar ($3.5 billion), less than 10% ($10.0 billion) by concerted reserve creation through SDR allocations and other I.M.F., E.F. and B.I.S. credits, and only about 6% ($6.4 billion) by physical increases in monetary gold stocks (see penultimate column of accompanying table).

SOURCES AND DISTRIBUTION OF WORLD MONETARY RESERVES, 1949-72

[In billions of U.S. dollars]

	End of—			Changes—	
	1949	1969	September 1972	1950-September 1972	1970 September 1972
I. World gold=net reserves of	35.0	41.0	[2] 44.9	+[2] 9.9	+[2] 3.9
A. United States	22.7	-.1	-49.3	-72.0	-49.2
1. Assets	26.0	17.0	13.2	-12.8	-3.8
2. Liabilities (-)	-3.4	-17.0	-62.5	-59.3	-45.5
B. Other countries	12.4	47.9	121.2	+108.8	+73.3
1. Assets	19.5	61.2	137.7	+118.2	+76.5
2. Liabilities (-)	-7.1	-13.4	-16.6	-9.5	-3.2
C. Undetermined [1]	-.1	-6.8	-26.9	-26.8	-20.1
II. Credit reserves=(IAZ+IBZ+IC)	10.5	37.2	106.0	+95.5	+68.8
A. Reserve currencies	10.4	32.4	96.0	+85.6	+63.6
B. SDR's			[3] 10.1	+[3] 10.1	+[3] 10.1
C. IMF, EF, and BIS credits	.1	4.8		-.1	-4.8
III. Gross reserves (I+II)=(IA1+IB1)	54.5	78.2	151.0	+105.5	+72.8

[1] Undistributed I.M.F. profits, minus unallocated reserve liabilities, about half of which (44 percent at the end of 1971) are estimated to be U.S. liabilities.
[2] Of which $3,500,000,000 from the dollar devaluation, rather than from physical increases in monetary gold stocks.
[3] Of which $800,000,000 from the devaluation of the dollar.

Source: Calculated from International Financial Statistics' tables on International Reserves.

PROSPECTS FOR INTERNATIONAL MONETARY REFORM

(By Robert Triffin, Frederick William Beinecke Professor of Economics, Yale University)

SUMMARY

Prospects for agreement on international monetary reform brightened conisderably at the Annual I.M.F. meeting, last September, and the meeting of the Deputies of the newly formed Committee of 20, on November 28-29, in Washington. There now is reason to hope that a so-called "outline" agreement might be ready by the next I.M.F. meeting, in September 1973, in Nairobi. Yet, this agreement is nearly certain to leave unresolved some crucial issues and to require still a time-consuming process for finalization and ratification.

In the meantime, a number of dollar crises should be anticipated, not only as a result of continuing—even though hopefully tapering-off—U.S. deficits, but

also whenever any other country—like the United Kingdom, last summer—settles its own deficits with previously accumulated dollars. The central banks of surplus countries will continue to face the unpleasant choice of *either* redeeming from the exchange markets these inflationary dollar overflows, *or* to let their own currency appreciate, *or* to adopt some compromise combination of these unpleasant policies.

Momentous developments should also be expected within the next year or two in the initial stages of the European Economic Union called for by the Paris Summit Meeting, last October. These developments cannot fail to play a major role in the shaping of the international monetary system and of the worldwide reforms still to be negotiated.

AN EMERGING CONSENSUS

The icy climate surrounding the negotiations thawed perceptibly at the I.M.F. meeting, following an unexpectedly conciliatory and constructive speech by Secretary Schultz, in sharp contrast with the bullying tactics of his predecessor. While still insisting on the link between monetary reform and "related negotiations", particularly on trade matters, he recognized that monetary reform need *not* await the results of specific trade negotiations. He also expressed encouragement—rather than suspicion—toward the European program for monetary union, saying that "For countries moving toward a monetary union, the guidelines [about the balance-of-payments adjustment process] might be applied on a collective basis, provided the countries were willing to speak with one voice and to be treated as a unit for purposes of applying the basic rules of the international monetary and trading system."

This new U.S. attitude elicited an equally conciliatory and constructive speech from the French Minister of Finance. Giscard d'Estaing proposed indeed a negotiating time-table that would maximize the chances for initial agreements and leave to later stages the negotiation of the most decisive issues:

(1) "At our meeting in Nairobi we should finalize our agreement on the exchange-rate mechanisms and on the specific monetary arrangements in favor of the developing nations."

(2) "In a second stage [i.e., *after* Nairobi] the restoration of the convertibility of currencies could be brought about."

(3) The status of gold in the future monetary system would be taken up only in "the third stage" of the negotiations.

Such a time-table dovetailed completely with the priority given by Secretary Schultz in the balance-of-payments adjustment process and with the U.S. reluctance to restore dollar convertibility until our own blance of payments is in better shape. Finally, it relegated to the third stage of the negotiations the gold issue in which French views have clashed most resoundingly in the past with those of the United States and of most other I.M.F. members.

Other governors also recognized the need for improvements in the adjustment process and for the role of exchange-rates in this process whenever national governments are unwilling to adopt, or unable to implement, a sufficient coordination of their internal budgetary, fiscal and credit policies. Equal stress, however, was placed on the need to reform the settlement and reserve system, in which the primary role should be assumed by an SDR type of asset, while the role of national reserve currencies—overwhelmingly the U.S. dollar—should be gradually confined to the level of working balances needed by central banks for their interventions in the exchange market. Convertibility should be defined in terms of SDR's, rather than gold, and the restoration of dollar, and sterling, convertibility would require the substitution of some modified SDR's for outstanding reserve currency holdings inherited from the past and in excess of necessary working balances.

Finally, considerable stress was placed by a number of governors on a revision of the present system of SDR allocations, and particularly on the possibility of establishing a "link" betwen SDR creation and development aid.

The favorable negotiating climate developed at the I.M.F. meeting was fully preserved at the first meeting of the Deputies of the Committee of 20, on November 28–29, in Washington. Its Chairman, Mr. Morse, succeeded beyond all hopes in organizing in an efficient manner the debates of this unwieldy gathering of more than 140 people from several scores of nationalities. The most ambitious and comprehensive paper offered for discussion was a remarkably blunt and detailed U.S. memorandum on the mechanism of adjustment.

THE MAIN ISSUES

The main issues in the current negotiation may be summarized under four headings:

1. The acceleration of the adjustment process;
2. The composition of reserves and settlements;
3. The future allocation of SDR's;
4. Controls over destabilizing movements of—primarily short-term—capital.

1. The Adjustment Process

The U.S. stresses that agrement on the process of adjustment is an indispensable prerequisite to the successful implementation of the institutional rules to be adopted regarding the restoration of any form of convertibility and the nature of the assets available and acceptable for settlements and reserve accumulation.

The basic U.S. proposal espouses fully the "fork" proposal which I first outlined briefly in an article for *Foreign Affairs*, three and a half years ago, and developed more fully in a number of other publications.[1] In brief, it suggests that reserve fluctuations—up or down—may be properly used to defend exchange-rate stability in the face of temporary balance-of-payments disequilibria, but not to frustrate needed adaptations in the case of *persistent* surpluses or deficits. International I.M.F. consultations should be triggered by any substantial (e.g., 25%?) increases or decreases of reserves above or below "normal" levels. Even then, changes in internal policies may be diagnosed as a more appropriate solution than exchange-rate changes, if the disequilibria can be ascribed to erroneous "demand policies", or interest-rates, rather than to basic cost and price disparities. The "burden of the proof", however, should be placed on the persistent surplus or deficit country. If it is unwilling, or unable, to adopt and implement alternative internal adjustment policies, it could be enjoined by the Fund from market interventions having the effect of pushing its reserves further away from "normal" levels (e.g., by 33%?). Alternatively, its interventions might be limited either in absolute amounts, or to whatever amounts would be necessary to smooth out exchange-rate changes to a "crawl" rather than to a sudden "jump". In any case, persistent surplus or deficit countries would no longer be free to intervene without limit in the market in defense of an overcompetitive or undercompetitive exchange-rate.

Agreement should—and is not unlikely to be—reached on a formula of this sort, but it leaves a number of questions open to debate.

For instance, many countries suspect the United States to be primarily concerned to force upvaluation upon persistent surplus countries, so as to ease its responsibility to correct its own huge deficits. They point out that the breakdown of the international monetary system was essentially the result of U.S. deficits which could be sustained for so long, and on such a scale, only because of the reserve currency role of the dollar enabled the U.S. to setle only a fraction of these deficits through asset losses, and to finance most—and recently partically all—of them through a continuing piling up of dollar claims as reserves by foreign central banks. The problem of adjustment disciplines is thus viewed as inseparable from a reform eliminating what President De Gaulle used to call the unique and "exorbitant privilege" of reserve currencies countries to encur unlimited deficits by being able to settle them with their own IOU's.

2. The Composition of Reserves and Settlements.

(*a*) *Reserve Accounts with the I.M.F.*

Summetry in the adjustment process thus requires a strict limitation in the use of *national* currencies in the *international* settlements and reserve system. This is interpreted by a few Colonel Blimps as dictating a return to a mythical pure gold standard, in which gold would replace reserve currencies in these functions. President De Gaulle himslef, however, recognized that an "international credit superstructure"—no longer monopolized by the dollar alone—was needed to complement gold in this respect, and Giscard d'Estaing has repeatedly argued

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[1] See particularly:
A. "The Thrust of History in International Monetary Reform", *Foreign Affairs*, April 1969, p. 490.
B. *The International Adjustment Mechanism*, Federal Reserve Bank of Boston, 1969, p. 61.
C. "International Monetary Collapse and Reconstitution", *Journal of International Economics*, September 1972, pp. 391–393.

that "an increasing role should be given to what I shall call 'objective liquidities', such as SDR's."

A large consensus has emerged in the official debates of the last few years on the need to center the international settlements and reserve system upon reserve accounts with the I.M.F.—broadly patterned upon the present SDR's—adjustable in amounts to the objective reserve requirements of an expanding world economy. Central banks would use such reserve accounts in settlements very much in the same way as private firms and individuals use their checking account with a commercial bank in their settlements. The payer's reserve account with the I.M.F. would be credited, and the reserve account of the payee debited, by the amount to be settled. The acceptance and maintenance of such deposit accounts with the Fund would, in turn, enable it to expand its credit and investment operations in such a way as to adjust the world reserve pool to the requirements of an expanding world economy (*i.e.*, probably at a presumptive 4 or 5% *average* annual rate, to be reviewed—and corrected—from time to time, when needed to combat worldwide inflationary or deflationary trends).

This consensus on the role of a reformed SDR system, however, is still marred by divergent views concernig the gradual "phasing out" of the traditional reserve instruments inherited from the past, i.e. gold and the national reserve currencies.

(*b*) *Gold.*

The use of gold in official settlements is practically paralyzed at the moment by the huge discrepancy between its market price (hovering above $60 an ounce) and its official parity ($38 an ounce). In view of the definitional link between gold, on the one hand, and SDR and I.M.F. transactions on the other, this discrepancy also makes member countries reluctant to incur gold-guaranteed obligations by using their special, or ordinary, drawing rights.

A first step, around which agreement seems probable, would be to review the Washington agreement of March 1968, and to revert to Article IV, Section 2 of the I.M.F. Articles of Agreement. Members would remain barred from buying, but *no longer from selling*, gold in the private market at prices above par value plus the margins prescribed by the Fund.

A second step would be to amend the Articles of Agreement so as to authorize official gold transactions between monetary authorities—including the I.M.F.—at current market prices. Gold would become a commodity, like any other, but would cease o be "monetized" in the future by *purchases* from the private market. Monetary authorities, on the other hand, would be free to mobilize their huge gold stocks, at realistic prices, by *selling* it to the market, to each other, or to the Fund, whenever they wish or need to do so in order to mop up excess liquidities in the market, or to procure SDR's or foreign currencies for the settlement of their deficits.

(*c*) *Reserve Currencies.*

As long as SDR's or I.M.F. accounts canot be held by private banks, firms and individuals, it will remain ecessary for central banks to use some reserve currency or currencies for their stabilization interventions in the private exchange market. Such use, however, should be limited to the modest working balances needed for this purpose. Otherwise, the untrammelled accumulation of *national* reserve currencies as *international* reserves could, once more, frustrate at their very roots, both the adjustment mechanism and the efforts to adjust world reserve creation to world needs rather than to the balance-of-payments deficits of one of a few reserve currency countries. Agreement on this point was expressed by many governors—notably the British Chancellor of the Exchequer—at the last two I.M.F. meetings. Acquisitions of national currencies from the market exceeding agreed working balances (5% of anual imports, or 15% of global reserves?) would be turned over to the I.M.F., credited to the reserve account of the depositor, and debited from the reserve account of the debtor. Conversely, any deficit country could draw any needed currencies from its I.M.F. account to reconstitute its depleted working balances.

It is also agreed that such a system could only be applied to reserve currencies accumulated in the future. All or most of the huge "overhang" of dollar—and sterling—claims inherited from the past, could not be debited overnight from the U.S.—or U.K.—account, but would have to be retained by the I.M.F. as long-term investments, or even "consols," to be amortized primarily at the initiative of the debtor country, or at the request of the Fund, when the reserves of that country rise well above "normal" levels.

Such a semi-consolidation would be essential—and, to my mind, urgent—to make a restoration of dollar convertibility possible, and particuarly to enable the U.S. to earn reserve assets when in surplus, and to lose reserve assets only when in deficit. Under the system now in operation, U.S. surpluses may be settled through a reduction of U.S. liabilities without any gain of reserve assets. Even more significant is the fact that the U.S. is exposed to reserve losses whenever any *other* country draws on its dollar "overhang" to settle deficits with a country which then presents the dollars to the U.S. for settlement.

Such proposals have long been advanced by various I.M.F. Governors and, at the last annual meeting of the I.M.F., Secretary Shultz finally acquiesced that "careful study should be given to proposals for exchanging part of existing reserve holdings into a special issue of SDR, at the option of the holder."

The last clause ("at the option of the holder") expresses, however, an important qualification, especially in the light of the preceding sentences: "At the same time, official foreign currency holdings need be neither generally banned nor encouraged. Some countries may find holdings of foreign currencies provide a useful margin of flexibility in reserve management, and fluctuations in such holdings can provide some elasticity for the system as a whole in meeting sudden flows of volatile capital." This may well be true, and it is extremely likely indeed that some countries may wish to become, or remain, members of a more or less formally defined "dollar area". At the same time, the unregulated and unlimited use of reserve currencies would continue to frustrate the basic objectives of international monetary reform, and remain the source of crises similar to those that were mainly responsible for the collapse of the previous system. Acceptable compromises on this point will not be easy to hammer out, but must—as a minimum—entail reasonable limitations on the use of national reserve currencies, particularly by large reserve holders.

3. The Future Allocation of SDR's.

Agreement is also likely to emerge about a needed revision of the present system of SDR allocations, which now allots about ¾ of them to the 25 richest, developed, countries, and only ¼ to 88 countries of the so-called third world. Even more absurd is the fact that SDR creation is used to finance blindly all national policies, whether readjusting or maladjusting.

Ideally, the international community that has to agree on SDR creation should also choose the objectives that should be financed by it and command the highest priority. The "link" to development financing should obviously be one—but not the only one—of several objectives that should qualify for this purpose. Others would include the traditional assistance of the I.M.F. to programs of monetary stabilization, the "recycling" of highly disturbing capital movements, in accordance with the stated purposes of the Fund's "General Arrangements to Borrow", etc.

The Joint Economic Subcommittee of the U.S. Congress on International Exchange and Payments has repeatedly and unanimously endorsed the earmarking of a portion of SDR creation for the financing of I.D.A. development assistance. At the last I.M.F. meeting, Chancellor Barber expressed the "considerable sympathy" of the Commonwealth Finance Ministers for such a "link", provided that certain obvious conditions were met, and particularly that "it would not lead to pressures for the excessive creation of SDR's beyond what prudent, internationally agreed judgment regarded as appropriate to the prospects for world liquidity as a whole."

In view of similar statements by many other Governors during the I.M.F. discussions, it would be surprising if some move of this sort were not finally agreed within the next year or two.

4. Controls over Destabilizing Capital Movements.

Secretary Shultz reiterated the U.S. view that "controls on capital flows should not be allowed to become a means of maintaining a chronically overvalued currency" and that "no country should be *forced* [italics mine] to use controls in lieu of other, more basic, adjustment measures." While nobody could object to these two important platitudes, there is a growing and generalized concern about the enormous size and high volatility of capital movements, capable of thwarting needed national policies of sound monetary management. Long debates are thus in prospect about the indispensable coordination and joint enforcement of agreed policies aiming at:

(a) "recycling" (see p. 9, above) destabilizing movements of—primarily short-term—capital;

(b) reducing, if possible, to a more manageable size sudden capital movements objected to by *both* the capital-exporting and the capital-importing countries;

(c) stimulating, on the contrary, capital movements deemed readjusting and desirable by the countries concerned;

(d) devising, in particular, some code of behavior limiting, or discouraging, sudden and excessive capital movements by large, multinational, corporations, either unrelated to their legitimate business activities, or resulting in excessive domination by foreigners of some important sectors of a national economy.

(e) introducing—through some form of reserve requirements, for instance—some kind of public supervision upon the now uncontrolled creation and pyramiding of liquidities in the so-called Euro-currencies or "Xenocurrencies" markets.

The glaring fact is that the integration of capital markets by private economic sectors has far outrun the integration of official policies and institutions, and left them unable to cope with the problems arising from such integration. The national framework of public policies must adjust to these developments and devise the joint policies and institutions indispensable to handle them efficiently, if we are to remove one of the major sources of international monetary crises and instability.

REGIONAL MONETARY INTEGRATION

It is widely hoped that the new climate of negotiations will rally agreement in Nairobi on a broad "outline" covering at least some essential points of the indispensable and drastic reform of an anachronistic international monetary system now in shambles. Yet, the completion and implementation of such a reform is still very distant. The Rio de Janeiro SDR "outline" was agreed in September 1967, but the legal finalization and ratification of the I.M.F. amendments took another two years, and the first issue of SDR's did not materialize until January 1970. The prospective time-table for needed I.M.F. amendments will be even slower, in view of the many issues unlikely to be fully resolved in Nairobi, and even for a considerable time afterward.

Ad hoc cooperation and transitional agreements—particularly among the major financial centers—will be indispensable in the meantime to prevent or handle foreseeable crises. They would also help pave the way for the worldwide agreements that must follow.

An accelerated pace of progress in the negotiations concerning European Economic and Monetary Union could play a most useful role in both of these respects. The Paris Summit Meeting of last October has not only produced a most ambitious agenda for the long term future. It has also outlined a number of concrete commitments and deadlines regarding the first phases of the program for Economic and Monetary Union.

A European Fund for Monetary Cooperation will enter into operation by next April 1st, and its prospective functions and means of action should grow rapidly, following the reports requested by next September 30th and December 31st, regarding the revision of existing short-term monetary support arrangements and, particularly, the progressive "pooling" of the international monetary reserves of the nine countries of the enlarged Community.

Exchange-rate margins between member currencies will continue to be progressively narrowed down, and ultimately eliminated, in sharp contrast with their enlargement vis-à-vis the dollar. This unavoidably entails a reduced role for the dollar, and an enlarged role for member currencies, both in market interventions and in subsequent settlements among central banks.

Pending worldwide agreements on the restoration of some form of dollar convertibility and on the respective roles of gold, SDR's, and reserve currencies in settlements—issues unlikely to be all resolved in Nairobi—the Community will inevitably be forced to evolve its own rules, and these will undoubtedly have a major influence on the final shaping-up of the world-wide reforms under negotiations in the I.M.F. and the Committee of 20.

A full appraisal of future prospects should consider three alternative hypotheses:

(a) Close cooperation between the Community, the United States and Japan would best assure an orderly transition and maximize the chances for successful worldwide agreements.

(b) The lack of such cooperation might lead to a division of the world between three major monetary blocs, maintaining some sort of internal order within their respective areas.

(c) Continued wrangling within the Community itself would also make worldwide agreements impossible. The final outcome, in this case, might be:

(i) either a worldwide surrender of national monetary sovereignty to the U.S., through the precarious consolidation of a more or less—probably less—formalized "dollar area", deeply resented by many of its participating members; or,

(ii) even worse, a generalized relapse into the nationalistic, beggar-my-neighbor policies that followed the suspension of convertibility by the former "reserve-currency" country, the United Kingdom, in September 1931.

As for syself, I am no crystal-gazer, but I remain an unredeemed "optimistic Cassandra", and continue to hope that past and future crises will, sooner or later, rally the indispensable agreement of men and goodwill around the common-sense reforms indispensable to world peace and prosperity.

Gold, SDR's, Liquidity and Inflation

(By Wolfgang Schmitz, Governor of the Austrian National Bank[1])

I welcome the opportunity to join in the Symposium of the Joint Economic Committee on the role of gold and international liquidity and I wish to thank you for the honor of having been invited. In the following I shall try to express my views on the subject in as concise a manner as possible.

1. THE ROLE OF GOLD

Nothing reflects more impressively the secular state of transition of the international monetary system than the present discussion of the role of gold in the future world monetary order. In the present monetary system, gold performs a dual function. First, it is the central unit of value and, second, it is also a major reserve asset.

Concerning its first function it may, for the present, be sufficient to point out that it still is the standard in which par values are expressed, the SDRs are defined and the assets of the IMF are being maintained. If, in the future, a unit of SDRs should be chosen as another yard-stick by maintaining the relation to gold, this would imply a presentational effect only.

The main differences of opinion concerning the future role of gold, however, refer to its second function, i.e. as a reserve medium. There are two main schools of thought: Some believe in a secular trend of demonetization of all precious metals, including gold, and would like to enforce this development in favor of an early exclusive system of deliberate creation of international money independent of any influence of non-monetary factors. They believe that a commodity for which private demand is relatively great and highly speculative suffers a disadvantage in being used as a major reserve asset. They hold that gold is a confusing rather than a stabilizing element in the international monetary system. They therefore propose to steadily sell all monetary gold to the private market by the central banks concerned or—even better—by the IMF as their agent and to replace this reserve asset by SDRs or foreign exchange.

Others advocate the maintenance of the central role of gold in the international monetary system, based upon their conviction that the elements of gold which qualified it for monetary use still exist: limited production, physical characteristics, tradition, universal use. In the light of present national monetary policies one argument has even gained in importance: gold is the only international asset held by monetary authorities that is not a liability of another monetary institution and is the only instrument of reserves that is subject to complete national control. There are also some who still believe that gold has a more disciplinary power than deliberate creation of international reserve assets; such observers thus advocate an increase in the price of gold to meet the need of international liquidity as well as to encourage gold production rather than to rely on the creation of "paper gold" (SDRs).

In the Report of the Executive Directors of the IMF to the Board of Governors on the Reform of the International Monetary System (IMF, Washington, D.C., 1972), the chapter on the role of gold seems to be one of the most controversial.

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[1] This paper does not necessarily reflect the opinion of the Austrian National Bank.

For no other problem, however, may a solution be found so easily; the good arguments in favor of an increase in the price of gold are good arguments against an enforced demonetization of gold; the good arguments of those who advocate an enforced ruling out of gold are good arguments against an increase in the gold price.

As long as there is so much confidence in gold among the public, as long as monetary authorities desire a certain distribution of risks among their reserve assets, and so long as gold still amounts to one third of total international monetary reserves, demonetization of gold should remain a long-term process, one which should not be interfered with by artificial additional measures. Those who advocate an increase in the price of gold overlook the destabilizing effect of a policy which subsequently would encourage additional price increases. They also underestimate the inflationary consequences: just to double the gold price would lead to a sudden increase in world liquidity of about 40 billion U.S. dollars in a period of international monetary abundance.

A substantial rise of the gold price is inflationary in two ways: first, in a par value system the loss of international reserves is supposed to expose a country in the adjustment process. A rise in the price of gold nullifies this mechanism in those deficit countries holding a relatively high proportion of their reserves in gold. Secondly in all countries with a certain amount of gold in their international reserves, the central banks would experience an abrupt gain in their balance sheets. Without special safeguards this would certainly lead to an unwanted increase in the internal money supply, when this gain is put at someone's disposal especially in those countries already fighting against an inflationary surplus in their balance of payments. Neither for the distribution nor for the determination of the useful amount of the liquidity created by an increase in the gold price are solutions available, which are more satisfactory than those for SDRs.

What, then, is to be done? To my mind, demonetization of gold should neither be enforced, nor should its role be enhanced by raising its price. The most realistic and useful way is to leave the function of gold entirely to the discretion of the various central banks. For the foreseeable future gold will probably remain the reserve of last resort and will retain its attraction for those who want to spread their risks.

The present so-called immobility of gold is no disadvantage at all, since it is primarily held as a reserve and is not used for everyday international settlements. As soon as there is a number of assets used as international reserves, Gresham's law works automatically: different assets necesarily are met with different degree of appreciation by the holder. Nobody's interests are hurt if gold is regarded as an international reserve of last resort. Also the gap between the official gold price of 38 dollars (35 units of SDRs per ounce) and the presently much higher price on the private gold markets should no longer be a matter of serious concern: no monetary interest is being hurt if a central bank decides to sell its gold step by step on the market and to increase its holdings in foreign exchange. On the contrary: selling gold from official holdings to the private market converts monetary reserves into a mere commodity and thus has a restrictive effect. Since a central bank under present circumstances rarely would wish to buy gold from the market, a laisser-faire solution of the gold policy of central banks will be a one-way street. Thus gold might well continue to serve as a major, though quickly declining, part of reserves for some time to come.

Both solutions (gold price increase as well as enforced demonetization) would be not only unwise. They also are unlikely to occur, since the authority to change the official price of gold rests with the Board of Governors of the IMF and its exercise requires a majority of 85 percent of the total voting power of members and since one-third of international reserves are now kept in gold.

In discussing the advantages of a liberal gold reserve policy, the question arises whether we further need to maintain an official gold price at all. I think we do! If we would discontinue to maintain an official gold price, we would have to break the link between SDRs and gold as well as the link between gold and the different currencies defining their par value in SDRs only. In this case one unit of SDRs would become the numeraire of the system and gold would be-become a reserve asset of a floating value in the central banks' accounts. Under present conditions this would probably increase monetary reserves and would introduce an additional element of uncertainty into monetary affairs since the relative values of different reserve assets could vary between each other. This

would, furthermore, overburden the SDRs' function in its early stage as international money, since gold still is *the* subject of confidence in the eyes of the public. Thus the arguments against enforced demonetization of gold also hold true against a cancellation of the official gold price.

2. THE FUNCTION OF SDR'S

The question whether an international liquidity gap should be bridged by an increase in the price of gold has been already answered by the amendment of the IMF Articles of Agreement in 1969 and the first allocation of SDRs in 1970. Compared with gold, SDRs are, therefore, in their present structure, more of an instrument of liquidity than a medium of reserve of full value.

In this capacity, they have become a subject of worry for those who deplore the present state of excessive liquidity. These warning voices should not go unheeded, all the more, since the argument is becoming less attractive that the monetary community has had to use, during the past three years, this newly created instrument in order to familiarize itself with its special features. We have now gained some experience necessary for us to know how to handle this tool and we should, therefore, remember that it was originally intended to supplement scarce liquidity and not to inflate even more the overabundance in international means of payment.

Since we find ourselves right now in such a position and since it may take years for an expanding world economy in real terms to grow into this loosely fitting suit, the international monetary community should rather search for ways and means to reduce—at least temporarily—this superabundance, e.g. through strengthening and widening the powers of the IMF, rather than engage in fanning the inflationary fire. Unless payments deficits of reserve currency countries can be eliminated or sharply reduced, the creation of additional SDRs is premature and will, in addition, postpone adjustment.

Consequently, great restraint should be exercised in deciding on the creation of SDRs in the next basic period, beginning in January 1973. In view of the fact that the next basic period still will be covered by the Articles of Agreement as they now stand and since the present SDR system will be subject to more or less drastic changes in the future monetary system, the next basic period should be limited to two years only.

If there is a feeling within the IMF that a further modest allocation of SDRs should keep developing members of the Fund interested in the reform of the world monetary order and if the view prevails that, for the sake of continuity, new SDRs should be created, the lack of a present need of additional liquidity should demonstrably be taken into account by providing for a first allocation of zero and by holding the second allocation to a nominal amount. For this reason also it seems reasonable to limit the time span of the second basic period to about two years.

By following this advice we would, on the one hand, take into due consideration the present abundance of international liquidity and, on the other hand, show confidence that the world monetary community will stick to this system. Insofar as confidence in the quality of this new international money is concerned—to my mind—more confidence will be generated if we show careful deliberation and responsible behaviour in the creation of SDRs rather than try to demonstrate the future importance of SDRs by emphasizing their continuity.

Under the present monetary system SDRs are to be created to supplement insufficient international reserves. In a future reformed system SDRs might eventually be created to substitute already existing international reserve currency holdings by converting into reserve assets liabilities of a country in deficit, the currency of which is held as international reserve, e.g. dollar holdings of foreign central banks.

From the viewpoint of liquidity control, this gives some hope for progress, as SDRs are—being held only by central banks—less mobile than a transaction currency and are, through the designation mechanism, susceptible to the harmonizing guidance at the IMF. In order to be readily accepted by central banks as replacements for other international reserves, SDRs must become more attractive than those assets. Since the U.S. authorities demonstrated by the devaluation of the U.S. dollar in December 1971 that insofar as an alteration of the exchange rate is concerned the dollar is a currency like any other and, as all concerned with the Washington realignment agreed, the SDR remains the only international reserve asset not bearing any exchange risk as compared with gold.

If their present interest rate of 1½ per cent were to be raised somewhat and if the convertibility of dollars into SDRs became part of the future monetary system, the general readiness to accept SDRs undoubtedly would increase.

3. INTERNATIONAL LIQUIDITY AND INFLATION

The future gold policy and the role of SDRs in the world monetary system to come has to be shaped against the background of the development of the overall international liquidity and its impact on world wide inflation. To be sure, the amount of internationally available money may be too small or too abundant at any particular moment. Political feasibilities, however, are asymmetric: whereas it is very popular to create money and to spend it (and therefore any parliament, government and central bank stands ready to act in this way),—a money squeeze is naturally opposed by everybody. Restrictions are much more difficult to achieve than expansionary measures.

Regarding the long-term secular trend and the growing inflationary dangers, it is indeed hard to understand that some people are still mainly concerned with the future of the world economy in case of a liquidity shortage. Today the opposite is the real source of trouble.

An excess of readily available international means of payment encourages inflationary tendencies in several ways. First, it is a handicap for internal control of inflation. Secondly, it slows down the pressure for the international adjustment process.

As to the fight against inflation in a parity system, the problem is the following: The unattractive part of this system is that the purchase of foreign currency flowing into a country is financed by the creation of additional domestic money; thus, domestic circulation is increased, unless compensatory restrictive action can be taken. As a result, money supply tends to increase faster than is necessary even in a growing economy working at full capacity and full employment, with the result that an inflationary development is practically inevitable.

Recently it has become a familiar practice for some countries to try to avert an inflow or to instigate an outflow of volatile funds. While such measures may bring relief to one country for a while, this procedure unfortunately leads to these funds moving toward other countries which, faced with the same discomfort, soon resort to similar measures in their turn. The outcome is a game of "pass the buck", played with foreign exchange controls and all too often restrictions on trade. This is no solution. Short-term capital flows may be much reduced once there is confidence in specific exchange rate structures, but such a calm is very unstable. If a lasting and effective remedy can be found at all, then it would only be by correcting the basic fault, namely, by reducing international liquidity and by restraint in the creation of new international means of payments.

The large volume of highly mobile funds threatens, in view of the advanced stage of liberalization for short-term and long-term capital movements within the OECD, to subvert internal restrictive measures introduced by stability-conscious governments and central banks. Excessive liquidity is, hence, one reason for inflation continuing to expand like a plague from country to country.

The impact of the present superabundance of international liquidity may, however, differ very much from country to country. The Annual Report of the IMF lists as one of the consequences of an increase in reserves—contrary to its more favorable conclusions mentioned one year ago—the imposition of restrictions on capital inflows. This is the other side of the coin. Better control of international reserve creation is probably the most efficient way to reduce the volume of short-term capital movements. The increase in international reserves compared to the need of a growing volume of world trade and world production in 1971 and 1972, developed on a large scale: At the end of 1968, international reserves amounted to 77.34 billion dollars, and rose to 78.21 billion dollars in 1969, to 92.55 billion dollars in 1970 and then to 121.82 billion SDRs in 1971. This means a rise of still only 1.1 per cent in 1969, of 18.3 per cent in 1970 and one of on less than 31.5 per cent, 14.7 per cent and 11.9 per cent, representing a rather steady develop-
256.4, 294.1, and 329.0 billion dollars, respectively; the growth rates were 14.0 per cent, 14.7 per cent and 11.9 per cent, representing a rather steady development.

A comparison of the periods January through July in 1972 and '72 yields, for world reserves, growth rates of 17.4 per cent in 1971 and 11.8 per cent in 1972. At the end of July 1972, total reserves were estimated at 147.72 billion dollars of 136.06 billion SDRs. Thus, on a dollar basis, international reserves

have grown by almost 70 billion dollars or almost 90 per cent since the end of 1969! (See table below.)

	End of 1968 in dollars (billions)	Growth 1968/69 in percent	End of 1969 in dollars (billions)	Growth 1969/70 in percent	End of 1970 in dollars (billions)	Growth 1970/71 in percent	End of 1971 in SDR dollars (billions)	End of July 1972 in SDR dollars
Total liquidity	77.34	1.1	78.21	18.3	92.55	31.5 (42.8)	121.72 (132.14)	136.06 (147.72)

	1968 in dollars (billions)	Growth 1968/69 in percent	1969 in dollars (billions)	Growth 1969/70 in percent	1970 in dollars (billions)	Growth 1970/71 in percent	1971 in dollars (billions)
World imports	225.0	14.0	256.4	14.7	294.1	11.9	329.0

The profuse reserve currency supply we have experienced should focus the concern of the international monetary community on possible ways and means to reduce excessive liquidity. As the IMF has taken upon itself a major role in the creation of international liquidity, it should be given also the instruments to absorb a superabundance of liquidity. The general desire of countries for rising reserves through appropriate amounts of global reserve creation in the form of SDRs must go hand in hand with an end to reliance on the payments deficits of some countries to accommodate the reserve needs of others.

It is in the interest of all countries to have a well-functioning monetary system, and the attainment of his goal depends primarily on the introduction of a mechanism for regulating the volume of international liquidity. The central task of the reform of the international monetary system matches, after all, the aim of national monetary policy in any country: the deliberate guidance and control of liquidity.

However, external defects are not the only source of inflation. Our most recent experience proves that monetary policy by itself cannot bear the burden; it will have to be assisted by fiscal and incomes policies in order to control the growth of private and public demand. On the international level much could be achieved by reducing excessive liquidity and exercising utmost caution in the creation of new world-wide means of payment. Thus international economics could offer a valuable contribution to containing inflation. This will have to be a major objective in our quest for monetary order.

What we are looking for, basically, and apart from the search for workable techniques, is a monetary system that will ensure the maintenance of convertibility, multilateralism and freedom in the world economy to the benefit of all mankind, not only in the economic sphere, but beyond that in the realm of social and moral values.

THE 1973 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 23, 1973

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

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

Present: Senators Proxmire, Sparkman, and Schweiker; and Representative Reuss.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; William A. Cox and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; L. Douglas Lee, research assistant; Michael J. Runde, administrative assistant; Leslie J. Bander, minority economist; and Walter B. Laessig, minority counsel.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. The committee will come to order.

This morning the committee turns its attention to the outlook for prices and the need for an effective anti-inflation policy for 1973. The present price outlook seems gloomy, and present policies are controversial. Many people—and I am one of them—find it incredible that the administration has decided to relax the severity of the price-wage control program at a time when the price outlook is so clearly unsatisfactory.

A great deal of publicity has been given to the fact that consumer food prices increased more last month than in any other single month since the statistics first became available in 1952. The food price problem is the most obvious, the most visible, aspect of the current inflation, but it is only part of the problem. In studying the wholesale price figures, I was quite disturbed to note that prices of every single major category of industrial products have risen within the past 3 months. And these figures were gathered prior to the announcement of phase 3.

The further price increases which may have been precipitated by phase 3 do not yet show up in the statistics. And of course the inflationary impact of the recent devaluation has and I think it could be significant—yet to be recorded in the statistics. The inflation problem is a serious and pervasive one. Our concern with the dramatic increases in food prices must not be allowed to distract our attention from other, and perhaps more fundamental, aspects of the problem.

Congress is faced now with a decision on whether to renew the Economic Stabilization Act and, if so, in what form. The administration

would like us to renew the existing, very broad authority, leaving it to administrative discretion as to when and in what form to exercise this authority.

In my view, the administration's idea of a highly discretionary, largely voluntary program is unlikely to work effectively.

Furthermore, it has created alarm both at home and abroad. It was a big factor in the currency crisis which necessitated devaluation of the dollar.

Observers attribute part of our devaluation problems to phase 3's weakness, and phase 3 is a mistake which needs to be rectified as quickly as possible. Apparently it will be up to Congress to achieve this rectification, by writing into the law some specific requirements of an effective program, such as pre-notification of major price or wage increases. And perhaps prior approval.

Among the many questions which we will put to our panel this morning will be the difficult and important question of precisely how Congress can act to insure a more effective anti-flationary policy than the one we have at present.

Our witnesses this morning are all well qualified to help us with this question.

Our first witness is Robert F. Lanzillotti, professor of economics and dean of the College of Business Administration at the University of Florida. Mr. Lanzillotti served as a member of the Price Commission throughout its brief existence. While a member of the Price Commission, Mr. Lanzillotti did not hesitate to speak out and give his own sensible and well-reasoned views on the weaknesses of current policy. I am sure that this morning we can count on him to continue to "tell it like it is."

Our second witness is Frank C. Pierson, Joseph Wharton professor of political economy at Swarthmore College. Mr. Pierson, I have had a chance to read your remarkable prepared statement—it is remarkable, because it is so specific, and it goes into such detail to indicate precisely what the problems are with respect to settlement, the big settlements coming up and the implications of the settlements. I have been searching for something like that for a long time, and was just delighted to find that in your prepared statement.

Mr. Pierson is the author of numerous works on labor economics, including a study just published by this committee summarizing the pending 1973 wage negotiations.

Our final witness is John Schnittker, president of Schnittker Associates. Mr. Schnittker served in the Department of Agriculture from 1961 to 1969, holding the office of Undersecretary of Agriculture from 1965–69. Prior to his Government service Mr. Schnittker was a professor of agricultural-economics at Kansas State University.

Mr. Schnittker, you are really the man on the spot in a way this morning because, all of us are so much aware of food price increases, and there is so much concern as to what we can do about it and there are proposals that we should try to act far more effectively on than we did in phase 2. And phase 3 proposals, while better in some ways with respect to food and some other products, may still leave presently much to be desired. So we will be looking to you.

Mr. Lanzillotti, would you lead off, please.

STATEMENT OF ROBERT LANZILLOTTI, PROFESSOR OF ECONOMICS AND DEAN, COLLEGE OF BUSINESS ADMINISTRATION, UNIVERSITY OF FLORIDA

Mr. LANZILLOTTI. Thank you, Senator Proxmire.

I am pleased and honored to be invited to testify before this committee on the Economic Report of the President, and especially the economic stabilization program.

I think it is more or less a standard reaction of the marketplace for major changes in economic policy to generate business uncertainty concerning the economic outlook. Events of the past few weeks merely serve to confirm this timeworn axiom. In my opinion, the January 11 shift from phase 2 to phase 3 triggered uncertainty at home and a resurgence of the dollar crisis aboard. Both reflected skepticism about the restructuring of the stabilization program, its implications for the U.S. balance of payments, and general concern that the U.S. economy might revert back to the conditions of the summer of 1971.

The February 12 decision to devalue the dollar by another 10 percent represented a realistic assessment of the situation in my opinion and a decisive move to take care of the unfinished business of the 1971 devaluation. But it is worth reminding ourselves that currency devaluation is an adjustment for past policy failure and not a cure for current weaknesses in policy. Therefore, if this last devaluation is to achieve the desired long-run economic efforts, phase 3 has its work cut out for it.

In short, I believe the recurring questions for economic policy today are (1) whether the move to phase 3 was perhaps a too sweeping and premature dash back to the marketplace, and (2) whether phase 3 can maintain and improve upon the record of phase 2 in stabilizing price levels.

Answers to these questions cannot meaningfully be made on the basis of the revised structure of phase 3 wage and price standards alone. I think it may come as a disillusionment to some, but it needs to be recognized that more fundamental to the course of inflation and the state of the U.S. economy generally in 1973 and beyond is the mix of fiscal and monetary policies—not direct controls. A major purpose of phase 2 was to give the other basic economic policies more time to "take hold" as much as it was to flatten out the inflation rate through direct controls alone.

This is not to say that direct controls can exert only negligible influence on prices, but rather that the kind of controls adopted were from the beginning supplemental, not fundamental in the economic policy mix. During 1972, major attention focused on phase 2 controls and there was a tendency, I believe, for many observers to regard these direct controls as the new single, all-purpose economic policy that could deliver all that was needed to produce a stable price level and a full-employment economy.

Phase 2 did not accomplish all it could have. That may be regrettable, but it is history, and hopefully we can learn something from this experiment. For the record, it needs to be recognized that according to internal Price Commission econometric estimates, phase 2 controls accounted for a reduction in the consumer price index of no more than 1.6 to 1.8 index points—and some of that I think has to

be attributed to the pressures of competition. The major restraint on both prices and wages in my opinion emerged more from the changed environment in which price and wage decisions were made than specific decisions of the Pay Board and Price Commission.

From the very beginning of phase 2, I expressed the concern that one of the major risks of too much attention on direct controls in the context of the economic situation of 1972 was not that the controls would fail to receive credit due the program, but rather that it might receive unwarranted accolades and thus be difficult to modify as economic conditions changed. This is not to argue, in my opinion, that the modifications announced on January 11 were precisely what was appropriate for more effective direct controls, but rather that it was important for some modifications to be made and the essential issues were "which" modifications and "when."

Just what were the major changes from phase 2 and what do these changes mean to business firms from an operational standpoint? The major change in phase 3 was the shift from a system of specific rules requiring cost justification and prior approval to a system that is largely governed by voluntary, self-administered standards. This aspect of phase 3 represents both a strength and weakness of the new program, in my opinion. By retaining the "threat" to challenge specific actions which are inconsistent with the price and wage "standards" of phase 3, the program keeps firms off balance, or at least reluctant to be caught in violation.

But this is also a weakness insofar as it leaves companies and unions, as well as the public generally, uncertain as to how and when the "stick in the closet" will be used. Phase 2 had a similar problem initially. However, the nature of the phase 3 program is geared to more of a "case-by-case" approach, concentrating in a more selective and personalized manner on the most visible cases, at least initially.

The point I am making here is that sometimes economic forecasts are criticized for missing the actual rate of inflation by fractions, but we notice that the psychological approach inspires great confidence in terms of its forecast based strictly on psychological impact.

I think that this means that there is an additional handicap of this system in that unlike phase 2 where the price rules were fairly clear cut, phase 3 will have to build up a kind of "case law" before business and labor uncertainty is relieved and general public confidence restored.

One of the important specific features on the price side of phase 3 is the more flexible standard for price adjustments. What are they?

(1) Prior notification and prior approval are no longer required (except for food, construction, and health);

(2) Unrestricted price increases to reflect increased costs are permitted so long as the company is under the modified base period profit margin;

(3) A weighted average increase of 1½ percent above January 10, 1973, prices when the firm is over the modified base period profit margin; and

(4) Higher increases are permitted "as necessary for efficient allocation of resources or to maintain adequate levels of supply."

The last provision is intended to help alleviate bottlenecks and shortages as the economy moves into high gear in 1973. Such adjust-

ments are authorized provided "the price increases are not inconsistent with the goals of the program." Also, when companies avail themselves of these provisions they are cautioned that they may be required to justify their actions with "hard" economic evidence.

On the wage side, the standard remains unchanged as under phase 2—5½-percent increase per annum is the base wage plus 0.7 percent for fringe benefits. I think it needs to be recognized that this standard was not achieved overall in 1972 by the Pay Board; however, purely as a result of the passage of time, "catch up" and "tandem" cases were being worked off. Hence, the 5½-percent standard would have become more than a target in 1973; it would very likely have represented what the Board reasonably could have achieved. Organized labor, of course, recognized this situation, and its determination to press for an end to the phase 2 apparatus must have been influenced by this outlook for Pay Board action in 1973.

Thus, the tactical question that arises for the Cost of Living Council in 1973 is whether it can hold wage adjustments to the basic 5½-percent standard, given the 3.4-percent increase in the CPI in 1972, the continued surge in food prices, especially meats—they went over 12 percent from January 1972 to January 1973—and the large rise in dollar corporate profits. Comparison of the percentage increase in average hourly wage rates in 1972 with the percentage increase in total dollar corporate profits from recession lows is nonsense economics but makes good collective bargaining rhetoric. Accordingly, organized labor can be expected to press for 1973 contract increases in excess of the basic standard.

I think Mr. Meany made that clear in an announcement in the Washington Post this morning.

What, then, is the outlook for 1973? Can we reach the target of 2½ percent rate of inflation by the end of 1971? This target is certainly "inspired," but it will be extremely difficult to reach. The reason is that we are unquestionably entering the most difficult stage of the current inflationary process. I think demand pressures will combine with, not replace, cost-push pressures. Hence, the impact of cost-push, especially wage cost-push, will remain a big threat to phase 3 policy.

In my opinion, the prospects for 1973 thus depend not only upon the effectiveness of the phase 3 apparatus in limiting new labor contracts to the basic 5½-percent standard, but to a large extent upon the degree of success in reducing the budget deficit. Since it appears that that will be clearly huge in fiscal year 1973 and still large in fiscal year 1974, it means that the major burden once again may be thrown back on monetary policy to do the job. This sounds very much like the early part of the scenario before controls came in—the crisis of 1971.

The Federal Reserve Board, of course, can, should, and I believe will reduce the growth in the money supply below the 8-percent rate reached at the end of 1972. But it not only would be asking too much of monetary policy to take on the entire burden of stabilizing the price level through monetary actions alone, it would be unwise. The tightness the Fed would now have to impart to the money supply, to insure our hitting the 2½-percent inflation, target, could mean a credit crunch along the lines of 1969, or worse.

Given the foregoing considerations, and the likelihood that the overall gain in productivity in 1973 will not match that of 1972, it

therefore would appear to me that a more realistic inflation rate target for 1973 must be in the 3½- to 4½-percent range.

This points up some of the important "legacies" of phase II which I think hopefully will help improve economic policy making in the future.

First, over the past few years we have learned more about the "economics of inflation." Most important, we must recognize that inflation is not caused by a single event, like one round of labor negotiations, or its attendant price increases. Inflation is a "process" that changes in terms of its triggering as well as its propelling forces. Moreover, the inflationary process of the early 1970's is different from that of the 1940's or the 1950's, and what will probably occur in the 1980's.

Second, the inflationary process of the 1970's is not as "tractable"—that is, not as susceptible—to moderation by traditional fiscal and monetary policies. Because of a variety of structural factors in today's economy, it simply takes longer for monetary and fiscal policies to "take hold." In this connection, I think it probable that the pre-1971 policy mix would have taken hold more firmly—given enough time. But the lag simply was too long to be acceptable.

A major contribution to the freeze and phase II was in allowing fiscal and monetary actions time to "catch up" and "take hold" without producing undesirable side effects in the process.

Third, what passes as "good economics" among professional economists is not necessarily "acceptable" economic policy to various segments of the public, business, or economic policymakers. As an economist, I find this regrettable, because it means that economists still have large amounts of unfinished business to complete in the area of economic literacy.

For example, perhaps the major legacy of phase II is the way in which it focused attention on the "perversity" of some long-standing economic policies vis-a-vis stabilization objectives. More specifically, I am talking here about agrciulture and trade policies which build in price floors, divert acreage from production, place limitations on market supplies, or limit imports have very little if any redeeming qualities and are long overdue for drastic overhaul. For the first time in decades the Congress has an opportunity to effectuate reforms in such outmoded policies. Reform in this area would constitute a major move toward stabilization of food prices. I urge you to do so.

Finally, as I am sure this committee knows, price and wage controls are not generally popular among economists. For my own part, I have consistently opposed a comprehensive set of pervasive wage-price controls, but I have reluctantly concluded that we should retain wage-price restraints as a supplementary tool alongside other basic economic policies. To some, the issue remains strictly one of economic philosophy, not practical economic policy. I respect this commitment to a market system, but am forced by events to recognize that there are important differences between the purified world of economic theory and the complex real world in which our system functions. Hence, while I too vastly prefer a system free of Government-imposed contraints or Government participation in private wage-price decisions, I believe it is a mistake to forgo the use of necessary economic actions purely for the sake of maintaining philosophical consistency. Nor does

it follow that selective government constraints on wage and price decisions mean the end of a free market economy. In real terms, such actions may be a cheap price to pay for improving the effectiveness of economic stabilization policies.

Thank you.

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

Mr. Pierson, please proceed.

STATEMENT OF FRANK C. PIERSON, JOSEPH WHARTON PROFESSOR OF POLITICAL ECONOMY, SWARTHMORE COLLEGE

Mr. PIERSON. You have my prepared statement, so I will restrict myself just to the highlights.

Senator PROXMIRE. Fine. We will appreciate that, if you will confine it to 10 minutes, it will be very helpful. As I say, it is a superb prepared statement, and I am sure all members will read it.

Mr. PIERSON. I appreciate that.

I will confine my remarks to the upcoming 1973 wage negotiations. And I direct your attention to two questions: What will be the effects of phase III on the major bargaining settlements? and secondly, how will these settlements affect, and be affected by, the current expansion and its continuing inflation? There are a number of imponderables about both of these questions, but I think the outline of answers to both is beginning to emerge.

As to the first question, it is hard to reach any other conclussion than that the shift to phase III will lead to moderately, or even substantially, higher settlement than would have occurred under phase II. The substitution of voluntary for mandatory controls, especially if combined with a general blurring of the 5½-percent increase standard, will invite vigorous attempts by present or potential union leaders to escalate their demands. Pronouncements that phase II regulations are still in effect and that the word "voluntary" should really be read "involuntary," may or may not prove significant, though one may wonder if there is to be no observable change in policy, why the step was taken in the first place. In any event, one fact seems certain: a number of unions are going to waste no time in trying to find out what the phase III rules will permit in the bargaining arena.

When viewed in terms of the upcoming wage negotiations, the more the decision to drop mandatory controls is examined, the more puzzling it becomes. Unless some secret understanding was reached with the union leadership which significantly strengthened the Government's hand in holding down wages and prices, it is difficult to make much sense out of it. I recognize that this is no longer a secret agreement, but the terms of that understanding remain obscure.

True enough, the 5½-percent increase standard had become subject to increasing criticism, but Pay Board regulations would have made some adjustment in that standard possible—5½ percent was not a completely inviolate figure even under phase II rules. The important point is that the spokesmen for most of the major unions and employers had tacitly agreed, however grudgingly or approvingly, to build their 1973 negotiations around this figure. Now the administration has put that key figure in considerable doubt without, apparently, having any other clear standard in mind to take its place. There is

something to be said for deliberately created ambiguity in certain areas of public policy, but once a general framework for the country's major wage negotiations has been set, it borders on the reckless to alter that framework in any essential way.

The hazards of the new policy have already been made painfully clear in the international finance sphere. Rightly or wrongly, the administration's decision was interpreted as a retreat in the fight to protect the value of the dollar. The roots of the so-called dollar crisis go much deeper than this would suggest, but on the record to date the conclusion seems inescapable that the move to phase III carried an unacceptably high element of risk.

Two mitigating considerations, however, should be kept in mind. First, the administration may move quickly to make clear what permissible wage increases will be allowed. If, for example, the recently concluded agreement in the apparel industry which calls for an 8-percent increase the first year, and 6-percent increase in each of the agreement's next 2 years, is cut back to a 5½-percent average, the phase II standard would to all intent and purposes be kept in force. Since this seems most unlikely to happen, the clarity/ambiguity issue will turn on how far the administration is prepared to move away from the phase II standards in this and other early 1973 settlements, and what grounds it gives for doing so. A new figure of 6 or 6½ percent which is geared into current estimates of cost-of-living and productivity trends, would be one thing, while a rubbery 7 to 9 percent range which is related to such vague considerations as social equity and balanced growth, would be something else. For reasons implicit in what has already been said, it seems to me that the 5½-percent standard should be retained with some liberalization of existing regulations regarding fringes, scarce labor categories and the like, so that increases as high as perhaps 7 percent per annum would be permitted in some special situations; it would not be feasible or even desirable, however, to set a precise limit to such special adjustments.

The second mitigating circumstance is the emphasis of the administration on macropolicies and monetary and fiscal restraint. It does seem to me, though, that this is subject to a fatal flaw or qualification, and that is, the effects of such policies, as Mr. Lanzillotti has pointed out, will be long delayed, and the critical question in wage negotiations is what is going to happen in the next 6 to 8 months.

I would like, then, to examine very briefly some of the key negotiations, and I would especially direct the attention of the committee to three areas in the nonmanufacturing part of the economy: Construction, railroads, and trucking. In all three of these areas there is a serious problem of unemployment, particularly in railroads, to some extent in construction, but less in trucking. Of these three nonmanufacturing areas I think the most explosive for the wage control program is in trucking. Despite the friendly and cooperative relationships between the teamsters and the administration, there is enough internal union rivalry and decentralization so that the trucking agreements might really turn out to be the breakhrough so far as wage ceilings are concerned. The picture, you know, in construction has changed very remarkably in the last year. And the problem of unemployment and the economic difficulties of railroads makes this less important from the point of view of overall wage controls.

In the manufacturing sector, it seems to me, is where you have the critical area in terms of wage control. I would emphasize three negotiations particularly: Rubber tires, which come in April; electrical equipment, in May, June; and then, of course, automobiles in the fall. And of these three I think rubber tires constitutes the critical point, because the employment picture in that industry has changed in a positive direction, and the union is in a much more militant mood than the unions in the other two fields I mentioned, electrical equipment and automobiles.

I turn, then, finally to the broader question as to how these wage pressures will fit into the general inflationary picture, and whether they will be particularly affected by current inflationary developments. And here my main point would be to ask: How much faster can the cost of living rise without destroying the basis for the present inflation control program? That program rests on the assumption that prices for a typical family's marketbasket will not rise much above 3 percent per annum. If prices begin moving up at a 4- or 5-percent rate for any extended period of time, the dam holding back negotiated wage increases will very likely break. In this connection, the single most important influence in 1973 will undoubtedly be the rate of increase in prices for food.

There is another element than cost of living that will affect 1973 bargaining outcomes and that is the "fair share" question. This is where many leaders of the business community and many spokesmen for the administration seem singularly nearsighted. There is no hard and fast line which determines when special privileges or benefits extended to corporations and upper income groups through tax concessions, higher profits, higher dividends, and the like, will spark counterdemands by union and other claimants. Indeed, the results of the last election would indicate that many union members are quite tolerant of such privileges, especially if the union groups are granted some special privileges of their own. The rub is that this can easily lead to an escalation of claims by the various interest groups which cannot be reconciled with a reasonable degree of price stability. Whatever the strict economic or social merits of each group's claim, the fact remains that there comes a point where this type of action and counteraction poses a real threat to the society's overall economic health

Thank you.

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

[The prepared statement of Mr. Pierson follows:]

PREPARED STATEMENT OF FRANK C. PIERSON

PHASE III AND THE 1973 WAGE NEGOTIATIONS

The shift from Phase II to Phase III makes the major 1973 bargaining negotiations even more crucial than before to the country's efforts to control the pace of inflation. Assessment of what the wage consequences of the shift will probably be breaks down to two questions:

1. What will be the effects of Phase III on the major bargaining settlements?
2. How will these settlements affect, and be affected by, the current expansion and the continuing inflation?

Despite the uncertainties and imponderables involved, at least rough answers can already be given to both questions.

I

As to the first question, it is hard to reach any other conclusion that the shift to Phase III will lead to moderately, or even substantially, higher settlements than would have occurred under Phase II. The substitution of voluntary for mandatory controls, especially if combined with a general blurring of the 5½ per cent increase standard, will invite vigorous attempts by present or potential union leaders to escalate their demands. Pronouncements that Phase II regulations are still in effect and that the word "voluntary" should really be read "involuntary," may or may not prove significant, though one may wonder if there is to be no observable change in policy, why the step was taken in the first place. In any event, one fact seems certain: a number of unions are going to waste no time in trying to find out what the Phase III rules will permit in the bargaining arena.

When viewed in terms of the upcoming wage negotiations, the more the decision to drop mandatory controls is examined, the more puzzling it becomes. Unless some secret understanding was reached with the union leadership which significantly strengthened the government's hand in holding down wages and prices, it is difficult to make much sense out of it. True enough, the 5½ per cent increase standard had become subject to increasing criticism, but Pay Board regulations would have made some adjustment in that standard possible—5½ per cent was not a completely inviolate figure even under Phase II rules. The important point is that the spokesmen for most of the major unions and employers had tacitly agreed, however grudgingly or approvingly, to build their 1973 negotiations around this figure. Now the Administration has put that key figure in considerable doubt without, apparently, having, any other clear standard in mind to take its place. There is something to be said for deliberately created ambiguity in certain areas of public policy, but once a general framework for the country's major wage negotiations has been set, it borders on the reckless to alter that framework in any essential way.

The hazards of the new policy have already been made painfully clear in the international finance sphere. Rightly or wrongly, the Administration's decision was interpreted as a retreat in the fight to protect the value of the dollar. The roots of the so-called dollar crisis go much deeper than this would suggest, but on the record to date the conclusion seems inescapable that the move to Phase III carried an unacceptable high element of risk.

Two mitigating considerations, however, should be kept in mind. First, the Administration may move quickly to make its position on permissible wage increases clear. If, for example, the recently concluded agreement in the apparel industry which calls for an 8 per cent increase the first year, and 6 per cent increases in each of the agreement's next two years, is cut back to a 5½ per cent average, the Phase II standard would to all intents and purposes be kept in force. Since this seems most unlikely to happen, the clarity/ambiguity issue will turn on how far the Administration is prepared to move away from the Phase II standards in this and other early 1973 settlements, and what grounds it gives for doing so. A new figure of 6 or 6½ per cent which is geared into current estimates of cost-of-living and productivity trends, would be one thing, while a rubbery 7–9 per cent range which is related to such vague considerations as social equity and balanced growth, would be something else. For reasons implicit in what has already been said, it seems to me that the 5½ per cent standard should be retained with some liberalization of existing regulations regarding fringes, scarce labor categories and the like, so that increases as high as perhaps 7 per cent per annum would be permitted in some special situations; it would not be feasible or even desirable, however, to set a precise limit to such special adjustments.

Second, the decision to remove mandatory controls may have been mostly based on an assessment of the price-side rather than the wage-side of the inflation picture. The details of this aspect of the argument I leave to other panelists, but the general justification advanced for removing mandataory controls—that by the end of 1972 the nature of the inflation had shifted from a predominantly cost-push to a demand-pull basis—applies as much to the wage question as to the price question. Once this shift occurred, so it is argued, the battle to curb inflation should center on broad macroeconomic policies, particularly fiscal and monetary restraints, while emphasis on incomes policies should be correspondingly reduced. According to this same line of argument, where selective action

is still called for, emphasis should not be placed on direct wage-price controls but rather on removing output restrictions and actively encouraging increased supplies in shortage areas. In other words, any direct intervention should henceforth be aimed at removing demand-supply imbalances rather than at controlling price-wage changes as such.

The trouble with this reasoning, at least as far as the 1973 wage negotiations are concerned, is that most of the steps which the Administration plans to take along these lines will not have any major impact for another eight or twelve months, and the most important bargaining settlements will have to be hammered out before that time. The issue, then, is how are we going to get by the next seven or eight months, a period when the inflation tide will probably be running quite strong again. The answer to this question calls for a review of the 1973 bargaining picture in key industries and of the general economic environment in which the major negotiations will take place.

II

In terms of worker coverage and potential impact, union contract settlements in 1973 will be among the most important of the last ten or fifteen years. According to the Department of Labor, contract expirations affecting 1,000 or more workers will apply to some 4½ million employees in 1973 as against about 2½ million in 1972. While expirations in 1973 will entail bargaining in only 679 situations compared to 888 in 1972, a significantly greater number of the nation's "wage-leading" settlements will be involved in the 1973 negotiations. Some of the most important of these will involve the major unions and corporations in automobiles, electrical equipment, rubber tires, meat packing. electric utilities and clothing. Major negotiations will also take place in construction, railroads and trucking. In the public sector, the most important bargaining will occur in the postal service. A listing of some of the major negotiations in the private sector, with a very tentative indication of the principal demands in each case, is given in the accompanying table.

In terms of the wage-price control program, the most significant negotiations will occur in the first half of 1973, with the months of April through June being especially important. A critical test for the wage control program will come in April when new agreement talks will begin between the United Rubber Workers and the major tire companies. Historically, the outcome of these negotiations has provided the floor from which contract bargaining in automobiles (scheduled for September 1973) has started. Furthermore, the rubber tire negotiations will have an important bearing on contract talks in the electrical equipment industry in May and June, in the meat packing industry in August, and even on the negotiations in Big Steel scheduled for 1974.

Outside heavy manufacturing, pattern following (or more accurately, pattern-following tendencies) are much less prevalent, so while a number of important contract expirations will occur in the first half of 1973 in apparel, food stores, and gas and electric utilities, they will not have nearly as broad an effect on wage-price trends in the rest of the economy. Bargaining outcomes in three non-manufacturing areas, however, will be of national significance in their own right: trucking, construction and railroads.

TABLE I

MAJOR 1973 CONTRACTS—DEMANDS AT A GLANCE

RUBBER

URW contracts with the Big Four rubber producers involving 70,000 workers expire in April. Its contract with General Tire & Rubber Co. lapses in May. The rest of URW's members negotiate on smaller contracts during the year.

- Job security.
- Improved retirement benefits.
- Shorter contracts.
- Liberalization of supplemental unemployment benefits.
- Improved insurance.
- Better plant health and safety efforts.
- Cost-of-living escalator.

ELECTRICAL

IUE's contract covering 90,000 members and UE's pact for 17,000 members at GE expire in May. IUE's agreement for 40,000 and UE's contract for 9,000 at Westinghouse lapse in June. IUE also has a contract covering 33,000 at GM up in September. The International Brotherhood of Electrical Workers has agreements covering 14,500 at Pacific Gas & Electric Co. up in June and one involving 19,200 at RCA expiring in December.

- Higher pay.
- Improved pensions.
- Union shop status.
- Improved insurance.
- Cost-of-living provisions.

TRUCKING

National Master Freight agreements covering 450,000 Teamsters expire in June. The Chicago Truck Drivers Union pact involving 12,000 drivers lapses in March. Contracts for 110,000 other Teamsters expire during the year.

- Moderate pay increases.
- Liberalized fringes.

RAILROADS

Pacts covering more than 566,000 members of 15 railroad unions come up for talks on July 1, their first common expiration date.

- Higher pay.
- Shorter workweek.
- Improved pensions.
- Job protection.

AUTOS, FARM IMPLEMENTS

UAW contracts with Big Three automakers involving 670,000 workers are up in September. Other UAW pacts covering more than 106,000 employees expire during the year.

- Reducing job boredom.
- Higher pay.
- Improved cost-of-living provisions.
- Increased insurance benefits.
- Sixth week of vacation after 20 years' service.
- Improved tuition refund program.
- Voluntary overtime.
- Job security.
- Eliminating the timeclock.

WESTERN UNION

UTW's Western Union Div. contract covering 13,000 employees is up in July, while CWA Local 1177's pact for its 1,500 members expires in September.

- Job security.
- Higher pay.
- Reducing contracting out work.

CONSTRUCTION

Major construction industry contracts involving more than 200,000 workers expire during the year.

- Work rules changes.
- Higher pay.
- Improved fringes.

Source: Thomas G. Rees and others, "Labor in '73: Tough But Less Hostile," *Industry Week*, Oct. 16, 1972, p. 1–7.

Important negotiations in the trucking industry will begin as early as March in the Chicago area but the National Master Freight agreements will not expire until June 30. Until the shift from mandatory to voluntary controls, it did not appear that wages would be a major issue in the 1973 trucking negotiations. Truck driver rates in most of the major Teamster agreements had already reached relatively high levels. Non-union competition in combination with fairly serious unemployment had served as a restraining force in a number of large population centers. Now, however, the wage issue is once again coming to the fore since the government itself has put the 5½ per cent wage standard

in doubt, and the employment picture has begun to improve markedly. It has been widely noted that relations between the Teamsters and the Administration are currently quite cooperative, but in view of the government's action ending mandatory controls it would not be surprising if the Teamsters after all were to lead the way in breaking through the present ceiling on wage increases.

Bargaining prospects in construction for 1973 are hardly less cloudy and disturbing even though the industry is still subject to mandatory controls. True, only some 400,000 workers will be directly affected by the major settlements next year, about one-half the number covered in the series of negotiations that took place in 1972. Moreover, there has been a dramatic slackening in the pace of wage increases in the construction industry in the past two years. As noted in the President's 1973 *Economic Report*, first-year increases in construction fell from 18.1 per cent in the year before March 1971 when the Construction Industry Stabilization Committee was established, to 12.5 per cent in the following year; during the last three quarters of 1972 increases dropped to 5.8 per cent. Thanks in good part to the Committee's efforts, the national offices of the building trades unions have established a good deal more control over local wage negotiations than was true in the past. Perhaps no less important, employment conditions in the unionized trades remain far from favorable in a number of localities. One of the issues that contractors will doubtless push in next year's talks is the long standing question of work rules.

A new element that is bound to affect construction bargaining in 1973 stems from the fact that the industry has shifted to a predominantly one-year, as opposed to a two- or three-year, pattern of labor contracts. This will serve to concentrate more bargaining pressures on any given year rather than spread them out over longer periods, and would doubtless result in a very sharp run-up in constuction wage levels next year if controls are loosened.

In the railroad industry contracts covering the fifteen rail unions with some 560,000 members all "reopen" on July 1—the first common expiration date in railroad history. While the demands of the union are not yet completely formulated, the shop crafts are talking about asking for a 30 percent rise in wages and a four day work week. In the last settlement the workers won pay increases of 42 per cent over 42 months. Both the unions and companies agree that employment attrition is rapidly undermining the Railroad Retirement Fund and that steps will have to be taken, perhaps by merging the fund into the Social Security program, in order to keep the industry's pension system from going into bankruptcy.

Despite the importance of next year's negotiations in these three industries, the crucial test for the wage-price control program in 1973 will nonetheless come in the big manufacturing industries. Until the Administration moved to remove mandatory controls, there was little reason to believe that existing wage ceilings would be subject to much pressure in these industries, although hard bargaining on various collateral issues was of course to be expected. The Phase II pay standards, as already indicated, provide considerable latitude with respect to wage increases. In addition to the 5½ per cent rule, another 7⁄10 of 1 per cent was permitted for "qualified fringes" (pensions, profit sharing, savings, insurance and health plans); the Pay Board also permitted such qualified fringe benefits to be included in determining the base from which permissible increases were to be determined. These and other regulations resulted in adjustments of 6½ per cent or more in given cases, even where no tandem relationships, productivity incentive plans, gross inequities or similar exceptions were involved.

It therefore seems clear that Phase II regulations, if they are allowed to remain in effect, will provide enough flexibility to meet the principal goals of the country's major bargaining groups in 1973. Whether the Administration is prepared to stand behind these regulations now that they are on a voluntary or self-administered basis and, even more importantly, whether the parties are prepared to abide by these regulations on this basis, becomes the crucial issue for this year's bargaining negotiations.

III

As for the second question noted at the beginning of this statement, how the 1973 wage negotiations will affect, and be affected by, the current inflation, no precise answer is possible at this time. Perhaps a more meaningful and more manageable formulation would be: how much faster can the cost of living rise without destroying the basis for the present inflation control program? That program rests on the assumption that prices for a typical family's market basket will

not rise much above 3 per cent per annum. If prices begin moving up at a 4 or 5 per cent rate for any extended period of time, the dam holding back negotiated wage increases will very likely break. In this connection the single most important influence in 1973 will undoubtedly be the rate of increase in prices for food.

There is another element than cost of living that will affect 1973 bargaining outcomes and that is the "fair-share" question. This is where many leaders of the business community and many spokesmen for the Administration seem singularly nearsighted. Admittedly, there is no hard and fast line which determines when special privileges or benefits extended to corporations and upper income groups through tax concessions, higher profits, higher dividends and the like, will spark counter-demands by union and other claimants. Indeed, the results of the last election would indicate that many union members are quite tolerant of such privileges, especially if the union groups are granted some special privileges of their own. The rub is that this can easily lead to an escalation of claims by the various interest groups which cannot be reconciled with a reasonable degree of price stability. Whatever the strict economic or social merits of each group's claim, the fact remains that there comes a point where this type of action and counter-action poses a real threat to the society's overall economic health.

Despite this disturbing prospect, underlying conditions surrounding the 1973 wage negotiations remain favorable to keeping the outcomes within non-inflationary bounds. During the year before August 1971 when the wage-price freeze went into effect, average hourly earnings in the private, nonfarm economy rose about 7 percent, but during the year after the freeze (excluding the immediate post-freeze bulge), they only rose about 5½ percent. Similarly, first-year increases under major agreements ran about 12 percent during the pre-freeze year as against about 8 percent during the post-year freeze. Over this period price increases were also slackening while productivity gained sharply. Viewed in this light, there is good reason to believe that the upcoming wage settlements should not exert strong upward pressures on the price level in 1973.

This favorable prospect is borne out by the comparative movements of prices, money earnings and real earnings which preceded the last round of major negotiations in 1970 as opposed to this year's negotiations. The two-sets of figures, which are taken from the President's 1973 *Economic Report*, are shown in the accompanying table.

TABLE II.—THE ECONOMIC PRELUDES TO 2 MAJOR COLLECTIVE BARGAINING ROUNDS, 1970 AND 1973

[Percent change; seasonally adjusted annual rates]

Series	Backdrop to the 1973 negotiations: 1969 [1]	Backdrop to the 1973 negotiations: 1972 [2]
Consumer Price Index	6.1	3.2
Earnings in current dollars: [3]		
Hourly [4]	6.5	6.3
Gross weekly	6.2	6.7
Spendable weekly [5]	4.9	7.3
Earnings in constant dollars: [3]		
Hourly [4]	.4	3.1
Gross weekly	.1	3.4
Spendable weekly [5]	−1.1	4.1

[1] December 1968 to December 1969.
[2] August 1971 to December 1972.
[3] For production or nonsupervisory workers on private nonfarm payrolls.
[4] Adjusted for overtime (in manufacturing only) and interindustry employment shifts.
[5] Gross weekly earnings, after taxes, for a worker with 3 dependents.

Note: In annualizing the rates of change, the effect of the change in tax rates at the beginning of 1972 is taken into account separately.

Source: Department of Labor, Bureau of Labor Statistics.

The data show that in the earlier period the rise in money earnings, while relatively large, was mostly eaten up by the rapid rise in prices. In the current period, the rate of price increase has been much less, so the increase in money earnings has yielded substantial increases in real earnings as well. For union members who will be involved in the 1973 negotiatings, this change means that

extra large bargaining gains are no longer needed to catch up with previous increases in the cost of living. In fact, recent developments indicate that union members under long-term contracts have finally begun to improve their relative position in the national wage structure.

These facts underscore the importance of keeping any short-term upsurge in food or other prices in early 1973 from triggering exorbitant wage settlements in the major industries. This finding reinforces the conclusion reached earlier that the existing structure of controls should be kept as fully intact as possible for the year ahead. But the corollary is no less important; unless convincing assurances are afforded that the current sharp rise in prices will be strictly temporary, it would be unrealistic to expect the 1973 wage negotiations to remain within a noninflationary framework. Thus, the Administration's entire anti-inflation control effort will largely turn on whether such assurances can be made and actually realized.

Senator PROXMIRE. Please proceed, Mr. Schnittker.

STATEMENT OF JOHN A. SCHNITTKER, PRESIDENT, SCHNITTKER ASSOCIATES, WASHINGTON, D.C.

Mr. SCHNITTKER. The extraordinary rise in the prices of agricultural commodities and in wholesale and retail food prices over the past few months can be traced to a number of causes. The most important single factor behind the rise in crop prices was the disastrous crop failure in the Soviet Union, requiring the U.S.S.R. to import some 25 to 30 million tons of grains and oilseeds in the 1972–73 season after having been in a small net export position for many years.

Food grain crops in India and China in 1972 were also down some 5 percent, while crops in the Middle East and west Africa were also below average, requiring larger imports or reduced exports. Australia had a searing drought that is cutting grain exports more than half this year. The result, taking all the countries of the world together, was the first reduction in total world grain production in modern history.

The world grain production for the year 1961 was 771 million tons: year 1962, 816 million tons; year 1963, 826 million tons; year 1964, 859 million tons; year 1965, 868 million tons; year 1966, 935 million tons; year 1967, 974 million tons; year 1968, 1,005 million tons; year 1969, 1,010 million tons; year 1970, 1,016 million tons; year 1971, 1,106 million tons; and year 1972, 1,057 million tons.

After rising an average of 33 million tons per year from 1961 to 1971, 1972 grain production fell 49 million tons under 1971's record harvest, to roughly 70 million tons or 7 percent below trend. The recent rise in world grain prices is a direct result of this situation.

Livestock price increases can be traced to the increased worldwide demand for meats, to the very long biological cycle required to expand beef production, and to high feed costs arising directly out of world climatic disturbances last year.

U.S. cattle numbers are increasing rather steadily, however, and we are fairly sure to have larger supplies of beef this fall and next year. Pork and poultry supplies will also increase, but so will the demand for all meat products.

Official predictions or promises that food prices will be lower at the end of the year than at the beginning, led by declines in meat prices, do not appear to rest on a realistic analysis of the situation. I believe objective USDA specialists anticipate a food price rise of some 6 percent in 1973. This might allow for some decline late in the year, since early

increases will exceed 6 percent. Consumers will take small comfort if food prices stabilize late in 1973 at or just below today's record high levels, and I would add that even if farm prices decline in the wake of large crops, the prospects for substantial food price declines are very, very poor, based upon past history.

The managers of Federal farm programs in the executive branch also bear a share of the responsibility for the current accelerated rise in food prices, as cited earlier. Only days after the U.S.S.R. had begun its massive purchases of U.S. grain last July, and when the full magnitude of the Russian crop disaster was well known in official circles, USDA announced a restrictive wheat acreage program for 1973. Officials consistently refused to correct that error until January of this year.

U.S. wheat exports were subsidized at a cost of millions of dollars for at least 2 months after the world grain situation had turned from a buyer's to a seller's market. A restrictive program was announced in December for feed grains, only to be changed in January, not because of new developments but because of belated recognition of the actual state of world grain and oilseed supplies and prices. There is every indication in today's markets that further changes may be required, doing away with all or nearly all remaining agricultural production restrictions for 1973.

Finally, the key feature of the Agricultural Act of 1970—the set-aside, has had the effect in 1971 and 1972 of accentuating the shortage and the spectacular price increase in soybeans, the scarcest of all the agricultural raw materials. The set-aside encourages expansion of corn acreage more than in soybeans, even though demand expansion is most rapid in soybeans. Congress should look closely at this program this year. Serious losses during harvet last fall were also an important cause of present high prices in the protein meal complex.

Carryover stocks in both grains and oilseeds are so badly depleted worldwide by the 1972–73 situation, that crop shortfalls in 1973 far less serious than in 1972 would set off a new spiral of grain and oilseed prices to new record highs. Russia's wheat crop is off to another poor start, India's food supplies remain tight, and the growing season is still a few months away in the United States and Canada, where record crops this year are essential if there is to be a degree of price stability later this year.

In this situation, the United States can afford to err only on the side of plenty. If record crops were to be harvested everywhere this year and prices fell toward early 1972 levels, present price support laws could be brought into play to help cushion the drop in farm prices, since it would be partly the result of expansionary production policies. But that possibility appears to be increasingly remote.

Thank you.

Senator PROXMIRE. You gentlemen certainly paint a tough problem for all of us. As I said, this is a very fine panel of outstanding experts. And to have you paint this kind of a picture indicates that both the Congress and the administration have an enormous job cut out for it, and even with our best efforts we may not be able to succeed.

Mr. Lanzillotti, you say in your statement:

A major purpose of phase 11 was to give the other basic economic policy more time to "take hold" as much as it was to flatten out the inflation rate through controls alone.

The other business economic policies, I take it, are fiscal and monetary policies.

Mr. LANZILLOTTI. Yes, sir.

Senator PROXMIRE. As I take it fiscal and monetary policies didn't even try to cope with inflation, fiscal policies during the last year were inflationary, we had an enormous deficit. The President is proposing a huge increase in spending this coming year of $19 billion, 7½ percent. Monetary policy which has some lag, and therefore 1972 policy will have its impact in 1973. So the action in 1972 increasing the money supply to 8.3 percent is going to be inflationary. And so these basic policies are going to give us a very tough problem to cope with. And now you say, as I understand it—your interpretation of phase II—and you are in excellent position to judge it, as one of the people who served on the Price Commission, and with great distinction—your view is that because it is vague and indefinite and lacks specificity, may be a weaker approach; is that right?

Mr. LANZILLOTTI. Yes, sir. I think that that is a fair assessment of it. Following the outlook and the view that you have expressed, it seems to me that even if we did not wish to place emphasis on direct controls in 1973, because of the comments you have made about the outlook for fiscal and monetary action, direct controls sort of occupy a pivotal role for 1973. Whether we like it or not, the effectiveness of these other policies will pivot on the effectiveness of direct controls.

Now, that may be regrettable. But it seems to me——

Senator PROXMIRE. That is interesting.

Now, you seem to say that if we have effective direct controls, then our fiscal and monetary policies may be improved; is that right?

Mr. LANZILLOTTI. What I am saying is really repeating the point you made about fiscal policies. We have had an inflationary impact with fiscal action in the past year. There is no question about it, and it looks that way in fiscal 1973 to me. And you recognize that if the money supply has increased, as it did in 1972 and toward the end of 1973, at an 8- to 8.2-percent rate, that means that in 1973, if we have these conditions already set, and if nothing else happens, I think an inflationary impact will occur, especially since the economy has recovered so well. That means, then, that whether we like it or not direct controls still have an important role to play. I think that these other policies sort of pivot on how effective the direct controls are.

Senator PROXMIRE. Let me just ask another questions of you right now about fiscal policy. You imply it should be tighter. What do you propose? The President has proposed a ceiling of $268.7 billion, I think it ought to be less than that. I propose a $265 billion ceiling, and Mr. Burns said it ought to be less than that. We know that we have these very serious needs, our country has, especially in the domestic area, that many of us feel are being neglected.

So if you don't want to be cruel about it, but realistic, what do you think we can do about cutting that?

Mr. LANZILLOTTI. I don't want to be cruel about anything, but I do want to be realistic. I think that my views are pretty much those that have been expressed by Arthur Burns. I think we simply have to bring the spending down. I think we just have to choose our priorities. I don't think we can do everything. And especially this year I think we have to select our priorities with greater care. Also, I firmly believe

that we have to bring the deficit under control. Whether it is the number you state or the one that Arthur Burns wants—I am on the low side of those numbers rather than the high side.

Senator PROXMIRE. You forecast inflation for 1973 of 3½ to 4½ percent, as a realistic estimate of what it is likely to be, in view of phase III. How much of this inflation will be due to food prices and how much to other factors? As I noted in my opening statement, industrial prices seem to be rising on a broad front. And I would appreciate it if you would comment on the industrial prices and their impact on other prices.

Mr. LANZILLOTTI. Industrial prices did very well—I should say the commodities less food did much better in the January index than food.

Adjusted for seasonal factors, as I recall, the January figure was flat, no change. I think that we have done much better in that area. But when you consider what is happening in the food area the outlook is not so promising, that is how I come up with a 3½ to 4½ percent.

I also think that the devaluation is going to mean that some commodities that we import are going to be higher. There is no question about it. Also, some finished goods that we import obviously will be higher priced. So my figure is an average, including food.

I think it needs to be said in fairness to the program that what we have witnessed in regard to commodity prices less food still to this date are the effects of the phase II apparatus. The figures collected for the CPI, as I understand it, were collected in the first 10 days of January. So, we haven't yet seen how phase III will affect even the commodities less food.

My outlook is that the whole sector might not do as well in 1973 as it did in 1972.

I am also concerned about the curious reversal in the two major indexes; that is, the Wholesale Price Index seems to be rising more rapidly than the consumer price index. But at this stage of the cycle that is a reversal of our previous experience. Normally toward the latter stages of the upswings wholesale prices tend to flatten out and rise less rapidly than retail prices. But in this upswing the reverse is taking place.

I think there was a very graphic representation of that reversal in the Washington Post today, showing the steepness of the wholesale price rises during most of 1972 compared to retail price increases.

Therefore my estimate would be that we will do better, clearly, in the industrial sector than we will do in the food sector. That depends upon holding firmly to the kind of standards we had under phase 2. My preferences on that were even a more rigid standard. As you know, I felt that we should have insisted on a limitation based on dollar for dollar cost passthrough without any percentage markup, including the normal markup the firms have taken. I felt that if you pass food costs on a dollar per dollar basis you are more likely to hold the industrial sector, industrial commodities down. I really don't know what other hope we have for 1973 other than holding very tight to that sector.

Senator PROXMIRE. My time is up. I couldn't agree with you more on the passthrough. Your position is unassailable.

With the sufferance of the other members, I would appreciate it if the other two panel members would comment on that.

Mr. PIERSON. I am a little concerned with one aspect of your question and Mr. Lanzillotti's response, that there seems to be almost an obsession of concern over the price inflation, as though unemployment has somehow or other become of secondary consideration.

I realize this is not your view. But I do want to stress that as we shift from direct controls to monetary and fiscal restraint, we will undoubtedly slow up the trend toward full employment. We talk about the cruel tax of inflation, but I think most of us would agree that the cruelest tax of all is unemployment.

Senator PROXMIRE. My question related to how important a role will food play in the coming inflation.

Mr. PIERSON. I realize that. But I would urge that as we move toward restraint in monetary and fiscal policy that we are keenly aware of the barrier that this is going to impose to any real full employment.

Senator PROXMIRE. Mr. Schnittker.

Mr. SCHNITTKER. Certainly I agree with Mr. Lanzillotti that food price increases will be greater in 1973 than the other products. And since so much of the crop is already committed, the crop harvested in 1972, there is relatively little that can be done about it over the next 6 or 8 months. Even export commitments are made very far in advance.

There is a very curious reverse twist on internal prices of farm commodities and other commodities as related to the dollar devaluation and the further weakness. At the present time there is a rush toward commodities of all kinds, particularly metals, but including scrap iron, lumber, and soybeans, so as the dollar weakens abroad, there is a tendency to try to buy more and more commodities. And that accelerates our food price increases and other commodity price increases at home.

Senator PROXMIRE. Senator Sparkman.

Senator SPARKMAN. I don't know that I can understand just what you propose we do with reference to this legislation.

Do you recommend that we continue controls as they are now?

Mr. PIERSON. I certainly do in the wage areas. As far as wage standards are concerned I think it is important to hold to the 5½ percent figure, with some flexibility as the Pay Board rules permit, incidentally, in the area of fringes and special labor categories.

Senator SPARKMAN. Well, they speak of guidelines in this so-called voluntary program. Could they establish the 5½ percent as a guideline and stick to it?

Mr. PIERSON. I think that is a possibility, although I wonder about the understanding that has been reached with the union leadership, and what the role of the Labor-Management Advisory Committee is to be in trying to formulate or reformulate a wage guideline.

So, I think the whole issue is at a rather delicate point of determination.

Mr. LANZILLOTTI. I would agree with Mr. Pierson on that. In direct response to your question, Senator Sparkman, I think the threshold question has been answered. I hope, that the Economic Stabilization Act will be extended. I think it is essential that it be extended for 1973. Indeed, I feel we should take a longer run stance on standby price and wage controls, so that we do not generate the uncertainty

and the prospect that for the next decade we are going to have stop-and-go wage and price controls. I think that is worse than none.

I think it is important that we take a position that we should not be fearful of using these particular kinds of actions as the economic circumstances require. So I am for an indefinite extension of the act in order to demonstrate that we firmly are committed to using these as the situation requires, but not that we are going to be addicted to them.

So I think that it is essential that we extend the act.

Now, in fairness to the program, you used the term "guidelines." The program calls them standards. There is nothing in the apparatus that precludes this phase III from being effective. I think that needs to be stated very clearly. I think John Dunlop has the authority under phase III to be firm. The problem right now is that we do not have any concrete evidence—we haven't faced enough cases to know what the specifics are and how it will function.

And that is why Mr. Pierson is concerned on the wage side, and why there is uncertainty on the price side. Will there be a rush, has there been a rush, in January and early February, of firms to raise their prices? And if there is, we need an early demonstration that the standards will be held to firmly in order that we could be on the stated target.

Senator SPARKMAN. What can be done legislatively to insure that? I am trying to differentiate between a purely voluntary program such as the administration has outlined—at least they call it voluntary, but they like to remind us that they have a club in the closet or a shotgun in the closet, that they are going to clobber them if they get out of line.

Mr. LANZILLOTTI. I think the clobbering aspect was unfortunate. I don't think that that is the way to manage economic policy. I prefer the regulations to be rather specific. And it gets back to the old adage about monetary policy. I prefer rules versus men in this regard as well as in other kinds of legislation. But I think the apparatus has the authority.

If you are asking me, Senator Sparkman, what would I recommend in legislation, I think that, one, we should extend the act; and, two, I think it is important that we do emphasize the importance of outlining more clearly what the standards are. We need flexibility, I urged flexibility in the conferences in which I was privileged to participate in those areas where demand pressure is very strong.

But I think our basic standards need to be clarified and specified very clearly so that we know exactly what to expect, and the public knows what to expect, and the firms do, and labor unions.

As Frank Pierson has pointed out, there must have been an orientation around the 5½ percent standard for collective bargaining agreements coming up. I think it is regrettable if that particular approach is now being altered as a consequence of the shift to phase III. I find that a very distressing bit of information to be given.

Senator SPARKMAN. Now, let me ask a question about food. I believe all of you have agreed that the food prices will go up in 1973, all of you I understand say that.

What can be done to hold that down? You do not advocate, I presume, any change in the present policy of not trying to control the original sale of the food products until they get into the processing stage, you don't advocate changing that, do you?

Mr. SCHNITTKER. I do not advocate direct controls on farm products. I think the strict dollar pass through that Mr. Lanzillotti referred to should have been adopted. And if it would be compatible with phase 3, it could perhaps still be adopted where it is not in effect. Beyond that, the principal opportunity in food is to make moves, many of which should have been made in the past, to expand the output of agricultural products as rapidly as possible during 1973. There has been some relaxation of imports of both dairy products and of meat, but to almost no effect, because meat is short worldwide, and dairy products are not seriously in excess supply.

So relaxing imports is little more than an empty gesture.

Relying on expanded production, relaxing all the acreage restrictions that presently have been announced for 1973 crops, would be the principal further action on food prices that I would propose. Otherwise we have just got to see it through.

Senator SPARKMAN. Thank you, Senator Proxmire.

Senator PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Senator Proxmire.

Mr. Schnittker, you point out that the Secretary of Agriculture is himself responsible for some of the increases in food prices. You point out that last July, at a time when everybody knew that the Soviet Union was having a crop failure, and was looking around for wheat, the Department of Agriculture announced a restricted wheat acrege program for 1973. As you may or may not know, last June I was upset by the increase in meat prices. And I made a formal request of the Department of Agriculture to use the authority which the Secretary had under the 1971 act to open up idle acres—and we have some 60 million of them in this country—to permit grass grazing of meat cattle. And the administration said, we can't do that. But 6 months later, last month, they belatedly decided they could do it, and issued the order. And you can multiply these instances.

I notice in the Soviet Union the other day the Minister of Agriculture, who had goofed off on food production and meat prices, was fired. Here our Minister of Agriculture is promoted to be a supercounselor on natural resources.

This is a political question for a political scientist, not an economist. But I am puzzled about it.

Let me ask you this. Had the Department of Agriculture done what I urged them to do last June, and by a stroke of the pen allowed cattle raising on our idle grasslands, wouldn't that have markedly stepped up the day when we are going to get a cessation of these price rises?

Mr. SCHNITTKER. Yes, it would be accelerated expansion of cattle herds, and it would put slightly more beef on the shelves between now and late 1973. Last year especially there was a very large acreage diverted from the feed grain crops, some 37 million acres. And this would have been a powerful addition to the grazing land available to cattle herds last year.

Now, that they have allowed grazing on diverted acres, we are in a situation for 1973 when there will be few acres diverted from the cultivated crops. And so that again is an empty action.

Representative REUSS. So, too little and too late once again.

Mr. SCHNITTKER. On many aspects of the farm program.

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Representative REUSS. Well, maybe he deserves a promotion. I am not sure.

Mr. Lanzillotti, in your interesting statement you list some of the more important specific features on the price side of phase 3 and the fourth one you mentioned is that higher increases are permitted, and you quote from the language of phase 3, "As necessary for efficient allocation of resources or to maintain adequate levels of supply."

Let me get this straight with your help.

Do you mean to say that a seller is actually permitted to interpret this vague language all by himself and decide whether a given price increase is necessary for efficient allocation of resources, or to maintain adequate levels of supply?

Mr. LANZILLOTTI. For some.

Representative REUSS. And if he feels that it is, he can then go ahead, and maybe months or years later somebody will tell him, well, that really wasn't necessary to fix an allocation or maintain adequate levels or supplies, but he can't be reached in any civil or criminal litigation?

Mr. LANZILLOTTI. Certainly, to the extent that the program is voluntary and self-administering. Initially firms that are faced with very strong demand pressures, and are witnessing a depletion of their shelves very quickly, they can use this provision as justification. I think it is intended to cover a kind of an industry problem, which I think is implicit in your question. But an individual firm may make the interpretation under the provision. The program does require—as the announcements have made clear—that any one firm that avails itself of this proviso should be prepared to demonstrate that the conditions were such that it was necessary to insure adequate supplies.

But it is a justification after the fact.

We had a provision under phase 2 like this, Congressman Reuss, that you may recall. These special cases were handled under the Exceptions Division. This procedure brings out more clearly into the open that where you do have exceptional circumstances, because of shortages, that you may have to allow higher prices, as we did allow under phase 2. I am not opposing that as a principle.

Representative REUSS. It may be a perfectly good principle, but is it a good principle to give to the millions of sellers in this country as the way in which they shall walk?

Is this a government of laws or of men? Are we giving a standard that a reasonable man who wants to do the right thing can follow?

Mr. LANZILLOTTI. I think that you are raising a good question. Operationally, is this the kind of thing that can be self-interpreted with the degree of care that it needs?

Representative REUSS. If I may interrupt you, it is one thing if one says, look, we are going to have a 3-percent permissible price rise, and everybody will please obey this, it will be voluntary. Well, there is something to be said for that, not much, but something. Because at least you know whether you are increasing the rise by more than 3 percent. But when you are given a standard and told to repair to your chapel and search your soul and decide whether you need this price increase to maintain adequate levels of supply, anybody can argue himself into believing, "I have got to increase my prices to keep supply up."

Mr. LANZILLOTTI. I think that the only sensible interpretation I can give this is that it really means that those who would wish to make, and try to make, a case for this provision in their price adjustments should be allowed to do so. The thing that is unclear is whether it is before the fact or afterward. We are back once again, I think, to the problem associated with ambiguity in the language of the program.

I don't know whether this will be before the fact or after. To the extent that it is self-interpreted and self-administered, it certainly means that some firms could go ahead on this basis and justify it after the fact if they are challenged. But I do not know how that is going to be handled, Congressman Reuss. I am giving you my personal interpretation.

Representative REUSS. Right.

Let me ask another food question somewhat related to your State of Florida.

As you know, the other night the papers said that President Nixon was dining at La Haste Restaurant in Coral Gables and used that place as a forum to speak to the American people who were pretty sick, as Mr. Schnittker pointed out, about the price of meat. And he advised the American people to eat fish.

Incidentally, the meat eaten by the President at the party consisted of red pompano and snapper, both of which retail at the restaurant at $6.95.

But passing that, is it not a fact that in the last year, according to the latest Consumer Price Index figures, the price of fish has gone up 10 percent?

Mr. LANZILLOTTI. Yes.

Representative REUSS. So how is the poor housewife going to make out with that kind of advice?

Mr. LANZILLOTTI. I think that the advice about what people should eat is not my bag. I don't believe I should tell people what to eat. I think that any of these statements tend to become historical quotations.

Arthur Burns, I think, slipped into that when he said, let them eat cheese. The President mentioned, let them eat fish, and someone else said, let them eat cake. I am not going to pretend that I should adivse anyone as to what they should eat. That may be a way of doing it, but I don't believe that you can run an economic policy on the basis of advising people as to what is best in their diet. I think they have to allocate their income according to what they think they prefer. And if the prices are not an indicator to them to cut back their consumption of certain commodities or certain foods, I don't want to set myself up to tell them what to eat.

I do agree that meats, poultry and fish did go up 12 percent from January to January. So, they are not low-cost food items.

On the other hand, I want to point out that you can get pompano and red snapper more inexpensively on the market than in the restaurant. Also, while I am not a great fish man, red snapper is a good fish and I recommend it to you.

Representative REUSS. It is a beautiful fish. And all I am saying is that it is up 10 percent.

Senator Sparkman has just suggested that perhaps President Nixon was trying not to emulate Disraeli or De Gaulle or some of these heroes, but Marie Antoinette with her, "Let them eat cake" advice.

Mr. LANZILLOTTI. I think that those statements can be unfortunate.

Representative REUSS. My time is up.

Senator PROXMIRE. Gentlemen, I think it is interesting to get into the notion of what the consumer can do voluntarily. Eating cheese is my bag, because, of course, that is what we have in Wisconsin. And I was delighted that Mr. Burns responded that way to me when I asked him a question about it. I thought that was a very wise observation.

Representative REUSS. Would the gentleman yield briefly at that point?

Senator PROXMIRE. Yes.

Cheese is underpriced, and I think it ought to go up higher.

Representative REUSS. Cheese, according to the latest figures, is down two-tenths of a percentage point from where it was 4 months ago. And it is better than ever.

Senator PROXMIRE. It is better than ever. And even if it were up in price—and it is up over a year ago—it is still not too high.

Mr. LANZILLOTTI. Do you want to discuss that?

Senator PROXMIRE. No, I cite it as a fact, we all accept, and that is it.

Mr. LANZILLOTTI. I will stipulate to that.

Senator PROXMIRE. I want to pursue the question that Senator Sparkman was asking and I want to get an answer from you fellows. This is not an academic exercise.

We have the problem of marking up the wage price bill within the next 10 days. We want to know from you experts what to do about it. So far I have got from Mr. Lanzillotti that we ought to have standards clarified. Whether that means we ought to write into the law that there should be a 5½ percent wage guideline, whether we ought to write into the law that there should be a 2-percent price guideline, and then write in some specifications as to how that is to be enforced, if it is, is a question, and whether we ought to write into the law a change in the profit margin requirements, which have been softened and eased so that prices have been increased, whether we ought to go back and vitiate that and provide that you have at least the tougher standards you had in phase II, and whether we want to write into the law that you must have prior notification, and whether we ought to write into the law that you have prior approval.

What should we write into teh law, nothing except an intention?

And incidentally, Mr. Lanzillotti, if we write in an indefinite extension we would be giving the President enormous power. He could be an economic dictator over prices and wages without any congressional review. That would mean that we wouldn't have a chance to look at it within a year or 10 years.

Starting with Mr. Schnittker this time, you have painted a very gloomy picture of food prices, I think an accurate picture and honest picture, and what can we do about it? Nothing—or can we do something?

Mr. SCHNITTKER. Food prices are not as closely related to a continuation of the act as industrial commodities, for example.

Senator PROXMIRE. Well, we can make them subject to it. We can provide controls at the farm level. I am against that, personally, but I would like to know your recommendation.

Mr. SCHNITTKER. My recommendation would be against that.

Senator PROXMIRE. All right, what do we do?

Mr. SCHNITTKER. I think the Congress should encourage, if not necessarily write into the law, application of the strict dollar pass-through instead of the percentage pass-throughs which prevailed in phase I and phase II in some elements of the food industry.

Senator PROXMIRE. I think we have to write it into the law if it is going to be effective. In fact, sometimes we write the thing into law and they don't pay much attention to it, but at least it has a better chance if we write it into law than if we simply encourage it in committee report language, for example.

Mr. SCHNITTKER. In fact, the firm application of limitations or standards on profit margins has an important application in the food industry. So strong standards should be applied there by the Congress in the law.

The other aspect would be in the farm laws, which is another act.

Senator PROXMIRE. Before you get away from that, let me ask you, would you require prenotification before price increases would go into effect?

Mr. SCHNITTKER. Yes, I would.

Senator PROXMIRE. I understand phase III would not.

Would you require prior approval?

Mr. SCHNITTKER. Yes, I think so, particularly for major commodities and large firms, not necessarily for every one, because of the administrative problems.

Senator PROXMIRE. That is very helpful.

Mr. Pierson.

Mr. PIERSON. I would agree that there should be written into the new legislation the prenotification requirement of the major wage negotiation settlements. And perhaps the word "major" could be defined a bit more narrowly than under phase II. But I would certainly emphasize the important of prenotification.

Prior approval would be a more difficult matter.

Senator PROXMIRE. We have prior approval now at tier 3.

Mr. PIERSON. Right. And I would still come down on the side of requiring prior approval if it seems feasible in the actual drafing of the legislation.

But the important point is to present to the major negotiators this year a clear standard. And those two requirements, I think, would help in that regard.

Senator PROXMIRE. Now, what I would like to know from you, Mr. Pierson, because you are an expert in this and you have thought about it so much, I have been very concerned about the impact of rising consumer prices in coming months on wage negotiations. As you point out in your fine prepared statement, 4½ million wage earners are going to have their wages determined for 3 years in the coming months. And those wage determinations are going to have a long-term inflationary impact.

Now, it seems that if we just let nature take its course it is going to be very likely that those wage determinations are going to be inflationary, they are not going to stick to a 5½ percent guideline, in all likelihood. We have already had a breakthrough in apparel, and we are going to have a breakthrough elsewhere. What would you think of providing a basic 3 percent productivity provision increase as part of the guideline, and the second part of the guideline a cost of living

escalator? Everybody tells us that the cost of living will begin to rise less rapidly toward the end of the year than it has in the first 5 months. It may not. But that would provide equity, it would provide at least an opportunity to move into a situation where wage increases wouldn't be automatically inflationary in the coming year, would it not?

What would you think of that as a realistic approach?

Mr. PIERSON. I think that is certainly defensible. Speaking as an economist, I must say that there should be some shaving of that cost of living protection, in the sense that there needs to be some degree of cost absorption.

Senator PROXMIRE. Maybe the best way to do that would be to shave the productivity figure.

Mr. PIERSON. That is a possibility.

Senator PROXMIRE. And then let the cost of living be reflected.

Mr. PIERSON. I think this would be a very defensible position.

Senator PROXMIRE. It is a lot easier for people to understand cost of living than productivity. Productivity is a term that economists understand.

Is it possible to write something like that into the law?

Mr. PIERSON. I think it would be. And it could be formulated, as you say, in clear cut enough fashion so that it would be intelligible to all parties. And it would give a clearer standard with sufficient flexibility on the cost-of-living side to make it defensible.

I do emphasize, though, that under the present regulations in effect you have something pretty close to this, because the phase 2 rules are fairly elastic. So the difference wouldn't be too great.

Senator PROXMIRE. I want you to know that I have already introduced an amendment which I intend to press requiring a 4-percent unemployment goal by April 30, 1974.

Mr. PIERSON. I would support it.

Senator PROXMIRE. Good.

You have criticized us for not bringing up unemployment. It is very much in the forefront of our mind. But inflation is certainly more obviously an immediate problem. And we have reduced unemployment somewhat.

Mr. Lanzillotti.

Mr. LANZILLOTTI. Reacting to your questions in turn, Senator, I think you may have misunderstood me on this matter of indefinite extension. I am not trying to take anything out of the purview of the Congress. I think there should be a commitment to an indefinite extension of the policy, just as we have in the Full Employment Act of 1946; namely, that it is a declared policy of the U.S. Government to pursue certain actions as necessary.

What I am saying is that I think it would be a declaration of policy that we recognize, and that we will use direct controls as the circumstances require to maintain price stability and full employment. I am not trying to urge you to delegate the responsibility.

Senator PROXMIRE. I understand.

Mr. LANZILLOTTI. On the specifics, I am concerned, as you know, about the specifics of the extension of the act. I don't know the best way to accomplish it. Certainly it is possible within phase 3 to get the specifics out in the open.

Senator PROXMIRE. Let me just say that I met with Senator Sparkman and with some of the top administration people a couple of

months ago. And they discussed what they might do. We were in phase 2 then, and phase 3 hadn't been conceived. And they said that what they would like to do is put phase 3 into effect. And I think that was very helpful, because we could take a look at it and see what it would be like. And we had to decide whether to extend the act or not extend it. We have the previous act to determine what our laws are. We have looked at it, and all of you seem to feel that it won't do the job. Clearly, we will have to change the act if we are going to get some change in the regulations they have.

Now, I am asking how we should do it.

Mr. LANZILLOTTI. I would have preferred simply to have kept the phase 2 apparatus and just made some modifications. If we can't have that, I suggest the standards be clarified. I understand you feel the way to get them clarified is to write the specifics into law. I do not think that is the only way to have the standards clarified, but I do believe they should be clarified. They can be clarified by the same kind of articulation that we gave the regulations under phase 2. The Commission clarified its standards——

Senator PROXMIRE. What I am getting at is, where the power is, of course, they can do anything they want to do. We can talk up, and maybe they will listen to us and maybe they won't. We know what they are going to do, they have set it, they have put phase 3 into effect. If we are going to change this, based on the support that you give us as to the best thing to do, we have to write into the law. And that there will be something that we have to change later, so we may have to write some flexibility into our standards or something in our criteria as to what we mean by prenotification or that kind of thing. But we have to write a specific law requiring a particular——

Mr. LANZILLOTTI. I think the power is lodged in the Director of the Cost of Living Council, John Dunlop. He has the power now, I think, to run this program effectively.

Senator PROXMIRE. He is running a program without prenotification, he is running it without prior approval, he is running it with a softer profit margin.

Mr. LANZILLOTTI. That is true.

Senator PROXMIRE. If we don't like that, we have to change the law and tell him to put into effect other measures.

Mr. LANZILLOTTI. What I am saying is that it is feasible to have the standards articulated with greater specificity within the context of phase 3 by Dunlop and the Council. Now, whether that is going to be done or not, or when, I cannot say.

But I do want to make one comment about your escalator. I am worried about that. I don't want to institutionalize inflation. Which employees get the escalation? Just the unionized workers or all workers? Do I understand that there is to be an adjustment in wage rates as the inflation rate changes?

Senator PROXMIRE. It is a sideline within which you negotiate. It doesn't mean that all wages go up by a certain amount, it means that this is the guideline, this is the maximum. The guideline at the present time, 5½ percent, isn't met by many wages, most of them are below it, although the average is above it.

Mr. LANZILLOTTI. I misunderstood you. I thought that was going to mean institutionalizing an automatic escalator which you and I wouldn't want to have, I think that would lead to further inflation.

Senator PROXMIRE. That might be attractive to Congressmen. We have not had a wage increase in 4 years.

Mr. LANZILLOTTI. I am not going to comment on that one.

Senator PROXMIRE. My time is up.

Senator Sparkman.

Senator SPARKMAN. I don't believe I have any further questions. I do appreciate the presentation by all three of you gentlemen. It has been most helpful. I think it does point out the difference between advocating principles and writing those into effective law. And, of course, Senator Proxmire and I are sitting on another committee to write that law. And I think that the presentations have been very fine indeed.

Senator PROXMIRE. I would like to ask you gentlemen some further questions. And one of the questions that I have in mind is that I think there has been a tendency to focus much too much on food prices and ignore the other inflationary elements in the economy. Wholesale industrial prices rose at a 3.7-percent annual rate in the last 3 months, industrial prices, not food prices. That is better than food prices, but it sure isn't good. And it is certainly not consistent with the 2½-percent inflation rate, and probably not consistent with the 4-percent inflation rate. On the basis of past experience industrial wholesale prices have been far more stable than consumer prices. Aren't we building up here, if not a time bomb, an element of pressure on consumer prices that we again have to anticipate, along with the increase in food prices?

Mr. Pierson.

Mr. PIERSON. I agree with that strongly. And that is why I urged as firmly as I could that we go back to prenotification and prior approval. I think the next 6 or 8 months are absolutely crucial. And in giving up these controls at this particular time, we are inviting the very thing that we have all been trying to avoid.

Senator PROXMIRE. Mr. Pierson and Mr. Lanzillotti, you have both made the point in your statement that the underlying situation in 1973 should have been favorable for achieving wage settlements conforming to the 5½-percent guidelines.

Mr. Lanzillotti said:

> The 5½-percent standard would have become more than a target in 1973; it would very likely have represented what the Board reasonably could have achieved.

Mr. Pierson said:

> Spokesmen for most of the major unions and employers have tacitly agreed, however grudgingly or approvingly, to build their 1972 negotiations around this figure.

You both then go on to say that the move to phase III made this guideline much harder to achieve. Mr. Pierson said: "Now the administration has put that key figure in considerable doubt." And Mr. Lanzillotti said that organized labor pressed for an end of phase II precisely because they wanted to get out from under an enforcible 5½-percent guideline.

In other words, we really blew it on the wage side by abandoning phase II. You have come from a situation in which we had a good chance of coping with this year's pace-setting negotiations to a situa-

tion in which the 5½-percent guideline looks almost impossible to enforce.

Is there any effective wage guideline at the moment?

Mr. Pierson.

Mr. Pierson. No, I don't think so, until the first important cases come through.

I mention the apparel settlement.

Senator Proxmire. That was 8 percent the first year.

Mr. Pierson. That was 8 percent the first year, and 6 percent the following 2 years, which is a very moderate settlement as union negotiations go.

Senator Proxmire. We hope it is not a pattern setting. That would be very inflationary.

Mr. Lanzillotti. I don't consider that moderate.

Senator Proxmire. That exceeds the 5½-percent guideline by 50 percent.

Mr. Pierson. But that is within the phase II regulations. I keep emphasizing, those regulations are quite elastic. And in fact the guideline that is really used in union circle is 6.2, because——

Senator Proxmire. Eight percent is well above that?

Mr. Pierson. Eight percent and six.

Mr. Lanzillotti. Does eight include fringes?

Mr. Pierson. Yes.

Mr. Lanzillotti. What is the breakdown of the base rate as against the fringes?

Mr. Pierson. I am not sure on that.

Senator Proxmire. The fringes after all, as far as the consumer is concerned, those fringes mean higher prices. You have to crank that in.

Mr. Pierson. As I say, if we get by with a settlement in rubber and electrical equipment of 8 percent, I think the administration would be very pleased.

Senator Proxmire. What new guideline, if any, do you think would be realistic?

Mr. Pierson. I would say either the present 5½-percent with the flexibility built in to phase II, or at the most a 6½-percent general wage increase.

Senator Proxmire. You have got to be realistic.

Mr. Pierson. I think that would be realistic.

Senator Proxmire. Are there actions that should be taken right away pricewise to be sure that labor interests will not be damaged during the guideline?

George Meany is meeting in Miami with union leaders to decide whether they are going to go along with phase III.

Mr. Pierson. I would certainly urge that in any further discussions with the top leadership it should be indicated that the administration and the Congress really mean business on controlling prices.

Senator Proxmire. How do we do that? The President has made all kinds of statements about how tough he is going to be, but it seems to me those haven't had any effect, because phase III is so feeble.

Mr. Pierson. I am not so sure on that.

I think that the union leadership, as opposed perhaps to some of the district leaders and rank-and-file people, are keenly aware that the

6-month picture is very different from the 2-year prospect. And I am not sure that the union leadership is hellbent to disregard the longer term price trend prospects. And I do not think it would take too much pressure from the administration to keep the union settlements within, say, a 6- or 7-percent increase.

Senator PROXMIRE. They are not doing it. Why didn't they cut back the apparel settlement?

Mr. PIERSON. They haven't decided that case yet, I don't believe, they have not decided any action on that case.

Mr. LANZILLOTTI. When is the date it becomes effective?

Mr. PIERSON. I am not sure.

Senator PROXMIRE. You say in your statement it is most unlikely that they will cut it back.

Mr. PIERSON. That is right.

I would think that that would be regarded as a moderate settlement within phase II regulations.

Senator PROXMIRE. How can they do that? How can they justify an 8-percent settlement for one industry and expect these other industries to bow down to something less?

Mr. PIERSON. Because the regulations include some qualifications having to do with, as you say, productivity, equities, tandem relationships, different branches of an industry. So that many of those settlements under phase II were in excess of 6½ or 7 percent.

Senator PROXMIRE. Let me ask you some direct questions, Mr. Lanzillotti, on something which you had experience with on the Price Board. Would it be desirable even now to change the guidelines in the following ways: No. 1, allow a passthrough into price increases only for direct costs already incurred?

Mr. LANZILLOTTI. I prefer that.

Senator PROXMIRE. Can we do that by law?

Mr. LANZILLOTTI. I don't know. As Senator Sparkman said, I think you are asking me a question that ought to be asked of a political scientist.

As an economist, I think it is a good standard. How you accomplish it is something else.

Senator PROXMIRE. Otherwise there is an incentive to let your costs go up, and the higher your costs the higher your profit margin.

Mr. LANZILLOTTI. That is the secret. If it is a cost-push problem, I think the way in which you minimize the pyramiding of costs is to limit the percentage addon to the cost.

So I am in complete agreement with you insofar as the standard is concerned, but I am not really qualified to tell you how to get it.

Senator PROXMIRE. How about if we eliminate "term limit pricing"? That would mean eliminating the new phase III?

Mr. LANZILLOTTI. "Term limit pricing" has a lot of good features. I think it needs to have some limits on it, however. I do think the term limit pricing——

Senator PROXMIRE. Let me say, this bothers me.

The new phase III regulation allows everybody to increase prices 1½ percent regardless of profit margins. And in effect that new rule is just a blanket extension of term limit pricing to everybody.

Mr. LANZILLOTTI. That is right. But it is with this caveat, it is 1½ percent overall if the firm is already at the base period profit margin.

Senator PROXMIRE. Why shouldn't we require price reductions where you have unusual industrial productivity?

Mr. LANZILLOTTI. I think the "term limit pricing" arrangement will encourage some of that, because firms will average in price cuts with the increases in order to get under the weighted average of 1½ percent.

Senator PROXMIRE. Gentlemen, but if you have an industry that has a product with—we had Mr. Elisha Gray, chairman of Whirlpool, testify a couple of years ago that between 1955 and 1965 the appliance industry had such good productivity that they raised wages 100 percent and cut their prices. They had a highly productive industry. If we can do that in this industry, there must be other such industries in the country.

Mr. LANZILLOTTI. You have put your finger on an important aspect of term pricing. I think it is a mistake to permit a firm which is a conglomerate to average in an activity which is a very diverse activity—hotel, rental cars, and the like. But if you limit the "term limit pricing" to categories that are more homogeneous, or industry lines, and cross industry lines, I think it can be meaningful and can provide the latitude that I think you would want here, the flexibility you would want, because it will encourage some reduction as a part of "term limit pricing."

I think the important thing is that normally you would want to have some kind——

Senator PROXMIRE. You are talking about in an industry?

Mr. LANZILLOTTI. Yes, sir.

Senator PROXMIRE. Not the firm-by-firm approach, which the administration is now putting into effect?

Mr. LANZILLOTTI. I think it would be better to put it on product lines actually.

Senator PROXMIRE. Sure. And then you have an incentive for more productive efficiency. And now you don't.

Mr. Schnittker, if we put into effect the proposal you suggest, what would this have done to farm income? The income per farm increased very greatly in this country in 1972, but the average is still shamefully low, $7,000 per farm. Do you think the efficiency of our farms now—we only have half as many farmers as before, and inefficient farmers have been driven out—when you consider the investment they make, the hours they work, the risks they take, their income is two-thirds of that of the people off the farm. Wouldn't this policy that you are suggesting have prevented the farm income from recovering on an equity basis as it should?

Mr. SCHNITTKER. No; I do not think so, Senator. Actually farm income is expected to be even higher in 1973 than in 1972, when it reached a record high.

Senator PROXMIRE. It should be.

Mr. SCHNITTKER. But also in regard to this gross average of $7,000 per farm, that includes about half a million really large productive farmers who are marketing something like 80 percent of all the farm products, and some 2 million very small farmers who are the fellows who get very little, but do lower the average.

Senator PROXMIRE. Maybe I am just too provincial about this, but in Wisconsin we have nothing but family farms. We don't have a dozen corporation farms. And the big farms don't produce 1 percent of

the dairy products in the State. They are all family farms. I have visited these farmers, I have been on their farms. And believe me, they just don't have an income commensurate with people in the city. I just cannot understand the notion that there are just a few rich farmers who are getting all the benefits of this.

Mr. SCHNITTKER. Wisconsin is somewhat atypical, having relatively smaller farms, especially dairy farms, than you will find in the Corn Belt, the Wheat Belt of the Plains, and the Cotton Belt. But it is certainly true not only in Wisconsin but across the Farm Belt that we have mostly family farms, but today some very, very large ones.

Senator PROXMIRE. I don't mean to ask you, of course—what I am asking maybe is contradictory, you can't have it both ways, I don't want to talk out of both sides of my mouth, but it seems that a policy that would serve the farmers may be inflationary to some extent, at least to a limited extent.

I don't see how you can help the small farmers by adopting policies that would cut farm income generally.

Mr. SCHNITTKER. Here I would say you do it by giving whatever assistance, payments, subsidies, principally to the smaller family farms.

Senator PROXMIRE. I agree with that.

I have consistently supported a $20,000 limitation or less on the amount that would go to one farmer. And while that would save some money, it would seem that it wouldn't necessarily assist even a small farmer, because our whole price support mechanism is based fundamentally on the market and the farmer who gets what he produces and sells in the market. And while the direct beneficiary of Federal aid would be the small farmer, what happens to the market price would affect all the farmers, even the big ones.

Mr. SCHNITTKER. Limiting payment is no cure-all, but it would orient the Federal programs somewhat more toward the smaller family farmers, whereas now they are directed very heavily to the larger farmers, especially in cotton and wheat.

Senator PROXMIRE. At any rate, you feel that it would be perfectly consistent to have a policy that would help farmers improve their income in 1973 and 1974, and yet hold down food prices?

Mr. SCHNITTKER. Yes; improve their income compared with the long-term trend.

I don't think that one can hold down food prices in 1973 and 1974, and improve farm incomes generally from the record high plateau reached in 1972. Overall farm income in 1972 was some $2½ or $3 billion higher than ever before, a tremendous jump of something like 20 or 25 percent.

I don't think one can take off from that highest level ever reached and go up again in 1973 and 1974 and have a farm policy and a food pricing policy that are compatible.

Senator PROXMIRE. And yet you argue that there will be a 6-percent increase in food prices in 1973.

Are you content that the administration is doing all it can do now under the present circumstances to hold down that price?

Mr. SCHNITTKER. Not quite.

Senator PROXMIRE. What else can we do?

Mr. SCHNITTKER. They can release some 15 or 20 million acres that farmers are signing up to divert under the feed grain programs. They took an action in January——

Senator PROXMIRE. And what effect would that have on farm income?

Mr. SCHNITTKER. I think it would probably have the effect of not lowering farm income, but certainly not raising it.

Senator PROXMIRE. Because they would get in production and sales enough to compensate for some——

Mr. SCHNITTKER. You have a little higher production, and prices not quite as high. But we are not going to break farm prices by bringing those last few marginal acres into production.

Senator PROXMIRE. I am very impressed by your analysis which indicates, if your judgment is correct, that any kind of substantial difficulty we may have, because of weather, drought, or anything else, could mean another skyrocketing of food prices. Your 6 percent is based on the assumption that we will have a good crop year?

Mr. SCHNITTKER. That is so, because this year we are cutting down wheat stocks in the United States by some 13 million tons, and feed grain stocks by about 12 million tons, soybean stocks have never been high, but will be reduced to virtually 3 or 4 days' supplies by the end of the summer. So a year ago we had something to fall back upon, both in the United States and in Canada, which is the other big world grainary. This year we have virtually nothing to fall back upon, and we are reduced to depending upon the new crop.

Senator PROXMIRE. It is very interesting, indicating the prospects that the administration may not be successful in trying to hold down food prices. You indicate that even if things work well, they probably wouldn't be able to do it, and with any kind of a bad break——

Mr. SCHNITTKER. It could be worse than a 6-percent rise in the price of food, if we have the coincidence of a bad crop in any two or three major countries in 1973.

Senator PROXMIRE. And you have indicated already that there is weather-trouble brewing in some countries?

Mr. SCHNITTKER. Yes.

Senator PROXMIRE. I would like to ask Mr. Lanzillotti and Mr. Pierson—I was fascinated by your observation, or the hint that both of you gentlemen dropped that there may have been tacit or even explicit agreements by big business and big labor to live up to phase III rules.

Mr. Pierson, you say that the movement to phase III when it took place could only make sense on that basis.

Mr. Lanzillotti, your reference is more oblique. You say that 5½ percent would have been a realizable target for wage increases in phase II during 1973, and that "organized labor recognized this situation," and that explains its determination to press for an end to phase II.

I wonder, both of you gentlemen, am I correct in interpreting you? I have heard such stories. but I want to ask you, would there not be apt to be large-scale collusion in both labor and business ranks for this to eventuate?

Mr. LANZILLOTTI. I think Mr. Pierson's reference—the context of his is different than mine—I don't think there needs to be collusion in order for there to be recognition of the facts of life. I think that the Pay Board was in effect becoming more rigorous in its standards.

Senator PROXMIRE. Yes: but there are several parties. It is just not a matter of the administration and the labor union agreeing that they

would like to have a higher wage. They have to bring the employer in on it. He is not going to be a push-over for this, unless he has some understanding that it won't hurt him.

Mr. LANZILLOTTI. Well, I didn't intend that at all. But I think it is in the nature of any kind of price and wage control program that price adjustments are cost-plus kind of arrangements. And it does not need—you don't need to have, I think, any meeting or collusion of the sort that perhaps Frank had in mind to understand that if the ceiling were pierced, that this would have to be passed through. I think it is a very curious development that in 1971 organized labor was saying, we need a price control apparatus, and we will take wage controls with it. And industry was a little bit more worried.

Now, here we are in 1973, and the positions of these two groups have been reversed. Labor has been opposed to controls, and business felt they were willing to live with them with some minor modifications. I find that very curious. I think that labor did not necessarily have to have any collusion among labor leaders, or labor leaders and business leaders, and I doubt that that occurred. I just think the rational sizing up of the Pay Board's actions and the outlook for 1973 made it quite clear, then, that 1973 was going to be a rough year for these new agreements that were coming up, so that 5½ percent might very well have been the effective standard. Mr. Pierson is right, I think the increase was probably around seven in phase II. So I am not suggesting, sir, that there was collusion among labor leaders or among labor and business leaders. I am merely saying that they did not need to do that, intelligent action on their part would have suggested to them——

Senator PROXMIRE. There is terrific competition among labor leaders, though, deep and strong competition, and they are constantly aware—as Mr. Pierson said, if the Teamsters get a big increase, then after all these other leaders' positions aren't very secure unless they can do as well.

Mr. LANZILLOTTI. They can decide that if we get rid of the Pay Board, then all of us will have a chance to compete in a market that has more flexibility. That is the only point I am making.

Without the Pay Board's constraint, it is easier for these fellows to fly their colors for their competitors.

Senator PROXMIRE. It may be easy for them to fly their colors, but it is a lot harder for them to defend their position. When wages go up, they can blame the Pay Board, and then the onus is not visited on the labor leader, it is visited on the Government for being unfair to that particular union. And you know everybody can hate the President, or John Dunlop.

Mr. LANZILLOTTI. You are drawing an analysis of labor leader motivation. I think that their motivation is essentially to get more for their membership. And I think they have a common motivation——

Senator PROXMIRE. They also have the motivation to stay in office and not get defeated in the next union election.

Mr. LANZILLOTTI. Mr. Pierson is the expert on that one.

Senator PROXMIRE. Mr. Pierson.

Mr. PIERSON. I would make a quick comment on the change in union attitude toward control. It is subject to a very important change on the price side.

Senator PROXMIRE. I want to ask you about what you meant when you were referring to the understanding. Do you mean a discussion with the Secretary of Labor?

Mr. PIERSON. I was leading into that. With the change in the price picture, with the cost of living rising as rapidly as it is, there had to be some quid for the quo of labor coming back into the control machinery, even in the limited way that it has. And I would assume, without any inside information. that there was an offer made by the administration to be more flexible with respect to permissible wage increases in order to take account of the change in the cost of living picture.

And it is on that basis, I would assume—and I repeat this is without any inside information—that the union leadership is willing to cooperate in the phase III regulations or approach. And this will mean somewhat bigger wage increases, in the range of anywhere from 6 to 7 percent per annum in some of these important settlements. It is hard for me to believe that labor would be willing to adopt tight rules in effect for phase II without some such agreement.

Senator PROXMIRE. George Meany and Leonard Woodcock and these other men are hard, tough, practical men. They wouldn't just have an understanding that if they go along with this the administration is going to be more flexible on phase III, and this could mean better settlements than 5½ percent, doesn't the administration have to be more specific than that?

Mr. PIERSON. Were you referring to protection on other matters on the price side?

Senator PROXMIRE. What I am refering to is that it is more than just the word "flexibility," don't they have to have an agreement that they will be able to go to an average of 8 percent, 9 percent?

Mr. PIERSON. I would not think that they would insist on any such major change as that. But who knows? These are matters that can only be interpreted in terms of rather personal relationships, and rather special circumstances that develop in particular industries, at particular points in the expansion phase of the upswinging. And I do not think anyone is really clear, perhaps even the participants themselves, as to just precisely what the meaning of this understanding is, or will be.

Senator PROXMIRE. Gentlemen, I want to thank you very, very much. As I say, this has been an excellent panel, most enlightening and helpful, and a fitting way for us to climax and complete our testimony on the President's Economic Report.

The committee will stand adjourned. It will file a report, and it will be greatly assisted by your presence.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

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